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**BEFORE THE
SURFACE TRANSPORTATION BOARD**

**STB DOCKET NO. EP 761
HEARING ON REVENUE ADEQUACY**

**STB DOCKET NO. EP 722
RAILROAD REVENUE ADEQUACY**

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**SUPPLEMENTAL WRITTEN TESTIMONY OF
THE AMERICAN CHEMISTRY COUNCIL**

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I. INTRODUCTION.

The American Chemistry Council (“ACC”) hereby submits this supplemental written testimony in the above-captioned proceedings. In a decision served on September 12, 2019 (“Notice”), the Surface Transportation Board (“Board”) announced that it would hold a public hearing in the above-captioned proceedings to solicit input on four recommendations regarding revenue adequacy that have been presented in a Report issued by the Board’s Rate Reform Task Force (“RRTF”) on April 25, 2019 (“RRTF Report”). Written testimony was filed on November 26, 2019 and the hearing was held on December 12-13, 2019. ACC submitted both written and oral testimony. In a decision served on December 17, 2019, the Board announced that it would keep the record open until February 13, 2020, for parties to submit supplemental written testimony.

A. ACC’s Initial Written Testimony.

ACC’s initial written testimony, filed on November 26, 2019, focused on three specific issues. First, ACC proposed a new methodology for determining maximum reasonable rates for

revenue-adequate Class I railroads in accordance with 49 U.S.C. § 10701. Second, ACC commented on the proposed definition of “long-term revenue adequacy” in the RRTF Report. Third, ACC commented on the bottleneck changes proposed in the RRTF report. ACC’s hearing testimony focused principally upon the first of these issues and this supplemental written testimony does the same.

ACC’s written and oral testimony was predicated upon the work of Dr. Kevin W. Caves, a Senior Economist at Econ One Research, Inc., to develop a method for determining the maximum reasonable rate for any challenged movement on a revenue adequate rail carrier. Dr. Caves and ACC have referred to this as the “Benchmark Method,” which Dr. Caves presented in detail through a Verified Statement and associated electronic work papers and summarized in oral testimony at the hearing on December 12th.

The Benchmark Method has been designed implement the revenue adequacy constraint in *Coal Rate Guidelines, Nationwide*, 1 I.C.C. 2d 520 (1985) (“*Guidelines*”). It is based upon the same economic principles that are the bedrock of the Board’s current standards adopted in *Guidelines*, which holds that “[c]aptive shippers should not be required to continue to pay differentially higher rates than other shippers when some or all of that differential is no longer necessary to ensure a financially sound carrier capable of meeting its current and future service needs.”¹ As demonstrated in Dr. Caves’ verified statement, the Benchmark Method is designed to determine what portion, if any, of the rate differential for any captive shipment is necessary to allow the railroad to be long-term revenue adequate.

The Benchmark Method employs a two-step approach to determining maximum reasonable rates of revenue-adequate rail carriers. The first step applies an econometric model

¹ *Guidelines* at 535. [emphasis added].

developed by Dr. Caves to predict competitive benchmark rate levels for captive movements based upon the characteristics of competitive movements that most explain their rates. The second step applies a concept called the “Competitive Threshold” (“CT”), which Dr. Caves designed to determine the degree of differential pricing above the predicted competitive benchmark rate that is necessary to maintain the long-term revenue adequacy of the defendant rail carrier. The maximum prescribed rate for a market dominant movement would be the predicted competitive benchmark rate determined in Step One as subsequently adjusted by the CT in Step Two. This can be summarized as follows: ***Maximum Reasonable Rate = Competitive Benchmark Rate * CT (for defendant carrier).***

B. Summary of Supplemental Comments.

At the two-day public hearing, various rail industry witnesses challenged the appropriateness of applying a revenue adequacy constraint to regulate the rates of captive traffic. They uniformly characterized the revenue-adequacy constraint as old-style rate-of-return regulation. For the most part, they ignored the inconvenient truth that ACC’s Benchmark Method implements the revenue adequacy constraint without imposing limits upon a railroad’s ability to earn returns in excess of its cost-of-capital so long as those excess returns are earned at competitive rate levels rather than through differential pricing of captive traffic. The few railroad witnesses who did acknowledge this truth nevertheless asserted that the Benchmark Method measures the wrong type of competition (i.e., short-run competition that results in marginal cost pricing) and that only Stand-Alone Cost (“SAC”) measures the “appropriate” type of competition (i.e., long-run competition that permits total cost recovery).

