

HARKINS CUNNINGHAM LLP

Attorneys at Law

Paul A. Cunningham
202.973.7601
pac@harkinscunningham.com

1700 K Street, N.W.
Suite 400
Washington, D.C. 20006 3804
Telephone 202.973.7600
Facsimile 202.973.7610

244916

ENTERED
Office of Proceedings
December 29, 2017
Part of
Public Record

December 29, 2017

BY E-FILING

Ms. Cynthia Brown
Chief, Section of Administration
Office of Proceedings
Surface Transportation Board
395 E Street, S.W.
Washington, DC 20423-0001

**Re: *New England Central Railroad, Inc. Trackage Rights Order Pan Am
Southern LLC (Docket No. FD 35842)***

Dear Ms. Brown:

We have identified a number of errata in the Petition for Reconsideration and accompanying Verified Statements of Julie M. Carey and Edward Foley ("Petition") filed by New England Central Railroad, Inc. on December 6, 2017. Corrections to those errata are shown in the redline version of the Petition enclosed as Exhibit A, with deleted text shown as stricken and inserted text shown as double underlined. A clean version of the corrected Petition is enclosed as Exhibit B. We have added "-E" to the page numbers of these pages so they can be readily distinguished from the originally filed pages.

We are submitting these exhibits in two forms: a Highly Confidential version filed under seal in accordance with the Protective Order in this proceeding, and a Public version, from which all Confidential or Highly Confidential material has been redacted.

Very truly yours,

/s/ Paul A. Cunningham

Counsel for New England Central Railroad, Inc.

Enclosures

cc: Parties of record

EXHIBIT A

PUBLIC VERSION
BEFORE THE
SURFACE TRANSPORTATION BOARD

Docket No. FD 35842

NEW ENGLAND CENTRAL RAILROAD, INC.
—TRACKAGE RIGHTS ORDER—
PAN AM SOUTHERN LLC

PETITION FOR RECONSIDERATION

New England Central Railroad, Inc. (“NECR”) hereby petitions for reconsideration of the decision served October 31, 2017 in the above-captioned proceeding (the “Decision”) on the grounds of material error. The Decision modified a trackage rights order (“TO”) governing the operations of Pan Am Southern LLC (“PAS”) over three contiguous segments of a railroad line owned by NECR (together, the “Line”).¹ The approach of the Surface Transportation Board (the “Board”)² to rate setting and the associated prescribed rate were both unlawful. They violated the Board’s mandate to “make an adequate and continuing effort to assist carriers in attaining revenue levels” that are “adequate, under honest, economical, and efficient management...to cover total operating expenses, including depreciation and obsolescence, plus a reasonable and

¹ The three segments include the 48.8 mile Middle Segment formerly owned by Boston & Maine Corporation (PAS's predecessor), and a 13.4 mile Northern Ssegment, and a 10.6 mile Southern Segment formerly owned by Central Vermont Railway, Inc. (NECR's predecessor).

² Reference to the Board, as the context warrants, may include reference to its predecessor agency, the Interstate Commerce Commission (“ICC”).

economic profit or return ~~(or (both))~~ on capital employed in the business.”³ Other aspects of the Decision were also unlawful.

One TO modification was a new trackage rights fee to be paid by PAS to NECR to supplant the prior prescribed fee, which had been in place for over twenty years. The Board recognized that the prior prescribed fee was too low and established the new fee. The most important component of the new fee (which the Board calls the Interest ~~Rental~~ate Component (“IRC”)) defines the return of, and on, the trackage assets to be paid by PAS. The Board set the IRC too low and effectively precluded NECR from earning adequate revenues on the Lines.

The Board violated its independent statutory duty to regulate the rail industry to promote an efficient and safe rail system by ensuring that a railroad can earn adequate revenues. The fee forces NECR to subsidize PAS’s usage, and the competitive situation leaves NECR with no means to recoup PAS’s equitable share of its capital costs from other shippers. The fee not only determines the pricing ~~not only~~ for the traffic hauled at any time by PAS, but also impacts the more than [REDACTED] of the car miles moving over the Line subject to competition between PAS and NECR. The resulting below adequate revenues compromise NECR’s ability to maintain efficient and safe rail operations over the Lines.

The Decision produced an unlawfully low rate because the Board erred by using an economically unsuitable tool to calculate the IRC and compounded the error by using the tool improperly. The Board’s use of the capitalized earnings (“CE”) approach to value the trackage rights assets was arbitrary and capricious, and produced an unlawful result; This is because there is no means by which the CE approach can arrive at thean accurate asset cost ~~that must be~~

³ 49 U.S.C.S. § 10704(a)(2); *see also id.* at § 10101(3) (a principalle policy in regulating the railroad industry is “to promote a safe and efficient rail transportation system by allowing rail carriers to earn adequate revenues”).

~~considered to consider~~ in establishing a rate that will assure the required earnings opportunity.

The Board erred further by using the CE approach in ways that frustrated even the use to which it might otherwise legitimately be put in other circumstances.

This doubly erroneous use of the CE approach, which assured an unlawfully low rate, was entirely unnecessary. The Board rejected the modified reproduction cost new less depreciation (“RCNLD”) method on the grounds that it did not fit squarely into one of the four historic methods traditionally used by the Board. Rather than seeking more information to ensure that the appropriate method was used, the Board deferred to (and misapplied) the unsuitable CE method. The Board had data ~~in~~ on the record (or could have required additional production of data) that would have permitted a direct determination of the cost of the Line assets using the RCNLD approach. The Board erred in rejecting that economically sound approach on grounds that were arbitrary and capricious. One of those grounds, which was the claim that the evidence of record was not sufficient for the proper determination of RCNLD, was especially noteworthy. By applying the wholly unsuitable CE method rather than securing any new evidence required to properly apply the RCNLD approach, the Board violated its independent duty to assure an adequate record upon which to base its decision. Accordingly, NECR requests that the Board reconsider the approach it used in valuing the Line assets and the inequitably low rate that resulted from its chosen approach.

Additionally, NECR requests that the Board reconsider its decision regarding various non-rate terms of the TO, including, but not limited to, ~~terms involving~~ insurance requirements, the rate escalator, the lack of retroactivity, and the term of the TO.

ARGUMENT

I. The Board's Legal Obligations

The Board has a duty a) to ensure that its orders comply with the law, b) to ensure that the record will permit that compliance, and c) to determine independently how to meet its mandate, and not merely choose among suggestions of the parties.

As the Supreme Court explained long ago, the Board, like the ICC before it, “is not intended to be a passive arbiter but the ‘guardian of the general public interest,’ with a duty to see that this interest is at all times effectively protected.” *Baltimore & O. R. Co. v. U.S.*, 386 U.S. 372, 429 (1967) (Brennan, J., concurring) (quoting H. R. Doc. No. 678, Practices and Procedures of Governmental Control of Transportation, 78th Cong., 2d Sess., p. 53 (1944)). The Board has an “independent review responsibility” to ensure that its decisions comply with all of its statutory mandates. *See Cleveland Cliffs Iron Co. v. Interstate Commerce Comm’n*, 664 F.2d 568, 578 (6th Cir. 1981).

To protect the public interest and satisfy its statutory mandates, the Board “is empowered to investigate and gather evidence beyond that presented by the parties where exercise of that power will advance the determination of what best serves the public interest.” *Baltimore & O. R. Co.*, 386 U.S. at 429-30; *see also Aberdeen & R.R. Co. v. U.S.*, 270 F. Supp. 695, 711 (E.D. La. 1967) (“When carriers fail to produce satisfactory evidence, the Commission may require them to produce additional and more satisfactory evidence.”). The Board “is not the prisoner of the parties’ submissions,” *Baltimore & O. R. Co.*, 386 U.S. at 429-430, and error may not be excused where the parties’ submissions were inadequate. *Aberdeen & R.R. Co.*, 270 F. Supp. at 711. Instead, the Board must “weigh alternatives and make its choice according to its judgment how best to achieve and advance the goals of the National Transportation Policy.” *Baltimore & O. R. Co.*, 386 U.S. at 430.

Under the substantive law governing this proceeding, the Board's paramount duty is to ensure that the TO and the trackage right~~s~~ fee set forth therein afford NECR the opportunity to earn adequate revenues to enable NECR to operate a safe and efficient rail line. The law also requires that the fee imposed on PAS ensures the same cost burden as is carried by NECR.⁴ Both are required to protect the public interest in sustainable rail transport. Neither precedent nor agency judgment can trump these requirements. *Cleveland Cliffs*, 664 F.2d at ~~579~~580 n.15.

Nor may the Board put its thumb on the scale to favor PAS by allowing it to avoid rates that the law requires, even if the PAS rates must be substantially increased from the prior rate, which the Board determined were too low. Decision at 8. As the Board has recognized, and as both PAS and NECR agreed, the methodology set forth in *SSW Compensation* provides the appropriate measure of trackage rights compensation ~~if~~where the Board must prescribe the terms and conditions under which one railroad may operate its trains and crews over the rail lines of another.⁵ And, just as the parties to privately-negotiated trackage rights agreements would rarely, if ever, make their terms permanent, lest they become commercially unreasonable as a

⁴ *St. Louis S.W. Ry.—Trackage Rights Over Mo. Pac. R.R.—Kansas City to St. Louis*, 1 I.C.C.2d 776 (1984) (“*Compensation I*”), 4 I.C.C.2d 668 (1987) (“*Compensation II*”), 5 I.C.C.2d 525 (1989) (“*Compensation III*”), 8 I.C.C.2d 80 (1991) (“*Compensation IV*”), 8 I.C.C.2d 213 (1991) (“*Compensation V*”) (together, “*SSW Compensation*”).

⁵ Decision, ~~slip op.~~ at 9; see also *Atchison, T. & S.F. Ry.—Operating Agreement—S. Pac. Transp. Co.*, 8 I.C.C.2d 297, 303 (1992) (“*ATSF/SP*”); *Ark. & Mo. R.R. v. Mo. Pac. R.R.*, 6 I.C.C.2d 619 (1990) (“*A&M I*”), 7 I.C.C.2d 164 (1990) (“*A&M II*”), *aff’d sub nom. Mo. Pac. R.R. v. ICC*, 23 F.3d 531 (D.C. Cir. 1994); *CSX Corp.—Control & Operating Leases/Agreements—Conrail Inc.*, Decision No. 109, 3 S.T.B. 955, 963-64 (1998).

result of changed business conditions after several years, so too does the Board typically provide an opportunity for parties to seek adjustment of the compensation terms it has prescribed.⁶

As the *SSW Compensation* methodology is intended to “put the tenant in the same position as the owning carrier,” *Compensation I*, 1 I.C.C.2d at 786, compensation that achieves that goal when set may, depending on how economic circumstances change over time, leave the tenant (PAS) in either a better or worse position than the owner (NECR), ~~depending on how economic circumstances change over time~~. Readjustment of the compensation terms to ensure that the rate continues to conform to the *SSW Compensation* methodology may be necessary to ensure that no implicit subsidy is provided to one party’s operations. *Cf.* Decision at 8. Readjustment was and is necessary here – after the passage of nearly 29 years – because the trackage ~~rate-rights~~ fee no longer reflects current conditions. Moreover, the fact that the adjusted compensation terms may constitute even “an inordinately large increase in compensation” is no excuse not to make an adjustment per the terms dictated by *SSW Compensation* principles. *See A&M II*, 7 I.C.C.2d at 168.

Most important, the Board is mandated by statute to ensure that a railroad has the opportunity to earn adequate revenues to maintain a safe and efficient line. Yet here, in the TO, in taking the unlawful approach and imposing the prescribed rate, the Board failed even to consider whether the trackage rights rates it imposed would permit NECR to earn adequate revenues, and it prescribed rates for PAS that would manifestly foreclose that opportunity. The

⁶ *See, e.g., ATSF/SP*, 8 I.C.C.2d at 302 (describing provision in trackage rights terms prescribed by the ICC in 1967, allowing either party to petition for revision of those terms each successive fifth year anniversary of the effective date of the 1967 decision, or at other times “for good cause shown”); *Nat’l R.R. Passenger Corp.—Conveyance of Boston & Me. Corp. Interests in Conn. River Line in Vt. & N.H.*, 1990 ICC LEXIS 52, at *14-15 (1990) (allowing either party to require renegotiation or seek agency imposition of new terms after 20 years).

Board merely relied on one valuation method set forth in the record, without consideration of its mandate, and ~~disregarded~~overlooked the fundamental flaw in its approach. Each is a reversible error, even if the issues were not fully developed by the parties. *See N.Y. Cross Harbor R.R. v. Surface Transp. Bd.*, 374 F.3d 1177, 1187-1188 (D.C. Cir. 2004) (reversing abandonment decision where the Board failed to mention its statutory duty to preserve and promote continued rail service); *see also Cleveland Cliffs-Iron Co.*, 664 F.2d at 578.

II. The Board did not exercise its duty to ensure that the record would support a legally compliant decision, and the Board's approach to rate setting and the resulting rate were unlawful.

The Board's failure to develop an adequate record to support a lawful decision is demonstrated, as we explore further below,⁷ by several aspects of the Decision, including the following:

- The Board's use of the CE method of asset valuation, despite the fact it could not, as a matter of basic economics, produce the relevant valuation.
- The Board's improper application of the CE approach, such that, even if the approach could have produced a reasonable result, the application ~~as~~ensured the wrong result.

