# A NOTEWORTHY DRIFT IN THE ECONOMICS OF TRANSPORTATION—THE IMPLICATIONS OF BALTIMORE & OHIO RAILROAD CO. v. UNITED STATES

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On March 16, 1953, the Supreme Court, by a vote of 6 to 2, decided the case of *Baltimore & Ohio R.R. v. United States*[1] (*Texas Vegetable Growers* case). The facts were prosaic and lacking in color, and although the decision received little attention its implications should have aroused some perturbation in transportation and investment circles.

The case came before the Court by virtue of an appeal by certain southwestern and eastern railroads from an order of the Interstate Commerce Commission which prescribed maximum carload rates on certain fresh vegetables originating in Texas and moving to points in various states.[2]

The order was attacked in the district court on the ground that the rates themselves were confiscatory and on the further ground that the commission had acted arbitrarily in denying the request for rehearing. The record had in fact laid no basis for a finding that the prescribed rates were confiscatory.[3] The district court sustained the commission's decision on the procedural point that the railroads had not raised the issue of confiscation in a timely manner and declined to hear the railroads' evidence of transportation costs or to remand the case to the commission.[4] The Supreme Court by-passed the ground upon which the district court had based its decision. In order to place his decision on the ground that noncompensatory

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1. 345 U.S. 146 (1953).

2. Texas Citrus & Vegetable Growers & Shippers v. Atchison T. & S.F. Ry., 279 I.C.C. 671 (1950).

3. A petition for further hearing to afford an opportunity to show that the rates were not compensatory was denied, although the proceeding was reopened for consideration of various exceptions to the decision and certain changes in the findings were made. 284 I.C.C. 206 (1952).

4. Baltimore & Ohio R.R. v. United States, 105 F. Supp. 631 (E.D. Mo. 1952).

rates are not per se violative of due process, Justice Black assumed without deciding that the issue of confiscation had been timely raised.

> "Denying that a commodity rate violates due process *merely* because it is noncompensatory, the Commission moved to dismiss the complaint on the ground that proof of everything that the complaint alleged [that the rates were below costs] would not justify invalidation of the order. On this ground, and without reaching another Commission contention on which the District Court relied, we hold that the case was properly dismissed by that court." [5]

Although the Supreme Court was not required to do so in simply sustaining the district court, it made a rather startling pronouncement in the language of its decision. The Court declared, through Mr. Justice Black, that even if the particular rates in question were below costs, in view of the fact that no claim was made that the challenged rates would cause any one of the railroads [6] to "operate its *entire* business at a loss, or even carry *all* fresh vegetables at a loss," [7] there was nothing objectionable about the rates. The Court then gave this unusual statement even greater emphasis by going on to say that, so long as a railroad is not caused by such regulations to lose money on its over-all business, "it is hard to think that it could successfully charge that its property was being taken for public use 'without just compensation.' " [8]

Never before in the history of railroad rate regulation had the Court gone so far.[9] In fact the Supreme Court appears previously to have held just the opposite. The Court considered two prior cases—*Northern Pacific R.R. v. North Dakota* [10] and *Norfolk & W.R.R. v. West Virginia* [11]—dealing with this subject and concluded that they were not in point. In both of these cases state statutes fixed railroad

5. Instant case at 147. The Court's footnote has been deleted.

6. The Court appears to have made no distinction between the effects of given rates on *a* railroad and on *all* railroads affected by the rates, as it used the expressions, "the railroads" and "any one of the complaining railroads." The distinction is of importance in some circumstances. As most rates apply over a considerable group of railroads, a given railroad might find itself unable to recover its costs from rates reasonable for the group of carriers. The Court apparently did not consider this possibility.

7. Instant case at 148 (Italics added).

8. *Ibid.*

9. There appear to be instances of this kind, however, in the public utility field. See, for example, Re Southwestern Bell Telephone Co., 95 P.U.R. (N.S.) 1 (1952), in which the Arkansas Public Service Commission upheld the generally accepted state-wide basis of making telephone rates, under which extensions of service to rural communities might be at rates conceivably below the costs incurred.

10. 236 U.S. 585 (1915).