In these supplemental comments, ACC further demonstrates that the Benchmark Method is not rate-of-return regulation and permits total cost recovery. Applying these same arguments, ACC also demonstrates that bottleneck relief will not result in marginal cost pricing that prevents

total cost recovery. Finally, ACC responds to criticism of the Benchmark Method for not accounting for line density in the econometric model. Because line densities are not publicly available, ACC could not account for that factor in the model, but this is a factor for more in-depth consideration in a rulemaking proceeding.

II. **THE BENCHMARK METHOD DOES NOT REGULATE RAILROAD EARNINGS.**

Throughout the public hearing, railroad witnesses criticized the revenue adequacy constraint as rate-of-return regulation. Even though *Guidelines* clearly and unequivocally identified the revenue adequacy constraint as an equally-legitimate method to SAC for implementing constrained market pricing (“CMP”) principles, the railroads are now challenging that as incorrect and focusing upon SAC as the only legitimate CMP constraint. The railroads have not articulated a cogent rationale for abandoning the revenue adequacy constraint. Rather, they have incorrectly linked revenue adequacy to old-style rate-of-return regulation that they assert has been discredited. ACC’s Benchmark Method proposal, however, demonstrates how to implement the revenue adequacy constraint without imposing a cap on railroad earnings, which moots this railroad criticism.

First, as is true for all rail rate regulation, the Benchmark Method could only be applied to movements over which a railroad possesses market dominance. Similarly, it can only be applied to market dominant movements when the shipper challenges the applicable rate. Therefore, railroads remain free to earn as much revenue as they can from competitive traffic and also captive traffic for which the rate is not challenged. Nothing in the Benchmark Method takes away those revenues.

Second, the Benchmark Method establishes the competitive rate level as a **floor** below which a maximum reasonable rate may not be prescribed. The econometric model developed by

Dr. Caves, as Step One of the two-step Benchmark Method, employs regression analysis, which is the standard econometric tool for analyzing relationships between a dependent variable and a set of explanatory variables, to develop an econometric model of the relationship between rates and multiple shipment characteristics of competitive rail movements. The model estimates the statistical relationship between the shipment characteristics and the rates of competitive rail movements and uses that relationship to predict competitive benchmark rate levels for captive movements based upon the same set of shipment characteristics for those captive movements. That predicted competitive rate establishes the floor for any rate prescription under the Benchmark Method.² If those competitive rates enable a railroad to earn revenue above its long-term revenue adequate level — by whatever definition the Board may assign to “long-term revenue-adequacy” — that railroad retains those earnings in their entirety. In such circumstances, the Benchmark Method merely restricts the ability of a revenue-adequate railroad to charge differentially higher rates to market dominant movements. A railroad may earn and retain as much revenue as it can at competitive rate levels regardless of whether such revenue exceeds the measure of long-term revenue adequacy.

Third, when a railroad must engage in differential pricing of market dominant movements to be revenue-adequate, the Benchmark Method preserves such differential pricing up to the level needed to preserve revenue adequacy. This comports with *Guidelines* which declared that “captive shippers should not be required to continue to pay differentially higher rates than other shippers when some or all of that differential is no longer necessary to ensure a financially sound carrier capable of meeting its current and future service needs.”³ It follows

² The only exception is when the competitive rate level is below 180% R/VC, in which case the higher 180% R/VC rate becomes the floor rather than the lower predicted competitive rate.

³ *Guidelines* at 535-36 (emphasis added).

therefore that CMP, through the revenue adequacy constraint, permits a railroad to exercise its market power over captive traffic through differential pricing only to the degree needed to achieve and maintain revenue-adequacy. The Benchmark Method accomplishes this in Step Two through application of a multiplier, which Dr. Caves has labelled the “Competitive Threshold” or “CT,” to the predicted competitive rate in Step One. At a minimum, the CT is set at a level that would preserve revenue adequacy even when all a railroad’s market dominant movements are repriced at the rate levels predicted by the regression model regardless of whether those rates are challenged. Although there may be other policy reasons why the Board might establish a higher CT, thereby permitting a greater degree of differential pricing, it would never establish a lower CT.