⁷ This Petition is supported by the substantiating economic testimony of Julie M. Carey regarding the validity of the economic reasoning that underpins NECR's claims of material error. It is also supported by the Verified Statement of Edward Foley, who reports and opines regarding aspects of rail competition that were not directly pertinent to the Board's calculations in the Decision but relevant to Ms. Carey's opinion on the economic significance of the prescribed rate on which Ms. Carey opines. Neither statement is offered as new evidence regarding the underlying facts in this case, which would be inappropriate in support of a petition for reconsideration on grounds of material error rather than of new evidence or changed circumstances. *See Middletown & N.J. R.R.—Lease & Operation Exemption—Norfolk S. Ry.*, Docket No. FD 35412, slip op. at 3 (STB served May 2, 2012). Rather, they are offered to validate the legal arguments NECR is advancing in this petition, in which we explain that the Board drew incorrect conclusions from the factual record before it, and that letting those conclusions stand would be contrary to law, arbitrary, capricious, and an abuse of the Board's discretion.

- The Board's rejection of RCNLD, an objective measure of the value of the trackage suggested by the record, and its failure to consider ~~to~~ seeking more information to apply ~~RCLNDRCNLD~~. Even assuming the Board's theory of RCNLD ~~were~~was valid, the record could readily have been supplemented to address those concerns, and the Board had a duty to require the parties to do so. *Baltimore & O. R. Co.*, 386 U.S. at 429; *Aberdeen & R.R. Co.*, 270 F. Supp. at 711.

III. The Board's neglect of its statutory duties is also shown by its complete failure to establish any link between its ultimate determinations and the statutory requirements it acknowledges it must follow in the opening of the Decision.

In failing to attend to its statutory duties and to make the independent determinations required to honor those duties, and because of the more particular errors identified below, the Board prescribed a rate that is patently unlawful and compromises NECR's ability to continue to operate a safe and efficient rail line. Because the Board's rate prescription is ultimately tied to values derived from the revenues on the line, ~~more than~~ approximately of which are competitively constrained by the original below market rates⁸ (which the Board even acknowledged were too low, Decision at 8), there is no possibility that NECR could earn adequate revenues under the new prescribed rate because NECR revenues have been artificially constrained below market on account of its competing with a subsidized PAS. And, any rate that denies the landlord (NECR) an opportunity to earn adequate revenues means that the tenant (PAS) is not bearing the same economic costs as the landlord.

⁸ Verified Statement of Edward Foley at 1.

IV. The Board's approach to valuing the Line assets to determine the IRC was unlawful.

The Board's principal error in the Decision was to confuse market values with economic costs. Meeting the requirement to ensure that the landlord (NECR) had an opportunity for adequate revenues and requiring the tenant (PAS) to bear the same costs as the landlord must begin with properly determining the economic cost of the trackage at issue. As the Board has long recognized, the relevant cost for determining the rates required to earn adequate revenues is the replacement cost of the facilities.⁹ Therefore, the touchstone of any effort to value the assets required for trackage must be the replacement cost of the trackage at issue.

The Board acknowledged that neither of the valuation methods presented by the parties directly measured replacement costs. But rather than requiring whatever data was required to properly calculate economic costs using RCNLD, which is a suitable proxy for replacement cost, the Board attempted to substitute a ~~the~~ CE approach, which is not a suitable proxy. A CE approach can only be used ~~here~~ by the Board lawfully to the extent that the market value determined might reasonably approximate replacement cost, which in this instance, cannot be done.¹⁰

⁹ See, e.g., *Simplified Standards for Rail Rate Cases*, STB Ex Parte No. 646 (Sub-No. 1), (~~STB served Sep. 5, 2007~~) 2007 STB LEXIS 516, at *27-28 (~~STB served Sep. 5, 2007~~) (“The principal objective of the S[tand-]A[lone] C[ost] constraint is to restrain a railroad from exploiting market power over a captive shipper by charging more than it needs to earn a reasonable return on the replacement cost of the infrastructure used to serve that shipper.”), aff’d sub nom. CSX Transp., Inc. v. STB, 568 F.3d 236 (D.C. Cir. 2009), vacated in part on other grounds on reh’g 584 F.3d 1076 (D.C. Cir. 2009).

¹⁰ The Board also erred in using the CE method here because the key factors required for the analysis ~~are~~ were not easily developed or ~~are~~ were unreliable. The use of the CE method requires, *inter alia*, a current market valuation of the landlord railroad, overall earnings for the landlord railroad and accurate specific earnings. Absent ascertainability of each of these factors, applying CE analysis is not consistent with Board precedent and should not be done. See *Toledo*,

As a logical matter, the CE approach can only reflect the replacement cost if the revenues being capitalized are economically adequate. Otherwise, there is no assurance that the market value determined will have any relationship to what it costs to provide a service; ~~rather,~~ CE merely calculates a value in terms of a discounted stream of revenue that the users are currently providing to support the Line. Leaving aside all the other errors inherent in the Board's approach to CE, its use here, notwithstanding any precedent to the contrary, is unlawful. *Cleveland Cliffs*, 664 F.2d at 579580 n.15.

Moreover, because the Board has recognized that the prior trackage rights paid by PAS did not offer NECR the opportunity to earn adequate revenues, the revenue inputs to the CE method had to be understated, and CE, even if elsewhere a reasonable market valuation approach, was inherently unsuited to measure the costs required to determine adequate revenues.¹¹

Accordingly, the only valuation approach suited for the valuation task at hand is to directly approximate replacement costs. And there is no question that RCNLD is a reasonable proxy for replacement cost. The Board therefore erred when it rejected the RCNLD approach. It should have either used the RCNLD evidence ion the record, or required the parties to supply

Peoria & Western Ry. Corp. – Trackage Rights Compensation Comp.—*Peoria and Pekin Union Ry. Co.*, Docket No. 26476-, 1994 ICC LEXIS 175, at *11 (1994) (finding the CE method inappropriate); ATSF/SP, Atchison, Topeka & Santa Fe Ry. Co. – Operating Agreement – S. Pac. Transp. Co., Dkt. 8 I.C.C.-2d 297, at 304-05 (1992) (concluding that the CE approach “may not be appropriate here, since the key elements of the formula may be unavailable or unreliable”); Ark. And Mo. Ry. Co. v. Mo. P. Ry. Co., A&M I., 6 I.C.C.-2d 619, 1990 ICC LEXIS 110, at *3, *10-11 (1990) (rejecting the CE methodology because the key elements of the formula were missing or unreliable).

¹¹ *Coal Rate Guidelines, Nationwide*, 1 I.C.C.-2d 520, 1985 ICC LEXIS 254, at *35-36 (1985), *aff’d sub nom. Consol. Rail Corp. v. U.S.*, 812 F.2d 1444 (3d Cir. 1987); *Ark. Power & Light Co. v. Burlington N. R.R. Co.*, 3 I.C.C.-2d 757, 1987 ICC LEXIS 310, at *15-16 (1987).

additional evidence to enable an economically sound RCNLD. Not having taken either path, the Board ~~made~~reached an unlawful decision.

We list below additional errors in the Board's CE approach and rejection of NECR's RCNLD evidence:

- The Board's erroneous use of CE was inherently doomed not to produce the economically relevant costs. That error was compounded by the Board's several errors outlined in Ms. Carey's Verified Statement.
- Among those errors were (1) reliance on a rate escalator that was unreasonable because it assumed no growth or change in the future, despite the fact traffic is growing on the Line; (2) the use of an IRC ~~interest rental component~~ that was unreasonable because it does not change even if the weighted average costs of capital ("~~WACC~~") changes.
- Again, since RCNLD is a standard methodology used by the STB in rate setting, its purpose and function are generally well understood; The Board's rejection of RCNLD was unlawful, ~~and~~ arbitrary, and capricious, because in so doing, the Board failed to assure NECR of the opportunity to earn adequate revenues (as is required by law).
- The Board offered no valid reason for not pursuing the RCNLD approach. As discussed above, the RCNLD developed by NECR, as well as the independent RCNLD developed by Duff and Phelps, were in the record and could have been used by the Board as the basis for applying that methodology using the evidence of record or such additional evidence as it could have requested from the parties.

V. A lawful, reasonable approach would produce higher rates.

A lawful, reasonable approach would produce a higher trackage rights fee. This is indicated by the ~~R~~revenue ~~to~~ ~~V~~variable ~~c~~Cost ratios (“R/VC”) calculated by Ms. Carey on the basis of PAS’~~s~~ variable cost evidence~~;~~ that show rates at an R/VC ratio of 180% (the Board’s jurisdictional threshold for rate regulation) and 240%~~respectively~~, which would result in a substantial~~a substantial~~ increase in the trackage rights compensation level from the \$1.06 per car mile set in the TO to \$1.70 per car mile and \$2.68 per car mile, respectively. And these calculations assume that PAS’~~s~~ variable cost evidence was accurate, which Ms. Carey did not investigate. Since it is generally assumed that railroads must earn rates at least falling in this range to earn adequate revenues, it is almost certain that a rate needed to assure NECR the opportunity to earn adequate revenues would be much higher than the rate prescribed in the Decision.

VI. The Board should reconsider several non-rate decisions.

In addition to the inadequate trackage rights fees payable to NECR, the Board materially erred in denying NECR the benefit of standard contractual provisions and protections in the TO.

As a threshold matter, the Board’s failure to retroactively apply the prescribed rate as initially agreed to by the parties, especially in light of the Board’s determination that the old rate denied NECR adequate revenues, was arbitrary and capricious and in violation of the Board’~~s~~ mandate. Despite recognizing that the trackage rights fee was too low, the Board continued to allow PAS to be subsidized by NECR for longer than was necessary.

The Board also failed to recognize the economic impact of including off~~-~~market indemnification and insurance provisions in the TO. If the Board is to satisfy its mandate, there should be no circumstance~~where~~ in which NECR bears additional risk or expense that it would not have faced absent PAS’~~s~~ operations on the Line. The indemnification and insurance provisions proposed by NECR would have accomplished this goal. It is not inconceivable to

envision a significant incident on the Line involving hazardous materials transported by PAS, where the associated damages exceed PAS's assets and insurance coverage. In that circumstance, NECR will be left to cover this exposure under the current TO. To protect itself, NECR must therefore buy additional insurance that further increases NECR's variable costs, and thereby exacerbates the subsidy that PAS already enjoys.

Further, to allow PAS to extend its preferential rates to any connecting carrier through the provision of haulage would require not only that the Board consider ~~not only~~ the competitive impact of the trackage rights fee on traffic on the Line, but ~~to~~ also that it extend the analysis to consider the traffic of connecting carriers to ensure that NECR is adequately compensated. While NECR would concede that cars can be interchanged (through a switch) into PAS's account and then moved over the Line in exchange for the trackage rights fee, ~~it does not believe that~~ PAS should not be able to haul cars or trains on behalf of other carriers, thereby extending PAS's advantage to connecting railroads.

Last, the ~~20-~~year term set forth in the TO has no relationship to market reality and should be revised to a term no longer than ~~ten~~10 years to be consistent with the Board's mandate. To the extent there is no change in the market conditions over the proposed ~~ten~~10-year term, the TO would not be reopened. However, precluding a reopening for 20 years could be significantly detrimental to the railroads and customers on the Line in the event NECR is unable to earn adequate returns. In any event, it is customary for economic provisions to be reopened in the event of a substantial change in circumstances. In addition, the escalator set forth in the TO is unduly burdensome, complex, and ambiguous, such that it will be difficult for NECR and PAS to implement.

For the reasons set forth above, ~~the~~ NECR requests the Board reconsider its Decision with respect to these TO provisions.

VII. Next Steps

Finally, NECR endorses the process recommended by Ms. Carey for the Board to follow upon deciding to reconsider the unlawful Decision.

Conclusion

The Board should reconsider and modify the Decision to remedy the errors identified in the Petition.

Respectfully submitted,

~~_____/s/ Paul Cunningham~~

/s/ Paul A. Cunningham

Matthew W. Ludwig

HARKINS CUNNINGHAM LLP

1700 K Street, N.W., Suite 400

Washington, D.C. 20006-3804

(202) 973-7600

Counsel for New England Central Railroad, Inc.