11. 236 U.S. 605 (1915).

rates, one on coal and the other on passenger service. In both, the rates were found to be noncompensatory and hence to be violative of the Due Process Clause of the Fourteenth Amendment.[12] The instant Court considered these cases distinguishable in that their records contained nothing to justify noncompensatory statutory maxima, whereas in the *Texas Vegetable Growers* case and in related earlier decisions the commission had given full consideration to the various factors which affect vegetable traffic.[13] The Court added that, since fair decisions as to vegetable rates are "vital to the welfare of farmers and whole sections of the country" [14] and since "the health and well-being of the Nation" [15] were involved, there was need for the exercise of commission discretion.[16] The validity of the Court's distinction may be questioned. Coal is as essential to the "health and well-being of the Nation" as are fresh vegetables. Although we now have substitutes for coal such as oil and natural gas, coal continues to be an essential; and furthermore, we also have methods of food processing which give us plenty of vegetables without requiring them to be in their natural state.[17]

Mr. Justice Douglas, joined by the Chief Justice, dissented on the grounds, first, that when the railroads petitioned for reconsideration the commission should have permitted them to prove their contention that the costs of operation would exceed the revenues under the new rates, and, second, that there was no justification for forcing carriers to haul traffic at less than cost. The dissenting Justices said that the commission, in presenting a "hodge-podge" of statistics dealing with rates on fresh vegetables from various states to eastern and northern points, was trying (as was the case) to equalize these rates by reducing rates out of Texas, and that there was no suggestion or intimation

12. The doctrine of the *Northern Pacific* case has been followed in a number of decisions; see, *e.g.*, Chicago, M. & St. P. Ry. v. P.U.C. of Idaho, 274 U.S. 344 (1927).

13. Instant case at 149-50. "Among the factors considered by the Commission in fixing these rates have been these: value of the vegetable; comparison of vegetable values; comparison with rates on the same vegetables in different sections of the country; comparisons with rates on commodities other than vegetables; special characteristics of some vegetables that add to or subtract from expense of transportation; perishability; claim hazards of the carrier as between different vegetables; competing truck rates; and possible harmful effects of rates on vegetable prices and sales."

14 Instant case at 150.

15. *Ibid.*

16. The decision appears to be in line with the "reasonableness of the results" doctrine laid down in FPC v. Hope Natural Gas Co., 320 U.S. 591, 602 (1943).

17. The Court used an additional broad ground for support of its decision, *viz.*, the commission's power to adjust rates to meet public needs as being implicit in the congressional plan for a nationally integrated railroad system.

that vegetable markets were suffering by reason of the Texas rates.[18] The dissenters concluded that a confiscatory rate can never be a "reasonable" rate in the absence of "dire emergencies." [19]

Now, although in this case there was no specific finding in the commission's decision or evidence in the record to support the claim of the railroads that the rates in question were actually confiscatory, the reasoning and language of the Court make expedient some interesting reflections as to the practical connotations of the decision. If this thinking and its implications are to be taken at face value, examination should be made of their possible import to the private ownership of transportation.

We must begin with the premise that railroads should remain privately owned and financed. Granting this, it follows that they must be able to attract investor interest in order to modernize, progress and expand. Investors are selective; they have a choice. A regulated industry may have appeal to certain types of investors, but it is doubtful if even these would not be drawn to investing in an industry which could be required to perform a service at a loss. At the same time our national transportation policy requires that commodity rates not be permitted to fall so low as to result in disruptive competition.

The inquiry arises: What limits are there to such broad standards as vital to the "health and well-being of the Nation," or "vital to the welfare of farmers and whole sections of the country"? In our closely knit economic pattern, which is so dependent on transportation for its supply of raw materials, semi-processed materials, and separately-produced components in order to assemble the finished product, who can say what is not vital to the health and well-being of the whole nation? Coal, petroleum and petroleum products, rubber and rubber products, grain, milk, meats, wool, cotton, chemicals, steel, copper, zinc, lead, among others, could qualify. With our highly developed methods of farming, are not agricultural machinery and implements, fertilizers, lumber and other construction materials needed for storage,

18. The Court undertook no discussion of whether consumers, middlemen, or the Texas producers actually would be the beneficiaries of the reductions or in what proportions they would share the benefits. The commission's findings indicated that Texas produce brought lower prices in the terminal markets. Possibly, Texas will produce more now, but this addition may displace other vegetable production rather than add to the total supply and thus cause no fall in prices.

