Public Interest Regulation: Lessons from Railroads

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The public interest goals of public utility regulation are identified, including efficient supply, financially sustainable supply, control of monopoly power over consumers, control of exclusionary power over inputs essential to competitors, tariffs that maximize consumer welfare, Pareto efficient differential and non-linear prices, and efficient incentives for innovation and investment.

It is shown how these goals have been systematically contradicted by the regulation of railroads in the US and other industries by means of various examples of mechanisms including franchise auctions, markup regulation, rate-of-return regulation, fully-allocated-cost price regulation, cost-based access-price regulation, and prohibitions of individual customer deals.

In contrast, the architecture of the current regulation of US railroads (termed "Constrained Market Pricing") has many features that are fully consistent with public interest goals, and an excellent "track" record. Recently prevalent systems of price-cap regulation are also theoretically excellent.

Criteria are articulated for whether vertical integration should be prohibited between natural monopoly stages of production and related stages of production that can support competition. Examples are drawn from railroads, telecommunications, and electric power.