December 6, 2017

PUBLIC VERSION

BEFORE THE
SURFACE TRANSPORTATION BOARD

Docket No. FD 35842

NEW ENGLAND CENTRAL RAILROAD, INC.
—TRACKAGE RIGHTS ORDER—
PAN AM SOUTHERN LLC

VERIFIED STATEMENT OF JULIE M. CAREY

TABLE OF CONTENTS

I.	INTRODUCTION AND SUMMARY OF OPINIONS	1
II.	ECONOMIC PRINCIPLES GOVERNING THE DERIVATION OF INTEREST RENTAL COMPENSATION.....	4
III.	THE CAPITALIZED EARNINGS (“CE”) APPROACH CANNOT DETERMINE THE ECONOMICALLY RELEVANT COSTS FOR THE TRACKAGE RIGHTS FEE IN THIS CASE AND THE APPLICATION OF CE WAS FLAWED	6
	A. CE is not an Economically Sound Approach for this Case.....	6
	B. Even if Deemed a Legitimate Approach, the Application of CE in this Case was flawed	887
IV.	INDICATORS THAT THE PRESCRIBED RATE IS TOO LOW	1111 10
V.	REVENUE ADEQUACY CONSIDERATIONS	1413
VI.	REPLACEMENT COST IS THE TOUCHSTONE OF RELIABLE ECONOMIC EVIDENCE AND A REASONABLE ESTIMATE OF RCNLD IS THE BEST AVAILABLE INDICATOR OF REPLACEMENT COST.....	1514
VII.	OTHER ISSUES IDENTIFIED IN THE RECORD	1918
	A. Another Potential Approach to Test the Reasonableness of the Fee.....	1918
	B. Term of Agreement.....	2019
VIII.	CONCLUSIONS	2120

PUBLIC VERSION
BEFORE THE
SURFACE TRANSPORTATION BOARD

Docket No. FD 35842

NEW ENGLAND CENTRAL RAILROAD, INC.
—TRACKAGE RIGHTS ORDER—
PAN AM SOUTHERN LLC

VERIFIED STATEMENT OF JULIE M. CAREY

I. INTRODUCTION AND SUMMARY OF OPINIONS

My name is Julie M. Carey. I am an economist and Director with National Economic Research Associates, Inc. (“NERA”). I routinely provide expert evidence before regulatory agencies, including the Surface Transportation Board (“STB” or the “Board”), in commercial disputes in arbitrations, and before state and federal courts. I have over 20 years of experience addressing economic issues in the energy and transportation sectors. I have worked on numerous rate reasonableness disputes before the STB by providing economic evidence regarding stand-alone costs and future expectations of volume, revenue and rates. I also routinely work on many other cases in which I provide consulting and testifying expert services involving railroad rates, traffic, economic damages, valuation, and other economic analyses within regulatory and commercial disputes associated with transportation and other regulated and unregulated industries.

Besides my economic consultancy practice, I am an Adjunct Professor at Georgetown University, where I teach energy economics in the graduate economics program, which includes

instruction on the economics and regulation of railroad transportation. My Curriculum Vitae is attached as Exhibit 1.

I was retained by Harkins Cunningham LLP on behalf of the New England Central Railroad, Inc. (“NECR”) to review the STB’s decision in Docket No. FD 35842 (the “Decision”) and the economic evidence submitted by the parties within that proceeding. This case involves the compensation to be paid by Pan Am Southern LLC (“Pan Am” or “PAS”) for using trackage rights on certain segments of rail line owned by NECR (“Line”). I was asked to review the Decision and the economic evidence in the record and conduct an economic evaluation regarding the evidence and the Board’s determination. I discuss economic aspects of ratemaking, including traffic revenue, volumes and rates, and other related transportation and economic issues.

As I discuss in more detail below, from the perspective of economics, several aspects of the analyses underlying the STB’s decision regarding the compensation for PAS’s s use of NECR’s tracks contradict basic principles.

Most important, the Board’s determination of the capital recovery portion of the trackage fee, which the Board calls the interest rental ~~factor~~ component (“IRCF”),¹ is materially inconsistent with sound economic principles, which precludes NECR from earning adequate revenues on the assets used by PAS. The capitalized earnings (“CE”) approach that was applied by the STB, even when properly applied, does not appropriately measure the capital costs of the Line that must be recovered, along with cost of capital, if rail service on the line is to be sustained. As a result, the STB’s CE analysis and its resulting trackage rights fee does not and

¹ I refer to the interest rental factor, IRC, interest rental component, or interest rental compensation interchangeably throughout my Verified Statement.

cannot ensure that NECR will be compensated in a manner consistent with revenue adequacy requirements, nor does it place PAS, as the tenant carrier, in the shoes of NECR, as required.

There is only one independent and objective measure--a cost based measure--of an appropriate economic value of the NECR track segments that is available on the record to inform the appropriate trackage rights compensation level. That objective measure is the reconstruction cost new less depreciation ("RCNLD"). RCNLD is an objective and standard methodology already used for ratemaking by the STB. RCNLD evidence is already in the case record and could have (and should ~~have~~) been used by the STB to determine the reasonable trackage rights fee to compensate NECR for PAS's use of its tracks. In ~~that~~the Decision, the Board deemed the Value in Place ("VIP") measure inappropriate because it did not equate to one of the methods set forth in the historic SSW methodology; ~~the~~ the only remaining viable method was the RCNLD. RCNLD provides an estimate of the cost to duplicate the railroad assets in their present position and assuming the parties would build the asset today to serve existing traffic. As discussed below, ~~a~~ an interest rental component based on a legitimate RCNLD measure of the value of the tracks would be substantially higher than the value the STB prescribed. The Board has relied on replacement costs as the appropriate economic measurement to use in ratemaking. RCNLD is a reasonable proxy for replacement costs and generates the proper economic measure of costs, if technology has not changed materially since the line was constructed.

I recommend that the Board reconsider its failure to use the appropriate economic costs measure for determining the trackage rights fee. I also recommend that the Board recognize that ~~the~~ a cost-based measurement is the only reliable approach to develop an economically appropriate trackage rights fee to ensure that NECR earns adequate revenues on the assets used by PAS. There is an independent and objective analysis of the NECR RCNLD from Duff and

Phelps in the record that can be used to develop an appropriate trackage rights fee. If the Board discovers gaps in the data, it could request the parties to supplement the record, as needed. This approach would ensure that the Board has all necessary inputs and other information to develop a reliable trackage rights fee to ensure that NECR earns adequate revenues on the assets used by PAS.

II. ECONOMIC PRINCIPLES GOVERNING THE DERIVATION OF INTEREST RENTAL COMPENSATION

In this section I outline the economic principles that apply to the calculation of the interest rental compensation due from a tenant to a landlord railroad.

The central economic issue in this dispute is the interest rental compensation² necessary to ensure that a landlord railroad can earn an economically appropriate contribution to capital and a return on its capital, which I understand is required (by statute).³ The tenant using the landlord's tracks should make a proportional payment for track that it uses (instead of the landlord absorbing all costs) and should also provide the landlord a return on its invested capital. The tenant should make the payment that the landlord would otherwise need to earn from shippers in the absence of the tenant. This approach places the tenant in the exact same economic

² The term “interest rental component” or interest rental factor is a misnomer since it’s not merely a return on debt as the name suggests. The interest rental component should include a capital component and the economic return on this capital. The Board described it as “[a]n interest rental component designed to compensate the owning carrier for the tenant carrier’s use of its capital dedicated to the track.” Decision at, p. 10.

³ 49 U.S.C.S. § 10704(a)(2); See also id. at § 10101(3) (a principle policy in regulating the railroad industry is “to promote a safe and efficient rail transportation system by allowing rail carriers to earn adequate revenues”).

position ~~that~~in which the landlord would otherwise be ~~insituated~~ (i.e., it places the tenant in the landlord's shoes).⁴

The importance of this economic concept can also be understood by considering the economic contribution expected from a shipper as compared to a tenant railroad. One can think about the tenant railroad as replacing the landlord's existing shipper. A shipper's² contribution to capital and the tenant railroad's contribution to capital must be the same in order to ensure that the landlord remains in the same exact economic position irrespective of the tenant. If a tenant railroad does not have to contribute to capital and return, the landlord will be underpaid relative to its economic position in serving the shipper. Underpayment by the tenant railroad to the landlord has two material effects. First, it creates an unfair competitive advantage for the tenant over the landlord such that a level playing field will not exist. Second, the landlord railroad will under~~re~~cover the necessary capital contribution and return, with the result that its revenues will be inadequate (i.e., too low) as long as the inadequate fee is in place. This is uniquely critical on short lines with generally smaller traffic bases³ with lighter density and smaller local customers. Absent proper compensation,⁴ the line ~~will not~~cannot be maintained for public use.

Whether the capital recovery and return portion of a trackage rights⁵ fee provides an adequate opportunity to earn adequate revenues cannot be based on the market value of an asset unless the market valuation is predicated on a revenue stream that provides adequate revenues. Otherwise, since the market valuation is intended as the basis for determining adequate revenues, this process is circular.

⁴ Even if the trackage rights fee is corrected and the cost-based measure is used, since an average price is used for the trackage fee, it precludes differential pricing in instances that would otherwise be possible (without average pricing).⁵ Consequently, the resulting total revenue is below ~~would~~what it ~~could~~should be even if the trackage rights fee is corrected because many shippers can't pay the average price.

For all these reasons, the only evidence of record that is indicative of an objective cost ~~segments~~measure is RCNLD evidence. While PAS conditionally proposed RCNLD less economic obsolescence, that measure is inappropriate for the same basic reasons as the CE approach. The proposed RCNLD less economic obsolescence is not an independent and objective measure of replacement cost. Economic obsolescence, like CE and other income stream valuation approaches, is linked to current or expected revenues to ~~derive to~~calculate market value – value which in this case ~~which~~ is constrained by the old trackage fee = rather than the cost of replacing the asset that the railroad requires to maintain service in the public interest.

With the record at hand, RCNLD remains the only plausible path to assess the ~~IRFIRC~~. RCNLD is the only reasonable approximation for replacement costs on the record that can ensure that the landlord railroad can earn an economically ~~defensible~~appropriate contribution to and return on capital.

III. THE CAPITALIZED EARNINGS (“CE”) APPROACH CANNOT DETERMINE THE ECONOMICALLY RELEVANT COSTS FOR THE TRACKAGE RIGHTS FEE IN THIS CASE AND THE APPLICATION OF CE WAS FLAWED

In this case, using any ~~capitalized earnings (“CE”)~~ valuation approach to determine the economically relevant costs is inherently inconsistent with economic principles and logic. Even if it were not, the Board’s approach to applying a CE approach to derive the interest rental ~~factor~~ component of the trackage rights fee did not comply with the economic logic that governs the proper use of the CE approach.

A. CE is not an Economically Sound Approach for this Case

The ~~capitalized earnings (“CE”)~~ approach cannot produce the objective economic cost required to determine an ~~IRCF~~ that will provide the landlord an opportunity to earn adequate revenues.

The CE valuation approach is not designed to approximate the economic cost of an asset. Rather, it is a simplified version of the income approach to valuing an asset based on the expected future earnings of the asset.⁵ The CE method truncates the traditional discounted cash flow (“DCF”) method of analyzing a stream of expected earnings over time, so that the CE method analyzes expected economic benefits for a single, relatively short period. While both the CE and DCF methods use forward-looking expectations for future earnings, the CE method measures value based on a representative future time period (*i.e.*, a single year), and is a less ~~is a~~ comprehensive measure than DCF, which typically forecasts 20 years into the future.⁶ The CE approach relies on a capitalization rate to derive the present value of earnings. The capitalization rate must also capture expected long-term growth in earnings and the risks associated with future earnings over time.⁷

As discussed in the previous section, the interest rental compensation must ensure that a landlord railroad can earn an economic contribution to capital and an economic return on its capital. The measure of market value used in the CE approach ~~or income approach~~ does not approximate replacement cost as required by the statute in a manner consistent with the STB’s general practice. The income approach can never approximate replacement costs because the method is circular. The income approach uses the expected revenues to determine the market

⁵ Shannon P. Pratt et al., *The Market Approach to Valuing Businesses Valuing a Business: The Analysis and Appraisal of Closely Held Companies*, Second Edition, p. 59 (2008) (citing Bonbright, *Valuation of Property*, pp. 249-250) (“Pratt and Niculita 2008”).

⁶ Pratt, S.P., and A.V. Niculita, *Valuing a Business* Fifth Edition, McGraw Hill: New York, 2008 Pratt 2008 and Niculita at, p. 238-239.

⁷ Id. Pratt at, p. 240-241; Shannon P. Pratt, *The Market Approach to Valuing Businesses*, Second Edition, Chapter 15, p. 245 (2005). See also Shannon P. Pratt, *The Income Approach—Estimating the Cost of Capital*, in *The Handbook of Advanced Business Valuation* 3, 6 (Robert F. Reilly & Robert P. Schweihs ed., 2000) Chapter 1, in *The Handbook of Advanced Business Valuation*, p. 6.A

value, whereas an analysis that computes the “required, adequate earnings” is derived from the development of the replacement costs.

B. Even if Deemed a Legitimate Approach, the Application of CE in this Case was Fflawed

Even if it were possible to use a legitimate CE approach, the STB’s approach underlying the Decision was improperly applied in numerous other ways that necessitate reconsideration. The most egregious of the Board’s errors are discussed below.

In general, the Board’s CE aAnalysis was predicated on the existing revenues, which were constrained by the legacy PAS trackage rights fee, which the Board determined was too low. As a consequence, the CE analysis made applied a circular application of the old, too low, trackage rights fee to determine a new fee, which is preordained to be too low. Accordingly, the STB’s trackage rights fee will not even provide NECR with a proper compensation level consistent with an independent and objective market value of the tracks. The effect of the Board’s CE aAnalysis was to capitalize a revenue stream it recognized and deemed inadequate.