19. Instant case at 152. Reference may have been intended here to the provisions of § 22 of the Interstate Commerce Act, 24 STAT. 387 (1887), as amended, 49 U.S.C. § 22 (1946), which permit railroads to put in reduced rates to provide relief in case of drought, flood, epidemic, etc., if approved by the commission. There are similar provisions for motor carriers, 49 STAT. 560 (1935), as amended, 54 STAT. 925 (1940), 49 U.S.C. § 317(b) (1946), for air carriers, 52 STAT. 992 (1938), as amended, 54 STAT. 1235 (1940), 49 U.S.C. § 483(b) (1946), and for water carriers, 54 STAT. 935 (1940), 49 U.S.C. § 906(c) (1946). Rates so reduced are not subject to the customary standards of reasonableness.

irrigation and other farm activities, vital to the welfare of farmers and whole sections of the country? It is easy to conclude that the list could be extensive.[20]

If railroads can be required to transport "essential" commodities at a loss, can the non-essential articles of commerce that remain bear the burden of rates necessary to produce a satisfactory over-all profit without seriously disrupting our economy? How can either the railroads themselves or the Interstate Commerce Commission determine until after the event when the "point of no return," *i.e.,* the point at which no over-all profit remains, is reached? Estimates are unreliable because too many intangible factors are involved. The basic and minimum protection against such a consequence can lie only in the knowledge that each rate is compensatory.

There are other inquiries which suggest themselves. Does the instant Court's sanction of noncompensatory rates permit railroads to install below cost rates in order to eliminate competition? Does it permit the commission to "confiscate" the earnings of one railroad on a joint haul by forcing it to contribute a larger share of the joint rate to another railroad which may need it to stay solvent?

Some of these questions answer themselves. It is obvious that although it may not have been so intended, the language of the decision has injected a new element for consideration in determining the "reasonableness" of rates which could have effects of grave importance.

Like other businesses, railroads [21] dislike interference with managerial discretion. But, since they are common carriers and because their business affects the public interest, Congress has seen fit to protect the public against possible abuses. Furthermore, carriers themselves look to the commission to protect them against unreason-

20. There are limitations on the power the decision may appear to grant if it is interpreted to mean that only commodities to which such rate making would be applicable are those which are "vital to the welfare of farmers and whole sections of the country" *and to* "the health and well-being of the Nation." While the first test is a broad one, the one linked to it would create a tremendously difficult problem for the commission. There is opportunity for disagreement as to what such commodities are. While articles of food appear to qualify, do all such articles, including avocados, artichokes and lobsters, belong in the essential list? The limitation of below-cost rates to situations in which carriers operate at a profit is discussed hereinafter.

21. It should be noted that the decision is applicable, as a practical matter, only to rail transportation. Here alone is there such a variety and so large an amount of traffic which by its inherent nature cannot be transferred to any other mode of transportation. Motor carriers and water carriers have no fighting reserves of this kind to fall back on. Conceivably, a water carrier, for example, could give a shipper a below-cost rate in return for an above-cost rate on other business of the same shipper or an affiliate. Such exceptions would involve contract carrier operations as a rule, in which there is presumed to be less of a public interest than there is in common carrier service.

able demands by shippers and against disruptive competition. Two principal aspects of the public interest have been the maintenance of relatively low rates on commodities affecting the national health and welfare and the prevention of unduly divergent rates among various parts of the country which might prejudice the economic welfare of certain of those areas. The commission has given consideration to these factors when compatible with proper consideration of transportation conditions as such.[22]

Often the commission's task has been to put a stop to zealous competitive reductions of railroad rates. It was such sharp competitive practices which, in part, led to the enactment of the original Act to Regulate Commerce (1887). In keeping with the statutory requirements, the commission has held religiously to the standard that rates must be no lower than necessary to meet, not destroy, competition, and must in any event meet "out-of-pocket" costs.[23] The desire to avoid disruptive competition has been so great that even under circumstances in which rates based on "out-of-pocket" costs are approved, the commission usually has been divided. Thus, in the instant case, five of eleven commissioners dissented on the ground that the rates therein prescribed were lower for traffic conditions than the record warranted.[24]

The pronouncement in the *Texas Vegetable Growers* case as to below-cost rates comes at a time when the trend in the commission is basically toward giving greater weight to costs in rate making. In a large proportion of the rate cases which come before the commission different modes of transportation are maneuvering for competitive advantage. While comparisons of service enter into the determinations, the fixing of rates in such cases necessarily revolves largely around relative costs. This emphasis on costs also is found in adjustments which involve a single mode of transportation. The net result in

22. See, *e.g.*, Fertilizers Between Southern Points, 113 I.C.C. 389, 421 (1926); Increased Railway Rates, Fares and Charges, 1942, 248 I.C.C. 545, 610-12 (1942); Express Rates, Practices, Accounts, and Revenues, 28 I.C.C. 131 (1913); National Ass'n, Chewing Gum Mfrs. v. Railway Express Agency, 165 I.C.C. 531, 532 (1930).