As described above, the Benchmark Method applies the revenue adequacy constraint to individual movements, not to a carrier’s total revenue. Revenue adequacy caps the degree of permissible differential pricing on individual movements, not a carrier’s total earnings. Once differential pricing is no longer necessary to the preservation of revenue adequacy, a railroad is free to earn and retain as much revenue as it can at competitive rate levels. Furthermore, because rates may not be prescribed below 180% R/VC or without a formal rate challenge, a railroad also retains those revenues in excess of competitive levels.

III. RAILROADS DO NOT OPERATE IN PERFECTLY-COMPETITIVE MARKETS WITH MARGINAL COST PRICING.

Throughout the two-day hearing, there was an extensive discourse about short-run versus long-run competition. Multiple railroad witnesses charged that shipper attempts to mimic competitive rates through proposals such as ACC’s Benchmark Method and attempts to enhance competition through bottleneck relief and competitive switching constitute short-run competition that would result in marginal cost pricing that would preclude railroads from recovering their

total costs. As demonstrated in the following subsections, the railroads are engaged in hyperbole that is intended to frighten the Board into inaction.

A. The Benchmark Method Prescribes Rates That Enable Railroads to Recover Their Total Costs.

Several railroad witnesses at the hearing charged that the Benchmark Method attempts to model the wrong type of competition. For example, Dr. Kalt claimed that the Benchmark Method mimics “Econ 1” competition which he described as a perfectly competitive market that drives rates down to marginal cost pricing.⁴ The implication is that any time there is direct competition between two railroads or between one railroad and another transportation mode the resulting rate is at the level of marginal costs. Instead, Dr. Kalt claims that SAC models the right type of competition. Norfolk Southern Vice President John Friedmann and others further alleged that the Benchmark Method mimics short-term competition, which results in marginal cost pricing, whereas SAC more appropriately mimic long-term competition, which results in full cost pricing.⁵ Therefore, the railroads charge that the Benchmark Method would prescribe rates below what is needed to recover total costs. Such claims are wrong.

As Dr. Kalt plainly concedes, Econ 1 competition exists only in a perfectly competitive market. At no point in the hearing did Dr. Kalt or any other railroad witness or economist testify that the market for rail transportation is perfectly-competitive. At best, in the handful of circumstances where head-to-head rail competition exists, the market is a duopoly, which is a far cry from perfect competition and marginal cost pricing. Duopolies are particularly susceptible to

⁴ EP 761, *Hearing on Revenue Adequacy*, Dec. 12, 2019 Hearing Transcript (“Day 1 Hearing Tr.”) at 38-41 (describing “Econ 1” competition as marginal cost pricing); 51-52 (comparing Benchmark Method of mimicking “Econ 1” competition).

⁵ Day 1 Tr. at 342-50 (discourse between Members Oberman and Fuchs and Witness Friedmann).

“conscious parallelism” which is a form of price-fixing by competitors without the need for an actual agreement. Two railroads that have similar cost structures and are the only railroads that serve an extensive overlapping geography (e.g., BNSF v. UP in the West; CSX v. NS in the East) have both the ability and the incentive to set rates at levels sufficient to recover their total costs even when competing for a movement. To suggest otherwise is to deny the remarkable pricing discipline that the rail industry has displayed over the past two decades.

This pricing discipline has been displayed most pointedly in the transportation markets for exempt commodities. The Board has exempted substantial portions of rail traffic from regulation after concluding that such regulation is not needed to carry out the rail transportation policies and to protect those shippers from the abuse of market power.⁶ In other words, the Board determined that there is sufficient competition from other transportation modes to protect those shippers. In the presence of these competitive alternatives, however, the rail industry has chosen to cede this business to alternative modes. Even when this business is profitable, the rail industry often has not pursued it because it is not profitable enough. This phenomenon of “demarketing” has been the subject of many recent shipper complaints to the Board and shows that railroads are unlikely to engage in anything close to marginal cost pricing.