More specifically, first, the STB’s approach was not based on an independent and objective measure of the market valuation of the track, a critical requirement to assure that the market valuation determined is not circular. Instead, the STB relies on historical NECR revenues (and an extrapolation to estimate PAS revenues) that are constrained directly or indirectly by the competitive pressures imposed by the old trackage rights fee.⁸ This is because

8



the PAS fees serve as a benchmark price to the majority of the carloads underlying the revenue on the NECR line because ~~more than~~ [REDACTED] ~~approximately~~ [REDACTED] of NECR's traffic over its line is subject to competition with PAS (as discussed in the Verified Statement of Edward Foley VS("Foley VS")). The revenue stream used is therefore inherently circular and incapable of indicating either the market value of the line or the appropriate cost-based trackage rights compensation.

To better understand the competitive dynamic and the impact of an artificially depressed trackage rights fee on NECR's traffic and revenues, consider the following. If a customer knows of a lower market rate than NECR offers (and the lower rate exists because of the artificially depressed trackage rights fee), the customer has the economic incentive to use the lower rate as a bargaining tool to force NECR to cede a lower rate to keep the business. If NECR does not agree to the lower price, the customer is likely to walk away from NECR and seek rail service from PAS, who can offer a lower rate because of the artificially depressed trackage rights fee. The net effect is that the vast majority of NECR traffic (~~over~~ [REDACTED] %) is affected by the old trackage ~~rate~~ rights fee.⁹ Thus, even if market value rather than cost were the relevant issue, the STB must not rely upon the revenues and earnings ~~affected-constrained~~ by the legacy PAS ~~prior~~ trackage fee to determine a new fee ~~the reasonable and~~ based on the market value of the tracks.

There are additional reasons that the STB's CE approach is economically unreliable. Further evidence in the record supports the conclusion that the STB's CE aAnalysis is flawed because it assumes no growth in traffic. The CE aAnalysis assumes a constant annual income stream in perpetuity—without accounting for any future changes or growth in future expected

⁹ The amount of competitively served traffic is discussed in the Foley VS.

income. To the extent that future changes are expected to occur, the discount rate must be adjusted for changes in growth to derive a direct capitalization rate.¹⁰ Recent historical trends in traffic for NECR indicate a potential for changes to traffic volumes in the future. Specifically, NECR's total car miles on the Line increased by approximately █% during the 2014~~2012~~ and to 2016 period, from █ to █ car miles, according to the Foley VS. Significant investment in ~~the~~ NECR, and road congestion, suggests that market share of transportation needs, and therefore traffic, should continue to grow. The effect of failing to account for growth results in an understated trackage rights fee.

In addition, the Board's calculation of the interest rental component and its use of the weighted average cost of capital ("WACC") contradict economic logic. The interest rental component is supposed to compensate the landlord for the cost of capital for its investment. However, in the STB's CE approach the interest rental component is unaffected by the specific WACC assumed as an input into the interest rental component of the trackage rights fee calculation. While the STB relies on a 14.77% pretax WACC in the CE calculation (for both the capitalization rate and the discount rate) for the interest rental component derivation, revising the WACC input (to 12.24% or another figure) results in no change to the interest rental component.¹¹ This demonstrates an inherent flaw with the Board's methodology since the

¹⁰ Pratt 2008, at S.P., and A.V. Niculita, Valuing a Business Fifth Edition, McGraw Hill: New York, 2008, pp. 245-246. This is not addressed by the STB. When earnings are expected to be stable or growing evenly, both the DCF and CE methods produce similarly accurate results. However, if changes in income flow are uneven (but predictable) or there is a high level of expected growth in the short-term, DCF is the more appropriate method. ~~Pratt, Pratt, S.P., and A.V. Niculita, Valuing a Business Fifth Edition, McGraw Hill: New York, 2008, p. 245.~~ Id.

¹¹

interest rental component compensates the landlord for the cost of capital of its investment. Simply put, the rate should change if the cost of capital to the railroad decreases or increases. It is implausible and economically inappropriate for the interest rental component to remain unchanged as it does in the STB's Decision, and even more concerning ~~in~~ that the trackage rights fee is expected to be in place for 20 years.

IV. INDICATORS THAT THE PRESCRIBED RATE IS TOO LOW

As I discuss below, there are several common indicators that the STB's prescribed trackage rights fee for PAS's use of NECR's railroad is materially too low.

Evidence in the record supports the conclusion that the prescribed rate is too low because substantial traffic has been diverted to PAS and away from NECR in recent years.¹² By way of example, PAS's share of traffic volumes on the Line increased from █% in 2012 to █% and █% in 2014 and 2016, respectively.¹² This supports my conclusion that the trackage rights fee is artificially depressed and that PAS has received an unfair competitive advantage. If the trackage rights fee is artificially depressed, substantial NECR revenues will also be too low because the STB trackage rights fee is erroneously based on the capitalized value of those revenues through the CE methodology.¹³

To illustrate how low the prescribed rate is, I calculated, based on record evidence, revenue to variable cost ("RVC") ratios to compare the RVCs of the STB prescribed rate to ratios commonly used in STB rate regulation. According to data in this record, the RVC ratio of

¹² █

¹³ █

In fact, certain movements observe revenues less variable cost. █

the NECR traffic for the ~~three issue segments~~Line underlying the STB trackage rights fee yields a RVC ratio well below the jurisdictional threshold of 180%.¹⁴ This comparison provides further economic indicia that the rate is too low and NECR is under-earning on its investment. It is certain to be below the level for which the STB has authority to regulate rates to shippers.¹⁵

To develop these ratios, I restated the NECR earnings used to extrapolate the PAS earnings on each segment to determine ~~for~~ the STB trackage rights fee compensation calculations.¹⁶ I updated the NECR earnings for each segment used in the trackage rights fee calculation to rely on revenue levels that yield a RVC ratio equal to 180%. These inputs are used in the work papers that were used in the STB trackage rights analyses, and were available for the Board to review.¹⁷ The STB calculations use the NECR earnings in the CE valuation calculation so an increase positively impacts the interest rental payment. According to this economic

14

15 “The Board is precluded from finding market dominance if the revenues produced by a challenged rate are less than 180% of the carrier’s variable costs of providing the service. ~~49 U.S.C. 10707(d)(1)(A).~~”- Major Issues in Rail Rate Cases, Docket No. EP MAJOR ISSUES IN RAIL RATE CASES—Surface Transportation Board Decision. STB Ex Parte No. 657 (Sub-No. 1), slip op. at 6. (Decided on STB served Oct. 30, 2006) (citing 49 U.S.C. 10707(d)(1)(A)). [https://www.stb.gov/decisions/readingroom.nsf/UNID/5C7E822CBDC68AD385257217005C5064/\\$file/37406.pdf](https://www.stb.gov/decisions/readingroom.nsf/UNID/5C7E822CBDC68AD385257217005C5064/$file/37406.pdf)

16

17

analysis, the trackage rights fee would increase from \$1.06 per car mile to [REDACTED] per car mile, assuming revenues are based on an RVC equal to 180%.¹⁸

Additional case precedent indicates higher RVC ratios are potentially reasonable, beyond the jurisdictional threshold of 180% and at least as high as 240%.¹⁹ A higher RVC for trackage service may be reasonable and appropriate if needed for the trackage ~~rate-rights fee~~ to put the tenant carrier (PAS) in the shoes of the landlord (NECR) so that the tenant is unable to undercut NECR on account of ~~PAS~~ being subsidized ~~by with~~ a too low trackage ~~rights~~ fee. I updated the NECR earnings for each segment used in the trackage rights fee calculation to rely on revenue levels that yield a RVC ratio equal to 240%. According to this economic analysis, the trackage rights fee would increase from \$1.06 per car mile to [REDACTED] per car mile, assuming revenues are based on an RVC equal to 240%.²⁰

From these figures, I conclude the compensation level required for NECR to earn adequate revenues is substantially higher than the \$1.06 rate prescribed by the STB.

¹⁸ To conduct this analysis and the other analyses discussed herein, I accepted the variable cost, revenue by segment and other data in the record developed by other parties. I did not seek to go behind to evaluate the assumptions.

¹⁹ ~~Surface Transportation Board Decision, STB Docket No. 42088, Western Fuels Association Ass'n, Inc. and Basin Electric Power Cooperative v. BNSF Railway Company, Docket No. 42088, slip op. at 2 (STB served, Decided on: February 1817, 2009), Page 2. Surface Transportation Board Notice, Docket No. EP 711, Petition for Rulemaking to Adopt Revised Competitive Switching Rules. Decided on July 25, 2012. Page 4.~~

²⁰ To conduct this analysis and the other analyses discussed herein, I accepted the variable cost, revenue by segment and other data in the record developed by other parties. I did not seek to go behind to evaluate the assumptions.

V. REVENUE ADEQUACY CONSIDERATIONS

Under the Staggers Act and the Coal Rate Guidelines (the “Guidelines”),²¹ the railroad industry has substantial freedom to set prices due to the recognition that differential pricing based on market demand conditions is economically appropriate in network industries (referred to as constrained market pricing). Pricing freedom enables railroads to develop rates based on market conditions (i.e., what the market will bear) except under certain circumstances, as discussed below. ~~The~~A goal of the regulatory construct was to ensure revenue adequacy for the railroads so that the carriers might ~~beco~~ame (and remain) financially sound.²² The construct was also designed to promote economic efficiency with necessary safeguards included to prohibit excessive charges.²³

While relying substantially on market forces to constrain railroad transportation rates, STB rate regulation comes into effect when a shipper faces a combination of circumstances including: (1) market dominance, and (2) a challenged rate over 180% of RVC ratio that exceeds the price that a stand-alone hypothetical least-cost most-efficient railroad would charge in a contestable market. Under these circumstances, a shipper can contest the reasonableness of ~~at~~the railroad rate. Rate relief will be provided to such shippers, upon a demonstration that rates are

²¹ *Coal Rate Guidelines, Nationwide, Interstate Commerce Commission*, 1 I.C.C. 2d 520757; 1987 ICG LEXIS 310 (1985).

²² ~~Coal Rate Guidelines, Nationwide, Interstate Commerce Commission~~, 1 I.C.C. 2d 757; 1987 ICG LEXIS 310.

²³ The revenue adequacy constraint ensures that a captive shipper will “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.” *Coal Rate Guidelines, Nationwide, Interstate Commerce Commission*, 1 I.C.C. 2d 520757; 1985 ICG LEXIS 310.254, at *535-37-38 at 6.535-536 (1985).

higher than necessary because of inefficiencies in the pricing practices, investments or operations of the carriers.

Since the STB's trackage rights fee that NECR earns from PAS's use of its tracks represents no objective measure of the economic cost of the track, the STB cannot be assured that ~~the~~ NECR is earning adequate revenues. Another measure is required.

VI. REPLACEMENT COST IS THE TOUCHSTONE OF RELIABLE ECONOMIC EVIDENCE AND A REASONABLE ESTIMATE OF RCNLD IS THE BEST AVAILABLE INDICATOR OF REPLACEMENT COST.

There is only one independent and objective measure, a cost-based measure, of an appropriate economic value of the NECR track segments that is available on the record to inform the appropriate trackage rights compensation level. It is RCNLD. RCNLD is an objective and standard methodology used for ratemaking by the STB.²⁴ RCNLD evidence is in the case record and could have been used by the STB to determine the reasonable trackage rights fee to compensate NECR for PAS's use of its tracks. RCNLD provides an estimate of the cost to duplicate the railroad assets in their present position and assuming the parties would build the asset today to serve existing traffic. As discussed below, an interest rental component based on a legitimate RCNLD measure of the replacement cost of the tracks would be substantially higher than what the STB prescribed. Historically, the Board has concluded that replacement costs are the appropriate economic measurement to use in ratemaking. RCNLD is a reasonable proxy for

²⁴ “The principal objective of the ~~stand-alone cost (SAC)~~ [stand-alone cost] constraint is to restrain a railroad from exploiting market power over a captive shipper by charging more than it needs to earn a reasonable return on the replacement cost of the infrastructure used to serve that shipper.” See, e.g., Simplified Standards for Rail Rate Cases, STB Ex Parte Docket No. EP 646 (Sub-No. 1), slip op. at 13 (STB served Sep. 5, 2007), 2007 STB LEXIS 516, at *27-28.

replacement costs, which is the proper economic measure of costs, if technology has not changed materially since the line was constructed.

A railroad rate based on the reconstruction costs provides an objective standard for ratemaking routinely used by the Board. RCNLD is an acceptable approach to measure replacement costs. An independent assessment of the RCNLD of NECR was conducted in connection with Genesee ~~and & Wyoming's Wyoming Inc.'s~~ ("G&W") 2012 acquisition of RailAmerica (which included the acquisition of the NECR). In order to comply with acquisition accounting and U.S. Generally Acceptable Accounting Principles, Duff and Phelps conducted an analysis of the RCNLD of NECR.²⁵ In Table 1 below, I show the RCNLD quantified by Duff and Phelps for the NECR, which approximates \$ [REDACTED] ²⁶ I also calculate an estimated RCNLD for the ~~issue-segments~~Line based on a mileage proration which yields approximately \$ [REDACTED] of value attributed to the ~~issue-segments~~Line.²⁷ This cost-based measure can be used to develop the appropriate trackage rights compensation, ~~(as discussed below)~~.