23. It should be observed that, while the "out-of-pocket" cost concept has undergone change over the years, such costs, which in the last analysis vary with the volume of traffic, are now conceived to include not only directly-assignable operating expenses but also an allocated return on 50% of the investment in road facilities and on 100% of the investment in equipment. See, New Automobiles in Interstate Commerce, 259 I.C.C. 475, 528 (1945). This general rule is subject to some variation. The return of 4% on the allocated capital investment when used in cost computations is after an allowance for income taxes. *Ex Parte* 175, Increased Freight Rates, 284 I.C.C. 589, 613-14 (1952) (commission pointed out that in getting the needed increase in revenues railroads were compelled to collect from shippers, as taxes, 1½ times as much as the amount remaining with the railroads, which accrues solely for the benefit of the federal government). Rates based on out-of-pocket costs as generally defined cannot, therefore, be characterized as "cut-throat" rates.

24. 284 I.C.C. 206, 209-210 (1952).

the more recent period therefore has been to bring the charge for transporting a carload or a cubic foot of freight more nearly to the same level whether the freight be cheap or expensive. The present situation is in sharp contrast with earlier conditions, when freer play was given to competitive factors.[25] The instant proceeding did not involve competition between carriers or modes of transportation to an important degree, but there is no evidence that the conclusion drawn in the Supreme Court's decision would have been different if this factor had been more prominent.

When rates are to be determined on the basis of costs the commission faces a substantial administrative difficulty. Although the instant decision does not change this problem in any basic respect, any discussion of rates based on costs requires some insight into these difficulties; and the very complexity of railroad rate structures make some of the dangers inherent in the language of the Court more significant. It is not to be assumed that every rate can be tested so closely that any charge which drops below a defined cost level can be detected in advance or readily removed. Rate-making procedures are inevitably complex and involved. The right of carriers to initiate changes in rates on specific commodities is protected by the Interstate Commerce Act. All such changes are subject to the commission's authority to suspend either increases or reductions, on or without protest, but necessarily, with rates as fluid and changes as frequent as they are, the commission lacks the means to check every rate proposal and, as fully as would be desirable, to relate it to other phases of the rate structure. There is also the important consideration that an element of judgment necessarily enters into the determination of costs, as well as the fact that the cost formulas used involve generalized factors which cannot be applied with precision to the situation presented in proposals to change a particular rate or rates. Furthermore, the cost picture is undergoing continuing change as the result of technological improvements such as mechanical devices for right-of-way maintenance, dieselization, centralized traffic control and improvements in freight cars; and as the result of other factors, as inflation, deflation and changes in wage scales.

The point here made will become clearer if use is made of a comparison. While the problems are basically much the same, there

25. Some have advocated legislation which would require all carriers to base their rates on full costs. See, 1 THE PRESIDENT'S WATER RESOURCES POLICY COMMISSION, A WATER POLICY FOR THE AMERICAN PEOPLE 213, 217 (1950). It is urged here that, if charges are to be assessed for the use of improved waterways, competitive rates should reflect full costs. It appears to be generally realized, however, that placing all rates on this basis would bring about far-reaching and in some respects disastrous effects on the country's economy.

are marked contrasts between rate-making in transportation and in the local public utility field. The Interstate Commerce Commission does not deal with one service or a few services in a fairly local area or with only relatively simple and stable rate structures. There are, to be sure, differentials in electric rates between those paid by the householder and the industrial user, but the characteristics of the demand, the investment, and the cost of service are more definitely ascertainable than they are in rail and most other transportation. In the local public utility field it is possible to isolate the operations to be covered by the rates to an extent wholly unattainable in the case of the railroads. The result is that it would not always be easy to prevent the shading of railroad rates down from full out-of-pocket costs (as defined in note 21) to a level that could be definitely non-compensatory. Such situations would be most unusual in the public utility field.