The reality of competition in the market for rail transportation is not the perfect competition model of Econ 1. Therefore, the competitive rates that Dr. Caves has modeled in the Benchmark Method do not reflect marginal cost pricing. Rather, they reflect the disciplined pricing of a duopolist determined to recover its total costs plus a healthy profit. In fact, several

⁶ See 49 U.S.C. § 10502(a); 49 C.F.R. Part 1039.

railroads recently have claimed that their revenue adequacy is attributed to improved pricing on competitive movements.⁷

Ultimately, however, even if the railroad witnesses are absolutely correct in their assertion that the competitive rates modeled in Dr. Caves' regression model reflect marginal cost pricing, the Benchmark Method will not prescribe a rate at that level. As noted in Part II above, the CT multiplier is set at the minimum level that is needed to preserve a railroad's revenue adequacy under the highly conservative assumption that every captive movement is repriced at the predicted competitive level. Therefore, even if the predicted competitive rates in the Benchmark Method reflect marginal cost pricing, the CT will increase those rates by a multiple that preserves the railroad's revenue adequacy, which means the recovery of total costs plus the cost-of-capital. This criticism of the Benchmark Method thus is a red-herring.

B. Bottleneck Relief Will Not Result In Marginal Cost Pricing.

For the same reasons discussed in the immediately preceding section, bottleneck relief will not result in marginal cost pricing. This is particularly true when market dominance is required for bottleneck relief as the Board has proposed in EP 711 (Sub-No. 1), *Reciprocal Switching* (served July 27, 2016). By definition, market dominant moves lack effective competitive alternatives to rail transportation.⁸ Thus, introducing a second rail carrier through bottleneck relief converts a monopoly situation to a duopoly situation. Although two carriers are better than one, a duopoly is not a perfectly-competitive market that produces marginal cost pricing. Duopolists may compete through incrementally lower rates (or they may not compete at

⁷ Day 1 Hearing Tr. at 185 ("The vast majority of BNSF's revenues come from competitive traffic."); 267-68 (noting the irony in railroad claims that they are earning more revenue from competitive traffic.).

⁸ 49 U.S.C. 10707(a).

all), but they will have the ability and the incentive not to price below their costs. Indeed, a duopolist remains likely to recover its total costs and still earn a supra-competitive profit, albeit perhaps less than it could earn as a pure monopolist.

IV. THE BENCHMARK METHOD IS CAPABLE OF ACCOUNTING FOR LINE DENSITY.

At the December 12 hearing, Dr. Kalt criticized the Benchmark Method for not incorporating line density into its regression analysis and Member Fuchs had a discourse with Dr. Caves regarding line density.⁹ Dr. Caves noted that he did not have access to public data on rail line density to include that as an independent variable in the regression model, but that such data, if available, could be incorporated. Each railroad does maintain line density maps which the Board could seek as part of a rulemaking proceeding on the Benchmark Method or grant access through discovery in individual cases. The latter situation would be complicated by the fact that all Class I rail density maps would be required to account for the line density of all competitive moves in the waybill sample, not just those of the defendant railroad in a case. As a practical matter, it also may be too labor- and time-intensive to incorporate the line densities of every competitive movement in the waybill sample into the regression model. If that were proven to be the case, however, there likely are ways to reflect line density in development of the CT multiplier. But without access to line density maps, ACC is not presently able to propose a method for doing so. That fact, however, does not indicate a deficiency in the Benchmark Method, but merely is one of the many issues that ACC already has identified for more in-depth examination through a rulemaking proceeding.

⁹ Day 1 Hearing Tr. at 52, 148-51.

V. CONCLUSION

ACC thanks the Board for this opportunity to submit the Benchmark Method for consideration as a methodology for determining rate reasonableness. ACC believes that the Benchmark Method can significantly advance the Board's objective to develop alternatives to SAC by providing this tool for determining reasonable rates through application of the revenue-adequacy constraint in *Guidelines*. The rail industry's criticisms of the Benchmark Method do not withstand scrutiny. They are flatly wrong or misleading, or they are subjects for more in-depth examination in a future rulemaking, which ACC strongly encourages the Board to initiate.

Respectfully submitted,

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