While I rely exclusively on the RCNLD cost-based measure to develop the appropriate trackage rights compensation for PAS's use of NECR's railroad assets, I recognize that Duff and Phelps also quantified a fair market value by making an adjustment to RCNLD to account for economic obsolescence. This fair market value estimate (with the economic obsolescence adjustment) is not economically sound. This is because, as discussed above, an estimate of

²⁵ Genesee & Wyoming Inc. Determination of the Fair Value and Remaining Useful Life of ~~c~~Certain Identifiable Tangible and Intangible Assets of RailAmerica, Inc. as of October 1, 2012, Duff and Phelps, (Nov. ~~ember~~ 14, 2013) ("Duff and Phelps").

²⁶ Duff and Phelps at Exhibit 2.25. Excludes rolling stock; RCNLD is apportioned to each segment based on the proportion of miles to the total system.

²⁷ The RCNLD developed by Duff and Phelps is higher than the VIP -estimates proposed by NECR in the opening evidence.

market value is not the cost-based measure required to ensure that NECR earns adequate revenues associated with the trackage rate rights fee.²⁸ Further the Duff and Phelps fair market value (RCNLD less economic obsolescence) is a circular application of the old, too low, trackage rights fee to determine expected cash flows in the future. Accordingly, the STB's trackage rights fee on the Line will not provide NECR with a proper compensation level consistent with an independent and objective assessment of the cost of the tracks.

28



Table 1

Reconstruction Cost New Less Depreciation of the NECR and Segments²⁹

(\$ thousands)

	Miles	Proportion of Miles	Reconstruction Cost Less Depreciation- RCNLD
NECR	394.0	100.0%	
South Segment	10.6	2.7%	
Middle Segment	48.8	12.4%	
North Segment	13.4	3.4%	
Total Relevant Segments	72.8	18.5%	

I have quantified the interest rental component by using the RCNLD by Duff and Phelps for NECR as applied to the ~~issue-segments~~Line (as discussed above). Specifically, I determined the annual revenue requirement associated with the RCNLD that provides the return of and return on the investment. The revenue requirement accounts for the impact of cash flows over twenty years and taxable income impacts from both depreciation and taxable income associated with debt financing. I assumed a straight line depreciation schedule. I also assumed d a capital structure consistent with the STB's most recent railroad industry WACC (along with G&W's consolidated tax rate) and consistent with the approach used by the STB in this matter. My approach to developing the interest rental component is economically consistent with the STB's methodology for quantifying the capital recovery component in the rate reasonableness

²⁹ ~~Opening Verified Statement of Charles Banks and John Ireland of R.L. Banks and Associates, Inc.; Surface Transportation Board Docket No. FD-35842; New England Central Railroad, Inc. Trackage Rights Order Pan Am Southern LLC; June 4, 2015, pp. 3-5. Genesee & Wyoming Inc. Determination of the Fair Value and Remaining Useful Life of certain Identifiable Tangible and Intangible Assets of RailAmerica, Inc. as of October 1, 2012, Duff and Phelps, November 14, 2013, Exhibit 2.25.~~

disputes.³⁰ The STB's methodology develops a future annual capital requirement for railroad ~~road~~ property adjusted for taxes to derive the required future cash flow associated with that capital requirement, which is converted to a present value.

Reliance on the Duff and Phelps RCNLD yields an interest rental component equal to [REDACTED] per car mile as the necessary rate to recover the capital investment and return on that investment. The schedules and calculations underlying this analysis are presented in Exhibit 2. I also conducted a sensitivity analysis that excludes the grant monies and the appraised easement value objected to by PAS.³¹ Adjusting the Duff and Phelps RCNLD to exclude the contested components yields an interest rental component ~~is~~ equal to [REDACTED] per car mile as the rate to recover the capital investment and a return on that investment.³²

VII. OTHER ISSUES IDENTIFIED IN THE RECORD

In this section I address a few remaining points.

A. Another Potential Approach to Test the Reasonableness of the Fee

Another approach that could have been used to test the reasonableness of the trackage rights fee would have been a stand-alone cost analysis. The ~~stand-alone cost~~ ("SAC") test relies on a hypothetical least cost, most efficient railroad as the economic standard applied to evaluate

³⁰ See ~~STB Decision Total~~ TOTAL Petrochemicals & Refining USA, Inc. v. CSX Transportation, Inc., Docket No. NOR 42121 ~~September 12, 2016, slip op. at pp. 215-228 (Appendix D), and Tables D-1 and D-2 (STB served Sept. 14, 2016) ("TPI/CSX"); and TPI Opening TOTAL Petrochemicals & Refining USA, Inc. v. CSX Transportation, Inc. Docket No. NOR 42124 Opening Evidence of Total Petrochemicals & Refining USA, Inc. at Exhibit III-H-1, Table I, TPI/CSX (filed Feb. 18, 2014) ("TPI Opening").~~

³¹ [REDACTED]

³² At this time, I am not opining as to whether it is economically appropriate to make these adjustments. I accepted at face value the data in the record and did not seek to go behind to evaluate the assumptions. Rather, my analysis is included to demonstrate the impact.

the reasonableness of railroad rates. It specifically utilizes a DCF analysis and compares the revenues of the stand-alone railroad to the costs (capital and operating costs). This approach would allow the STB to determine the rate and revenue level required to ensure that the trackage rights fee provides compensation consistent with the hypothetical least cost, most efficient railroad.³³ In this case, the trackage rights fee is reported for separate components, including: interest rental fee, variable dispatch and maintenance expense. The ~~stand-alone cost~~ SAC methodology incorporates s all three components ~~and along with~~ other operating costs, and reports the capital requirement for the railroad separately from the operating expenses.³⁴

Absent evidence that there ~~would be~~ is a significant likelihood of a materially different outcome using a SAC test from the outcome using a legitimate RCNLD approach, there would appear to be no need to use the SAC approach here. And I saw nothing in the record that would suggest such a materially different outcome, at least not one that PAS would be likely to support.

B. Term of Agreement

It is a very dynamic time period within the railroad transportation industry. A 20-year locked term before either party can renegotiate the compensation level does not enable the parties to address changing economic circumstances. Substantial changes have occurred since this agreement went into place. Customer agreements today are seldom if ever made for that long of a term, and we expect shorter ~~than longer~~ terms in the future throughout the industry. Indeed,

³³ Most cases that utilize a stand-alone cost analysis involve shipper rate disputes. In these cases there are primarily independent market rates determined by negotiations between the railroads and shippers which comprise a substantial portion of the SARR traffic volumes and revenue. In these instances the ~~S~~ s stand-alone cost test provides an independent check on the reasonableness of the rate instead of determining what the appropriate rate should be.

³⁴ ~~See STB Decision TOTAL Petrochemicals & Refining USA, Inc. v. CSX Transportation, Inc., Docket No. NOR 42121 September 12, 2016, at pp. 215-228 (TPI/CSX at Appendix D,) and Tables D-1 and D-2; and TPI Opening TOTAL Petrochemicals & Refining USA, Inc. v. CSX Transportation, Inc. Docket No. NOR 42121 at Exhibit III-H-1, Table I.~~

a ten-year term is a very long time period in the current market climate to assume no changes to the economic circumstances will occur from the current state of the world. Technological change is also accelerating, which could impact all modes of transportation over a twenty~~20~~ and ten year interval. PAS is unlikely to enter customer agreements for more than five years because neither party will believe that the economic circumstances are static. Consequently, ~~only a period of ten years or less it~~ is reasonable to establish rates only for a period of ten years or less under these circumstances, and any term should be qualified by ~~an~~ incorporating an additional provision to allow a reopener based on materially changed circumstances.

VIII. CONCLUSIONS

It is my opinion that the CE approach as applied by the Board is economically unreliable because it is not a cost-based measure. It is also circular because of reliance on the critical input based on the old trackage rights fee as opposed to an independent market rate.

The result of the ~~ise~~ flaws is that the trackage rights compensation deemed to be payable by PAS to NECR set forth in the Decision is too low.

PUBLIC VERSION
BEFORE THE
SURFACE TRANSPORTATION BOARD

Docket No. FD 35842

NEW ENGLAND CENTRAL RAILROAD, INC.
—TRACKAGE RIGHTS ORDER—
PAN AM SOUTHERN LLC

VERIFIED STATEMENT OF EDWARD FOLEY

I am Edward Foley. Currently, I am employed by Genesee & Wyoming Railroad Services, Inc. as the Vice President, Marketing and Sales for the Northeast Region railroads of Genesee & Wyoming Inc., which includes the New England Central Railroad (“NECR”). I oversee corporate marketing, planning, and strategy for the NECR, which includes the trackage rights line segments over which Pan Am Southern LLC (“PAS”) operates and which are at issue in the above-referenced matter (the “Line”). I am familiar with NECR’s customers, revenue, and competition on the Line.

In light of the Board’s decision served October 31, 2017 (“Decision”), I was asked by counsel for NECR to identify what percentage of NECR traffic on the Line is subject to competition from PAS.

Based on my review and calculation, nearly [REDACTED] % of NECR’s traffic system wide and more than [REDACTED] % of NECR’s traffic on the Line, in car miles, was subject to competition from PAS in 2016. 2016 was a typical year in terms of traffic volumes and distributions across the three segments that encompass the Line. One indicia of PAS’s strength as a competitor is the

growth in PAS's market share. PAS's share of traffic on the Line has been increasing: total PAS car miles on the Line grew by a factor of [REDACTED], or approximately [REDACTED] percentage points, from 2012 through 2016. Total traffic on the Line has also increased in recent years: total car miles grew [REDACTED] percentage points from 2014 through 2016, from [REDACTED] to [REDACTED].

EXHIBIT B

PUBLIC VERSION
BEFORE THE
SURFACE TRANSPORTATION BOARD

Docket No. FD 35842

NEW ENGLAND CENTRAL RAILROAD, INC.
—TRACKAGE RIGHTS ORDER—
PAN AM SOUTHERN LLC

PETITION FOR RECONSIDERATION

New England Central Railroad, Inc. (“NECR”) hereby petitions for reconsideration of the decision served October 31, 2017 in the above-captioned proceeding (the “Decision”) on the grounds of material error. The Decision modified a trackage rights order (“TO”) governing the operations of Pan Am Southern LLC (“PAS”) over three contiguous segments of a railroad line owned by NECR (together, the “Line”).¹ The approach of the Surface Transportation Board (the “Board”)² to rate setting and the associated prescribed rate were both unlawful. They violated the Board’s mandate to “make an adequate and continuing effort to assist carriers in attaining revenue levels” that are “adequate, under honest, economical, and efficient management... to cover total operating expenses, including depreciation and obsolescence, plus a reasonable and

¹ The three segments include the 48.8 mile Middle Segment formerly owned by Boston & Maine Corporation (PAS's predecessor), and a 13.4 mile Northern Segment, and a 10.6 mile Southern Segment formerly owned by Central Vermont Railway, Inc. (NECR's predecessor).

² Reference to the Board, as the context warrants, may include reference to its predecessor agency, the Interstate Commerce Commission (“ICC”).

economic profit or return (or both) on capital employed in the business.”³ Other aspects of the Decision were also unlawful.

One TO modification was a new trackage rights fee to be paid by PAS to NECR to supplant the prior prescribed fee, which had been in place for over twenty years. The Board recognized that the prior prescribed fee was too low and established the new fee. The most important component of the new fee (which the Board calls the Interest Rental Component (“IRC”)) defines the return of, and on, the trackage assets to be paid by PAS. The Board set the IRC too low and effectively precluded NECR from earning adequate revenues on the Line.

The Board violated its independent statutory duty to regulate the rail industry to promote an efficient and safe rail system by ensuring that a railroad can earn adequate revenues. The fee forces NECR to subsidize PAS’s usage, and the competitive situation leaves NECR with no means to recoup PAS’s equitable share of its capital costs from other shippers. The fee not only determines the pricing for the traffic hauled at any time by PAS, but also impacts the more than ■■■ of the car miles moving over the Line subject to competition between PAS and NECR. The resulting below adequate revenues compromise NECR’s ability to maintain efficient and safe rail operations over the Line.

The Decision produced an unlawfully low rate because the Board erred by using an economically unsuitable tool to calculate the IRC and compounded the error by using the tool improperly. The Board’s use of the capitalized earnings (“CE”) approach to value the trackage rights assets was arbitrary and capricious, and produced an unlawful result. This is because there is no means by which the CE approach can arrive at an accurate asset cost to consider in

³ 49 U.S.C.S. § 10704(a)(2); *see also id.* at § 10101(3) (a principal policy in regulating the railroad industry is “to promote a safe and efficient rail transportation system by allowing rail carriers to earn adequate revenues”).

establishing a rate that will assure the required earnings opportunity. The Board erred further by using the CE approach in ways that frustrated even the use to which it might otherwise legitimately be put in other circumstances.

This doubly erroneous use of the CE approach, which assured an unlawfully low rate, was entirely unnecessary. The Board rejected the modified reproduction cost new less depreciation (“RCNLD”) method on the ground that it did not fit squarely into one of the four historic methods traditionally used by the Board. Rather than seeking more information to ensure that the appropriate method was used, the Board deferred to (and misapplied) the unsuitable CE method. The Board had data in the record (or could have required additional production of data) that would have permitted a direct determination of the cost of the Line assets using the RCNLD approach. The Board erred in rejecting that economically sound approach on grounds that were arbitrary and capricious. One of those grounds, which was the claim that the evidence of record was not sufficient for the proper determination of RCNLD, was especially noteworthy. By applying the wholly unsuitable CE method rather than securing any new evidence required to properly apply the RCNLD approach, the Board violated its independent duty to assure an adequate record upon which to base its decision. Accordingly, NECR requests that the Board reconsider the approach it used in valuing the Line assets and the inequitably low rate that resulted from its chosen approach.