As railroads would find no advantage in permanent reductions of rates below costs, it may be assumed that below-costs rates would be established, as they had been prior to federal regulation and even thereafter, primarily or solely to drive out competition; and the financially strong railroads alone would have this weapon available. Losses could be borne in the expectation of placing rates on a profitable level when the competition has been removed. A railroad would be taking a gamble, however, in embarking on such a rate-cutting program. Shippers whose pressure might have inspired the reduction,[26] would object to subsequent increases and the commission, under this decision of the Supreme Court, would not necessarily allow them, at least to the extent contemplated at the time the rates were reduced. There is also Section 4(2) to reckon with.[27] Although the Supreme Court has limited the availability of this section,[28] it nevertheless indicates a congressional policy which could be made fully effective by restatement.

The commission might be powerless under the Court's decision in the *Texas Vegetable Growers* case to prevent rate cutting, despite the declaration of national transportation policy and the many provisions of Part I of the Act, including the prohibitions against unjust discrimination. The view here expressed is, in effect, that the Court's

26. Persistent shipper pressure for lower or preferential rates is a powerful influence, but its many ramifications cannot be considered here.

27. Section 4(2) reads: "Wherever a carrier by railroad shall in competition with a water route or routes reduce the rates on the carriage of any species of freight to or from competitive points it shall not be permitted to increase such rates unless after hearing by the Commission it shall be found that such proposed increase rests upon changed conditions other than the elimination of water competition." 24 STAT. 380 (1887), 49 U.S.C. § 4(2) (1946).

28. Skinner & Eddy Corp. v. United States, 249 U.S. 557, 568-69 (1919).

decision is a startling departure from precedents in railroad rate-making. If it results in destructive rate cutting, it seems likely that the recourse would be to ask Congress to debar such a practice.

Another danger—or at least uncertainty—inherent in the decision arises from the fact that only railroads in an over-all profit position would qualify for use of the power granted by the decision. If the cuts involve minor items of traffic or are made by a railroad in an unquestionably secure financial position there is, of course, no serious problem of endangering the carrier's financial position. But in cases which approach the borderline the commission will have no knowledge until too late of how a carrier's finances are being affected by below-cost rates or by other factors. Under the Court's holding, the lawfulness of a particular rate would be dependent in part on extraneous and variable factors such as changes in general economic conditions as well as wage changes and other less extensive elements in the cost picture.

The economics of railroad transportation are singular in that inevitably certain types of traffic in effect subsidize other kinds of traffic. This is done sometimes by choice by the railroads in order to promote volume or prevent competition. In other instances it is done by commission action under the powers contained in the Act in order to serve the "public interest." At present all types of freight in effect are subsidizing the losses sustained in the operation of passenger trains which for the year 1952 amounted to $643,000,000.

The theories expressed by the majority in the instant case complicate such economics even further. The doctrine could extend the concept of national welfare to the point where esssential commodities would be carried at a loss for the benefit of some at the expense of others. These are the elements which make for attrition of the system of private ownership—a conatus toward socialization.

Investors in transportation do not, and should not be expected to, dedicate their capital investment to public service without expectation of a profit. The ultimate consequence of a declining trend in the return on investment or the wasting of capital by draining its reserves can be nationalization, since the country cannot survive without sound transportation. Not only is such a result undesirable but in the final outcome it will cost the consumer more, since history has shown that public ownership is less progressive, less efficient and more expensive than private ownership. In government ownership there is lacking the vital spur of competition which if it is non-disruptive keeps up the imagination, the ingenuity and the drive necessary to maintain progress.

The objective of the national transportation policy is to promote sound, efficient transportation. The language of the *Texas Vegetable Growers* case tends to create one of two possible situations, either of which could seriously disturb the comparative stability of our present transportation pattern. The permitting or imposing of below-cost rates could result, in the case of financially strong railroads, in disruptive competition; or, in the case of financially weak railroads, in loss of investor interest. It is well to signalize this decision. It sets a dangerous precedent and can well be viewed with alarm as laying the basis for an unwarranted enlargement of government action in the field of private enterprise. As a minimum justification for non-compensatory rates, it would seem that the commission should be required to make a specific finding that there is a dire emergency or some strong public interest which makes them necessary. One can only wish that if the Court felt compelled to uphold the commission in this case, it had restricted its basis for the decision to the same grounds that the district court chose.