Additionally, NECR requests that the Board reconsider its decision regarding various non-rate terms of the TO, including, but not limited to, insurance requirements, the rate escalator, the lack of retroactivity, and the term of the TO.

ARGUMENT

I. The Board's Legal Obligations

The Board has a duty a) to ensure that its orders comply with the law, b) to ensure that the record will permit that compliance, and c) to determine independently how to meet its mandate, and not merely choose among suggestions of the parties.

As the Supreme Court explained long ago, the Board, like the ICC before it, “is not intended to be a passive arbiter but the ‘guardian of the general public interest,’ with a duty to see that this interest is at all times effectively protected.” *Baltimore & O. R. Co. v. U.S.*, 386 U.S. 372, 429 (1967) (Brennan, J., concurring) (quoting H. R. Doc. No. 678, Practices and Procedures of Governmental Control of Transportation, 78th Cong., 2d Sess., p. 53 (1944)). The Board has an “independent review responsibility” to ensure that its decisions comply with all of its statutory mandates. *See Cleveland Cliffs Iron Co. v. Interstate Commerce Comm’n*, 664 F.2d 568, 578 (6th Cir. 1981).

To protect the public interest and satisfy its statutory mandates, the Board “is empowered to investigate and gather evidence beyond that presented by the parties where exercise of that power will advance the determination of what best serves the public interest.” *Baltimore & O. R. Co.*, 386 U.S. at 429-30; *see also Aberdeen & R.R. Co v. U.S.*, 270 F. Supp. 695, 711 (E.D. La. 1967) (“When carriers fail to produce satisfactory evidence, the Commission may require them to produce additional and more satisfactory evidence.”). The Board “is not the prisoner of the parties’ submissions,” *Baltimore & O. R. Co.*, 386 U.S. at 430, and error may not be excused where the parties’ submissions were inadequate. *Aberdeen & R.R. Co.*, 270 F. Supp. at 711. Instead, the Board must “weigh alternatives and make its choice according to its judgment how best to achieve and advance the goals of the National Transportation Policy.” *Baltimore & O. R. Co.*, 386 U.S. at 430.

Under the substantive law governing this proceeding, the Board's paramount duty is to ensure that the TO and the trackage rights fee set forth therein afford NECR the opportunity to earn adequate revenues to enable NECR to operate a safe and efficient rail line. The law also requires that the fee imposed on PAS ensures the same cost burden as is carried by NECR.⁴ Both are required to protect the public interest in sustainable rail transport. Neither precedent nor agency judgment can trump these requirements. *Cleveland Cliffs*, 664 F.2d at 580 n.15.

Nor may the Board put its thumb on the scale to favor PAS by allowing it to avoid rates that the law requires, even if the PAS rates must be substantially increased from the prior rate, which the Board determined were too low. Decision at 8. As the Board has recognized, and as both PAS and NECR agreed, the methodology set forth in *SSW Compensation* provides the appropriate measure of trackage rights compensation where the Board must prescribe the terms and conditions under which one railroad may operate its trains and crews over the rail lines of another.⁵ And, just as the parties to privately-negotiated trackage rights agreements would rarely, if ever, make their terms permanent, lest they become commercially unreasonable as a

⁴ *St. Louis S.W. Ry.—Trackage Rights Over Mo. Pac. R.R.—Kansas City to St. Louis*, 1 I.C.C.2d 776 (1984) (“*Compensation I*”), 4 I.C.C.2d 668 (1987) (“*Compensation II*”), 5 I.C.C.2d 525 (1989) (“*Compensation III*”), 8 I.C.C.2d 80 (1991) (“*Compensation IV*”), 8 I.C.C.2d 213 (1991) (“*Compensation V*”) (together, “*SSW Compensation*”).

⁵ Decision at 9; *see also Atchison, T. & S.F. Ry.—Operating Agreement—S. Pac. Transp. Co.*, 8 I.C.C.2d 297, 303 (1992) (“*ATSF/SP*”); *Ark. & Mo. R.R. v. Mo. Pac. R.R.*, 6 I.C.C.2d 619 (1990) (“*A&M I*”), 7 I.C.C.2d 164 (1990) (“*A&M II*”), *aff’d sub nom. Mo. Pac. R.R. v. ICC*, 23 F.3d 531 (D.C. Cir. 1994); *CSX Corp.—Control & Operating Leases/Agreements—Conrail Inc.*, Decision No. 109, 3 S.T.B. 955, 963-64 (1998).

result of changed business conditions after several years, so too does the Board typically provide an opportunity for parties to seek adjustment of the compensation terms it has prescribed.⁶

As the *SSW Compensation* methodology is intended to “put the tenant in the same position as the owning carrier,” *Compensation I*, 1 I.C.C.2d at 786, compensation that achieves that goal when set may, depending on how economic circumstances change over time, leave the tenant (PAS) in either a better or worse position than the owner (NECR). Readjustment of the compensation terms to ensure that the rate continues to conform to the *SSW Compensation* methodology may be necessary to ensure that no implicit subsidy is provided to one party’s operations. *Cf.* Decision at 8. Readjustment was and is necessary here – after the passage of nearly 29 years – because the trackage rights fee no longer reflects current conditions. Moreover, the fact that the adjusted compensation terms may constitute even “an inordinately large increase in compensation” is no excuse not to make an adjustment per the terms dictated by *SSW Compensation* principles. *See A&M II*, 7 I.C.C.2d at 168.

Most important, the Board is mandated by statute to ensure that a railroad has the opportunity to earn adequate revenues to maintain a safe and efficient line. Yet here, in the TO, in taking the unlawful approach and imposing the prescribed rate, the Board failed even to consider whether the trackage rights rates it imposed would permit NECR to earn adequate revenues, and it prescribed rates for PAS that would manifestly foreclose that opportunity. The Board merely relied on one valuation method set forth in the record, without consideration of its

⁶ *See, e.g., ATSF/SP*, 8 I.C.C.2d at 302 (describing provision in trackage rights terms prescribed by the ICC in 1967, allowing either party to petition for revision of those terms each successive fifth year anniversary of the effective date of the 1967 decision, or at other times “for good cause shown”); *Nat’l R.R. Passenger Corp.—Conveyance of Boston & Me. Corp. Interests in Conn. River Line in Vt. & N.H.*, 1990 ICC LEXIS 52, at *14-15 (1990) (allowing either party to require renegotiation or seek agency imposition of new terms after 20 years).

mandate, and overlooked the fundamental flaw in its approach. Each is a reversible error, even if the issues were not fully developed by the parties. *See N.Y. Cross Harbor R.R. v. Surface Transp. Bd.*, 374 F.3d 1177, 1187-1188 (D.C. Cir. 2004) (reversing abandonment decision where the Board failed to mention its statutory duty to preserve and promote continued rail service); *see also Cleveland Cliffs*, 664 F.2d at 578.

II. The Board did not exercise its duty to ensure that the record would support a legally compliant decision, and the Board's approach to rate setting and the resulting rate were unlawful.

The Board's failure to develop an adequate record to support a lawful decision is demonstrated, as we explore further below,⁷ by several aspects of the Decision, including the following:

- The Board's use of the CE method of asset valuation, despite the fact it could not, as a matter of basic economics, produce the relevant valuation.
- The Board's improper application of the CE approach, such that, even if the approach could have produced a reasonable result, the application ensured the wrong result.

⁷ This Petition is supported by the substantiating economic testimony of Julie M. Carey regarding the validity of the economic reasoning that underpins NECR's claims of material error. It is also supported by the Verified Statement of Edward Foley, who reports and opines regarding aspects of rail competition that were not directly pertinent to the Board's calculations in the Decision but relevant to Ms. Carey's opinion on the economic significance of the prescribed rate on which Ms. Carey opines. Neither statement is offered as new evidence regarding the underlying facts in this case, which would be inappropriate in support of a petition for reconsideration on grounds of material error rather than of new evidence or changed circumstances. *See Middletown & N.J. R.R.—Lease & Operation Exemption—Norfolk S. Ry.*, Docket No. FD 35412, slip op. at 3 (STB served May 2, 2012). Rather, they are offered to validate the legal arguments NECR is advancing in this petition, in which we explain that the Board drew incorrect conclusions from the factual record before it, and that letting those conclusions stand would be contrary to law, arbitrary, capricious, and an abuse of the Board's discretion.

- The Board's rejection of RCNLD, an objective measure of the value of the trackage suggested by the record, and its failure to consider seeking more information to apply RCNLD. Even assuming the Board's theory of RCNLD was valid, the record could readily have been supplemented to address those concerns, and the Board had a duty to require the parties to do so. *Baltimore & O. R. Co.*, 386 U.S. at 429; *Aberdeen & R.R. Co.*, 270 F. Supp. at 711.

III. The Board's neglect of its statutory duties is also shown by its complete failure to establish any link between its ultimate determinations and the statutory requirements it acknowledges it must follow in the opening of the Decision.

In failing to attend to its statutory duties and to make the independent determinations required to honor those duties, and because of the more particular errors identified below, the Board prescribed a rate that is patently unlawful and compromises NECR's ability to continue to operate a safe and efficient rail line. Because the Board's rate prescription is ultimately tied to values derived from the revenues on the line, approximately [REDACTED] of which are competitively constrained by the original below market rates⁸ (which the Board even acknowledged were too low, Decision at 8), there is no possibility that NECR could earn adequate revenues under the new prescribed rate because NECR revenues have been artificially constrained below market on account of its competing with a subsidized PAS. And, any rate that denies the landlord (NECR) an opportunity to earn adequate revenues means that the tenant (PAS) is not bearing the same economic costs as the landlord.

⁸ Verified Statement of Edward Foley at 1.

IV. The Board's approach to valuing the Line assets to determine the IRC was unlawful.

The Board's principal error in the Decision was to confuse market values with economic costs. Meeting the requirement to ensure that the landlord (NECR) had an opportunity for adequate revenues and requiring the tenant (PAS) to bear the same costs as the landlord must begin with properly determining the economic cost of the trackage at issue. As the Board has long recognized, the relevant cost for determining the rates required to earn adequate revenues is the replacement cost of the facilities.⁹ Therefore, the touchstone of any effort to value the assets required for trackage must be the replacement cost of the trackage at issue.

The Board acknowledged that neither of the valuation methods presented by the parties directly measured replacement costs. But rather than requiring whatever data was required to properly calculate economic costs using RCNLD, which is a suitable proxy for replacement cost, the Board attempted to substitute a CE approach, which is not a suitable proxy. A CE approach can only be used by the Board lawfully to the extent that the market value determined might reasonably approximate replacement cost, which in this instance, cannot be done.¹⁰

⁹ See, e.g., *Simplified Standards for Rail Rate Cases*, STB Ex Parte No. 646 (Sub-No. 1), 2007 STB LEXIS 516, at *27-28 (STB served Sep. 5, 2007) ("The principal objective of the S[tand-]A[lone] C[ost] constraint is to restrain a railroad from exploiting market power over a captive shipper by charging more than it needs to earn a reasonable return on the replacement cost of the infrastructure used to serve that shipper."), *aff'd sub nom. CSX Transp., Inc. v. STB*, 568 F.3d 236 (D.C. Cir. 2009), *vacated in part on other grounds on reh'g* 584 F.3d 1076 (D.C. Cir. 2009).

¹⁰ The Board also erred in using the CE method here because the key factors required for the analysis were not easily developed or were unreliable. The use of the CE method requires, *inter alia*, a current market valuation of the landlord railroad, overall earnings for the landlord railroad and accurate specific earnings. Absent ascertainability of each of these factors, applying CE analysis is not consistent with Board precedent and should not be done. See *Toledo, Peoria & W. Ry. Corp. – Trackage Rights Comp.—Peoria & Pekin Union Ry. Co.*, Docket No. 26476, 1994 ICC LEXIS 175, at *11 (1994) (finding the CE method inappropriate); *ATSF/SP*, 8

As a logical matter, the CE approach can only reflect the replacement cost if the revenues being capitalized are economically adequate. Otherwise, there is no assurance that the market value determined will have any relationship to what it costs to provide a service. CE merely calculates a value in terms of a discounted stream of revenue that the users are currently providing to support the Line. Leaving aside all the other errors inherent in the Board's approach to CE, its use here, notwithstanding any precedent to the contrary, is unlawful. *Cleveland Cliffs*, 664 F.2d at 580 n.15.

Moreover, because the Board has recognized that the prior trackage rights paid by PAS did not offer NECR the opportunity to earn adequate revenues, the revenue inputs to the CE method had to be understated, and CE, even if elsewhere a reasonable market valuation approach, was inherently unsuited to measure the costs required to determine adequate revenues.¹¹

Accordingly, the only valuation approach suited for the valuation task at hand is to directly approximate replacement cost. And there is no question that RCNLD is a reasonable proxy for replacement cost. The Board therefore erred when it rejected the RCNLD approach. It should have either used the RCNLD evidence in the record, or required the parties to supply additional evidence to enable an economically sound RCNLD. Not having taken either path, the Board reached an unlawful decision.

I.C.C.2d at 304-5 (concluding that the CE approach "may not be appropriate here, since the key elements of the formula may be unavailable or unreliable"); *A&M I*, 6 I.C.C.2d 619, 1990 ICC LEXIS 110, at *3, *10-11 (rejecting the CE methodology because the key elements of the formula were missing or unreliable).

¹¹ *Coal Rate Guidelines, Nationwide*, 1 I.C.C.2d 520, 1985 ICC LEXIS 254, at *35-36 (1985), *aff'd sub nom. Consol. Rail Corp. v. U.S.*, 812 F.2d 1444 (3d Cir. 1987); *Ark. Power & Light Co. v. Burlington N. R.R. Co.*, 3 I.C.C.2d 757, 1987 ICC LEXIS 310, at *15-16 (1987).

We list below additional errors in the Board's CE approach and rejection of NECR's RCNLD evidence:

- The Board's erroneous use of CE was inherently doomed not to produce the economically relevant costs. That error was compounded by the Board's several errors outlined in Ms. Carey's Verified Statement.
- Among those errors were (1) reliance on a rate escalator that was unreasonable because it assumed no growth or change in the future, despite the fact traffic is growing on the Line; (2) the use of an IRC that was unreasonable because it does not change even if the weighted average cost of capital changes.
- Again, since RCNLD is a standard methodology used by the STB in rate setting, its purpose and function are generally well understood. The Board's rejection of RCNLD was unlawful, arbitrary, and capricious, because in so doing, the Board failed to assure NECR of the opportunity to earn adequate revenues (as is required by law).
- The Board offered no valid reason for not pursuing the RCNLD approach. As discussed above, the RCNLD developed by NECR, as well as the independent RCNLD developed by Duff and Phelps, were in the record and could have been used by the Board as the basis for applying that methodology using the evidence of record or such additional evidence as it could have requested from the parties.

V. A lawful, reasonable approach would produce higher rates.

A lawful, reasonable approach would produce a higher trackage rights fee. This is indicated by the revenue to variable cost ratios ("R/VC") calculated by Ms. Carey on the basis of PAS's variable cost evidence that show rates at an R/VC ratio of 180% (the Board's

jurisdictional threshold for rate regulation) and 240%, which would result in a substantial increase in the trackage rights compensation level from the \$1.06 per car mile set in the TO to \$1.70 per car mile and \$2.68 per car mile, respectively. And these calculations assume that PAS's variable cost evidence was accurate, which Ms. Carey did not investigate. Since it is generally assumed that railroads must earn rates at least falling in this range to earn adequate revenues, it is almost certain that a rate needed to assure NECR the opportunity to earn adequate revenues would be much higher than the rate prescribed in the Decision.

VI. The Board should reconsider several non-rate decisions.

In addition to the inadequate trackage rights fee payable to NECR, the Board materially erred in denying NECR the benefit of standard contractual provisions and protections in the TO.

As a threshold matter, the Board's failure to retroactively apply the prescribed rate as initially agreed to by the parties, especially in light of the Board's determination that the old rate denied NECR adequate revenues, was arbitrary and capricious and in violation of the Board's mandate. Despite recognizing that the trackage rights fee was too low, the Board continued to allow PAS to be subsidized by NECR for longer than was necessary.

The Board also failed to recognize the economic impact of including off-market indemnification and insurance provisions in the TO. If the Board is to satisfy its mandate, there should be no circumstance in which NECR bears additional risk or expense that it would not have faced absent PAS's operations on the Line. The indemnification and insurance provisions proposed by NECR would have accomplished this goal. It is not inconceivable to envision a significant incident on the Line involving hazardous materials transported by PAS, where the associated damages exceed PAS's assets and insurance coverage. In that circumstance, NECR will be left to cover this exposure under the current TO. To protect itself, NECR must therefore

buy additional insurance that further increases NECR's variable costs, and thereby exacerbates the subsidy that PAS already enjoys.

Further, to allow PAS to extend its preferential rates to any connecting carrier through the provision of haulage would require not only that the Board consider the competitive impact of the trackage rights fee on traffic on the Line, but also that it extend the analysis to consider the traffic of connecting carriers to ensure that NECR is adequately compensated. While NECR would concede that cars can be interchanged (through a switch) into PAS's account and then moved over the Line in exchange for the trackage rights fee, PAS should not be able to haul cars or trains on behalf of other carriers, thereby extending PAS's advantage to connecting railroads.

Last, the 20-year term set forth in the TO has no relationship to market reality and should be revised to a term no longer than 10 years to be consistent with the Board's mandate. To the extent there is no change in the market conditions over the proposed 10-year term, the TO would not be reopened. However, precluding a reopening for 20 years could be significantly detrimental to the railroads and customers on the Line in the event NECR is unable to earn adequate returns. In any event, it is customary for economic provisions to be reopened in the event of a substantial change in circumstances. In addition, the escalator set forth in the TO is unduly burdensome, complex, and ambiguous, such that it will be difficult for NECR and PAS to implement.

For the reasons set forth above, NECR requests the Board reconsider its Decision with respect to these TO provisions.

VII. Next Steps

Finally, NECR endorses the process recommended by Ms. Carey for the Board to follow upon deciding to reconsider the unlawful Decision.

Conclusion

The Board should reconsider and modify the Decision to remedy the errors identified in the Petition.

Respectfully submitted,

/s/ Paul A. Cunningham
Matthew W. Ludwig
HARKINS CUNNINGHAM LLP
1700 K Street, N.W., Suite 400
Washington, D.C. 20006-3804
(202) 973-7600

Counsel for New England Central Railroad, Inc.

December 6, 2017

PUBLIC VERSION

BEFORE THE
SURFACE TRANSPORTATION BOARD

Docket No. FD 35842

NEW ENGLAND CENTRAL RAILROAD, INC.
—TRACKAGE RIGHTS ORDER—
PAN AM SOUTHERN LLC

VERIFIED STATEMENT OF JULIE M. CAREY

TABLE OF CONTENTS

I.	INTRODUCTION AND SUMMARY OF OPINIONS	1
II.	ECONOMIC PRINCIPLES GOVERNING THE DERIVATION OF INTEREST RENTAL COMPENSATION.....	4
III.	THE CAPITALIZED EARNINGS (“CE”) APPROACH CANNOT DETERMINE THE ECONOMICALLY RELEVANT COSTS FOR THE TRACKAGE RIGHTS FEE IN THIS CASE AND THE APPLICATION OF CE WAS FLAWED	6
	A. CE is not an Economically Sound Approach for this Case.....	6
	B. Even if Deemed a Legitimate Approach, the Application of CE in this Case was flawed	8
IV.	INDICATORS THAT THE PRESCRIBED RATE IS TOO LOW	11
V.	REVENUE ADEQUACY CONSIDERATIONS	13
VI.	REPLACEMENT COST IS THE TOUCHSTONE OF RELIABLE ECONOMIC EVIDENCE AND A REASONABLE ESTIMATE OF RCNLD IS THE BEST AVAILABLE INDICATOR OF REPLACEMENT COST.....	14
VII.	OTHER ISSUES IDENTIFIED IN THE RECORD	18
	A. Another Potential Approach to Test the Reasonableness of the Fee.....	18
	B. Term of Agreement.....	19
VIII.	CONCLUSIONS	20

PUBLIC VERSION
BEFORE THE
SURFACE TRANSPORTATION BOARD

Docket No. FD 35842

NEW ENGLAND CENTRAL RAILROAD, INC.
—TRACKAGE RIGHTS ORDER—
PAN AM SOUTHERN LLC

VERIFIED STATEMENT OF JULIE M. CAREY

I. INTRODUCTION AND SUMMARY OF OPINIONS

My name is Julie M. Carey. I am an economist and Director with National Economic Research Associates, Inc. (“NERA”). I routinely provide expert evidence before regulatory agencies, including the Surface Transportation Board (“STB” or the “Board”), in commercial disputes in arbitrations, and before state and federal courts. I have over 20 years of experience addressing economic issues in the energy and transportation sectors. I have worked on numerous rate reasonableness disputes before the STB by providing economic evidence regarding stand-alone costs and future expectations of volume, revenue and rates. I also routinely work on many other cases in which I provide consulting and testifying expert services involving railroad rates, traffic, economic damages, valuation, and other economic analyses within regulatory and commercial disputes associated with transportation and other regulated and unregulated industries.

Besides my economic consultancy practice, I am an Adjunct Professor at Georgetown University, where I teach energy economics in the graduate economics program, which includes

instruction on the economics and regulation of railroad transportation. My Curriculum Vitae is attached as Exhibit 1.

I was retained by Harkins Cunningham LLP on behalf of the New England Central Railroad, Inc. (“NECR”) to review the STB’s decision in Docket No. FD 35842 (the “Decision”) and the economic evidence submitted by the parties within that proceeding. This case involves the compensation to be paid by Pan Am Southern LLC (“Pan Am” or “PAS”) for using trackage rights on certain segments of rail line owned by NECR (“Line”). I was asked to review the Decision and the economic evidence in the record and conduct an economic evaluation regarding the evidence and the Board’s determination. I discuss economic aspects of ratemaking, including traffic revenue, volumes and rates, and other related transportation and economic issues.

As I discuss in more detail below, from the perspective of economics, several aspects of the analyses underlying the STB’s decision regarding the compensation for PAS’s use of NECR’s tracks contradict basic principles.

Most important, the Board’s determination of the capital recovery portion of the trackage fee, which the Board calls the interest rental component (“IRC”),¹ is materially inconsistent with sound economic principles, which precludes NECR from earning adequate revenues on the assets used by PAS. The capitalized earnings (“CE”) approach that was applied by the STB, even when properly applied, does not appropriately measure the capital costs of the Line that must be recovered, along with cost of capital, if rail service on the line is to be sustained. As a result, the STB’s CE analysis and its resulting trackage rights fee does not and cannot ensure that NECR

¹ I refer to the interest rental factor, IRC, interest rental component, or interest rental compensation interchangeably throughout my Verified Statement.

will be compensated in a manner consistent with revenue adequacy requirements, nor does it place PAS, as the tenant carrier, in the shoes of NECR, as required.

There is only one independent and objective measure--a cost based measure--of an appropriate economic value of the NECR track segments that is available on the record to inform the appropriate trackage rights compensation level. That objective measure is the reconstruction cost new less depreciation ("RCNLD"). RCNLD is an objective and standard methodology already used for ratemaking by the STB. RCNLD evidence is already in the case record and could have (and should have) been used by the STB to determine the reasonable trackage rights fee to compensate NECR for PAS's use of its tracks. In the Decision, the Board deemed the Value in Place ("VIP") measure inappropriate because it did not equate to one of the methods set forth in the historic SSW methodology; the only remaining viable method was the RCNLD. RCNLD provides an estimate of the cost to duplicate the railroad assets in their present position and assuming the parties would build the asset today to serve existing traffic. As discussed below, an interest rental component based on a legitimate RCNLD measure of the value of the tracks would be substantially higher than the value the STB prescribed. The Board has relied on replacement costs as the appropriate economic measurement to use in ratemaking. RCNLD is a reasonable proxy for replacement costs and generates the proper economic measure of costs, if technology has not changed materially since the line was constructed.

I recommend that the Board reconsider its failure to use the appropriate economic costs measure for determining the trackage rights fee. I also recommend that the Board recognize that a cost-based measurement is the only reliable approach to develop an economically appropriate trackage rights fee to ensure that NECR earns adequate revenues on the assets used by PAS. There is an independent and objective analysis of the NECR RCNLD from Duff and Phelps in

the record that can be used to develop an appropriate trackage rights fee. If the Board discovers gaps in the data, it could request the parties to supplement the record as needed. This approach would ensure that the Board has all necessary inputs and other information to develop a reliable trackage rights fee to ensure that NECR earns adequate revenues on the assets used by PAS.

II. ECONOMIC PRINCIPLES GOVERNING THE DERIVATION OF INTEREST RENTAL COMPENSATION

In this section I outline the economic principles that apply to the calculation of the interest rental compensation due from a tenant to a landlord railroad.

The central economic issue in this dispute is the interest rental compensation² necessary to ensure that a landlord railroad can earn an economically appropriate contribution to capital and a return on its capital, which I understand is required by statute.³ The tenant using the landlord's tracks should make a proportional payment for track that it uses (instead of the landlord absorbing all costs) and should also provide the landlord a return on its invested capital. The tenant should make the payment that the landlord would otherwise need to earn from shippers in the absence of the tenant. This approach places the tenant in the exact same economic position in which the landlord would otherwise be situated (*i.e.*, it places the tenant in the landlord's shoes).⁴

² The term "interest rental component" or interest rental factor is a misnomer since it's not merely a return on debt as the name suggests. The interest rental component should include a capital component and the economic return on this capital. The Board described it as "[a]n interest rental component designed to compensate the owning carrier for the tenant carrier's use of its capital dedicated to the track." Decision at 10.

³ 49 U.S.C.S. § 10704(a)(2); *see also id.* at § 10101(3) (a principal policy in regulating the railroad industry is "to promote a safe and efficient rail transportation system by allowing rail carriers to earn adequate revenues").

⁴ Even if the trackage rights fee is corrected and the cost-based measure is used, since an average price is used for the trackage fee, it precludes differential pricing in instances that would otherwise be possible (without average pricing). Consequently, the resulting total

The importance of this economic concept can also be understood by considering the economic contribution expected from a shipper as compared to a tenant railroad. One can think about the tenant railroad as replacing the landlord's existing shipper. A shipper's contribution to capital and the tenant railroad's contribution to capital must be the same in order to ensure that the landlord remains in the same exact economic position irrespective of the tenant. If a tenant railroad does not have to contribute to capital and return, the landlord will be underpaid relative to its economic position in serving the shipper. Underpayment by the tenant railroad to the landlord has two material effects. First, it creates an unfair competitive advantage for the tenant over the landlord such that a level playing field will not exist. Second, the landlord railroad will under-recover the necessary capital contribution and return, with the result that its revenues will be inadequate (*i.e.*, too low) as long as the inadequate fee is in place. This is uniquely critical on short lines with generally smaller traffic bases with lighter density and smaller local customers. Absent proper compensation, the line cannot be maintained for public use.

Whether the capital recovery and return portion of a trackage rights fee provides an adequate opportunity to earn adequate revenues cannot be based on the market value of an asset unless the market valuation is predicated on a revenue stream that provides adequate revenues. Otherwise, since the market valuation is intended as the basis for determining adequate revenues, this process is circular.

For all these reasons, the only evidence of record that is indicative of an objective cost measure is RCNLD evidence. While PAS conditionally proposed RCNLD less economic obsolescence, that measure is inappropriate for the same basic reasons as the CE approach. The

revenue is below what it should be even if the trackage rights fee is corrected because many shippers can't pay the average price.

proposed RCNLD less economic obsolescence is not an independent and objective measure of replacement cost. Economic obsolescence, like CE and other income stream valuation approaches, is linked to current or expected revenues to calculate market value – value which in this case is constrained by the old trackage fee – rather than the cost of replacing the asset that the railroad requires to maintain service in the public interest.

With the record at hand, RCNLD remains the only plausible path to assess the IRC. RCNLD is the only reasonable approximation for replacement costs on the record that can ensure that the landlord railroad can earn an economically appropriate contribution to and return on capital.

III. THE CAPITALIZED EARNINGS (“CE”) APPROACH CANNOT DETERMINE THE ECONOMICALLY RELEVANT COSTS FOR THE TRACKAGE RIGHTS FEE IN THIS CASE AND THE APPLICATION OF CE WAS FLAWED

In this case, using any CE valuation approach to determine the economically relevant costs is inherently inconsistent with economic principles and logic. Even if it were not, the Board’s approach to applying a CE approach to derive the interest rental component of the trackage rights fee did not comply with the economic logic that governs the proper use of the CE approach.

A. CE is not an Economically Sound Approach for this Case

The CE approach cannot produce the objective economic cost required to determine an IRC that will provide the landlord an opportunity to earn adequate revenues.

The CE valuation approach is not designed to approximate the economic cost of an asset. Rather, it is a simplified version of the income approach to valuing an asset based on the

expected future earnings of the asset.⁵ The CE method truncates the traditional discounted cash flow (“DCF”) method of analyzing a stream of expected earnings over time, so that the CE method analyzes expected economic benefits for a single, relatively short period. While both the CE and DCF methods use forward-looking expectations for future earnings, the CE method measures value based on a representative future time period (*i.e.*, a single year), and is a less comprehensive measure than DCF, which typically forecasts 20 years into the future.⁶ The CE approach relies on a capitalization rate to derive the present value of earnings. The capitalization rate must also capture expected long-term growth in earnings and the risks associated with future earnings over time.⁷

As discussed in the previous section, the interest rental compensation must ensure that a landlord railroad can earn an economic contribution to capital and an economic return on its capital. The measure of market value used in the CE approach does not approximate replacement cost as required by the statute in a manner consistent with the STB’s general practice. The income approach can never approximate replacement costs because the method is circular. The income approach uses the expected revenues to determine the market value, whereas an analysis that computes the “required, adequate earnings” is derived from the development of the replacement costs.

⁵ Shannon P. Pratt et al., *Valuing a Business: The Analysis and Appraisal of Closely Held Companies* 59 (2008) (citing Bonbright, *Valuation of Property* 249-250) (“Pratt 2008”).

⁶ Pratt 2008 at 238-239.

⁷ *Id.* at 240-241; Shannon P. Pratt, *The Market Approach to Valuing Businesses* 245 (2005). See also Shannon P. Pratt, *The Income Approach—Estimating the Cost of Capital*, in *The Handbook of Advanced Business Valuation* 3, 6 (Robert F. Reilly & Robert P. Schweihs ed., 2000)

B. Even if Deemed a Legitimate Approach, the Application of CE in this Case was Flawed

Even if it were possible to use a legitimate CE approach, the STB's approach underlying the Decision was improperly applied in numerous other ways that necessitate reconsideration. The most egregious of the Board's errors are discussed below.

In general, the Board's CE analysis was predicated on the existing revenues, which were constrained by the legacy PAS trackage rights fee, which the Board determined was too low. As a consequence, the CE analysis made a circular application of the old, too low, trackage rights fee to determine a new fee, which is preordained to be too low. Accordingly, the STB's trackage rights fee will not even provide NECR with a proper compensation level consistent with an independent and objective market value of the tracks. The effect of the Board's CE analysis was to capitalize a revenue stream it recognized and deemed inadequate.

More specifically, first, the STB's approach was not based on an independent and objective measure of the market valuation of the track, a critical requirement to assure that the market valuation determined is not circular. Instead, the STB relies on historical NECR revenues (and an extrapolation to estimate PAS revenues) that are constrained directly or indirectly by the competitive pressures imposed by the old trackage rights fee.⁸ This is because the PAS fees serve as a benchmark price to the majority of the carloads underlying the revenue on the NECR line because approximately 70% of NECR's traffic over its line is subject to

8 [REDACTED]

competition with PAS (as discussed in the Verified Statement of Edward Foley (“Foley VS”)). The revenue stream used is therefore inherently circular and incapable of indicating either the market value of the line or the appropriate cost-based trackage rights compensation.

To better understand the competitive dynamic and the impact of an artificially depressed trackage rights fee on NECR’s traffic and revenues, consider the following. If a customer knows of a lower market rate than NECR offers (and the lower rate exists because of the artificially depressed trackage rights fee), the customer has the economic incentive to use the lower rate as a bargaining tool to force NECR to cede a lower rate to keep the business. If NECR does not agree to the lower price, the customer is likely to walk away from NECR and seek rail service from PAS, who can offer a lower rate because of the artificially depressed trackage rights fee. The net effect is that the vast majority of NECR traffic (■■%) is affected by the old trackage rights fee.⁹ Thus, even if market value rather than cost were the relevant issue, the STB must not rely upon the revenues and earnings constrained by the legacy PAS trackage fee to determine a new fee based on the market value of the tracks.

There are additional reasons that the STB’s CE approach is economically unreliable. Further evidence in the record supports the conclusion that the STB’s CE analysis is flawed because it assumes no growth in traffic. The CE analysis assumes a constant annual income stream in perpetuity—without accounting for any future changes or growth in future expected income. To the extent that future changes are expected to occur, the discount rate must be adjusted for changes in growth to derive a direct capitalization rate.¹⁰ Recent historical trends in

⁹ The amount of competitively served traffic is discussed in the Foley VS.

¹⁰ Pratt 2008 at 245-246. This is not addressed by the STB. When earnings are expected to be stable or grow evenly, both the DCF and CE methods produce similarly accurate results. However, if changes in income flow are uneven (but predictable) or there is a high level of expected growth in the short-term, DCF is the more appropriate method. *Id.*

traffic for NECR indicate a potential for changes to traffic volumes in the future. Specifically, NECR's total car miles on the Line increased by approximately █% during the 2014 to 2016 period, from █ to █ car miles, according to the Foley VS. Significant investment in NECR, and road congestion, suggest that market share of transportation needs, and therefore traffic, should continue to grow. The effect of failing to account for growth results in an understated trackage rights fee.

In addition, the Board's calculation of the interest rental component and its use of the weighted average cost of capital ("WACC") contradict economic logic. The interest rental component is supposed to compensate the landlord for the cost of capital for its investment. However, in the STB's CE approach the interest rental component is unaffected by the specific WACC assumed as an input into the interest rental component of the trackage rights fee calculation. While the STB relies on a 14.77% pretax WACC in the CE calculation (for both the capitalization rate and the discount rate) for the interest rental component derivation, revising the WACC input (to 12.24% or another figure) results in no change to the interest rental component.¹¹ This demonstrates an inherent flaw with the Board's methodology since the interest rental component compensates the landlord for the cost of capital of its investment. Simply put, the rate should change if the cost of capital to the railroad decreases or increases. It is implausible and economically inappropriate for the interest rental component to remain unchanged as it does in the STB's Decision, and even more concerning that the trackage rights fee is expected to be in place for 20 years.

11 █

IV. INDICATORS THAT THE PRESCRIBED RATE IS TOO LOW

As I discuss below, there are several common indicators that the STB's prescribed trackage rights fee for PAS's use of NECR's railroad is materially too low.

Evidence in the record supports the conclusion that the prescribed rate is too low because substantial traffic has been diverted to PAS and away from NECR in recent years. By way of example, PAS's share of traffic volumes on the Line increased from █% in 2012 to █% and █% in 2014 and 2016, respectively.¹² This supports my conclusion that the trackage rights fee is artificially depressed and that PAS has received an unfair competitive advantage. If the trackage rights fee is artificially depressed, substantial NECR revenues will also be too low because the STB trackage rights fee is erroneously based on the capitalized value of those revenues through the CE methodology.¹³

To illustrate how low the prescribed rate is, I calculated, based on record evidence, revenue to variable cost ("RVC") ratios to compare the RVCs of the STB prescribed rate to ratios commonly used in STB rate regulation. According to data in this record, the RVC ratio of the NECR traffic for the Line underlying the STB trackage rights fee yields a RVC ratio well below the jurisdictional threshold of 180%.¹⁴ This comparison provides further economic indicia that the rate is too low and NECR is under-earning on its investment. It is certain to be below the level for which the STB has authority to regulate rates to shippers.¹⁵

¹² See Foley VS at 2.

¹³ In fact, certain movements observe revenues less variable cost. █

¹⁴ █

¹⁵ "The Board is precluded from finding market dominance if the revenues produced by a challenged rate are less than 180% of the carrier's variable costs of providing the service."

To develop these ratios, I restated the NECR earnings used to extrapolate the PAS earnings on each segment to determine the STB trackage rights fee compensation calculations.¹⁶ I updated the NECR earnings for each segment used in the trackage rights fee calculation to rely on revenue levels that yield a RVC ratio equal to 180%. These inputs are used in the work papers that were used in the STB trackage rights analyses, and were available for the Board to review.¹⁷ The STB calculations use the NECR earnings in the CE valuation calculation so an increase positively impacts the interest rental payment. According to this economic analysis, the trackage rights fee would increase from \$1.06 per car mile to [REDACTED] per car mile, assuming revenues are based on an RVC equal to 180%.¹⁸

Additional case precedent indicates higher RVC ratios are potentially reasonable, beyond the jurisdictional threshold of 180% and at least as high as 240%.¹⁹ A higher RVC for trackage service may be reasonable and appropriate if needed for the trackage rights fee to put the tenant carrier (PAS) in the shoes of the landlord (NECR) so that the tenant is unable to undercut NECR on account of PAS being subsidized with a too low trackage rights fee. I updated the NECR

Major Issues in Rail Rate Cases, Docket No. EP 657 (Sub-No. 1), slip op. at 6 (STB served Oct. 30, 2006) (citing 49 U.S.C. 10707(d)(1)(A)).

¹⁶

¹⁷

¹⁸

To conduct this analysis and the other analyses discussed herein, I accepted the variable cost, revenue by segment and other data in the record developed by other parties. I did not seek to go behind to evaluate the assumptions.

¹⁹

W. Fuels Ass'n, Inc. and Basin Elec. Power Coop. v. BNSF Ry. Co., Docket No. 42088, slip op. at 2 (STB served Feb. 18, 2009).

earnings for each segment used in the trackage rights fee calculation to rely on revenue levels that yield a RVC ratio equal to 240%. According to this economic analysis, the trackage rights fee would increase from \$1.06 per car mile to [REDACTED] per car mile, assuming revenues are based on an RVC equal to 240%.²⁰

From these figures, I conclude the compensation level required for NECR to earn adequate revenues is substantially higher than the \$1.06 rate prescribed by the STB.

V. REVENUE ADEQUACY CONSIDERATIONS

Under the Staggers Act and the Coal Rate Guidelines (the “Guidelines”),²¹ the railroad industry has substantial freedom to set prices due to the recognition that differential pricing based on market demand conditions is economically appropriate in network industries (referred to as constrained market pricing). Pricing freedom enables railroads to develop rates based on market conditions (*i.e.*, what the market will bear) except under certain circumstances, as discussed below. A goal of the regulatory construct was to ensure revenue adequacy for the railroads so that the carriers might become (and remain) financially sound. The construct was also designed to promote economic efficiency with necessary safeguards included to prohibit excessive charges.²²

While relying substantially on market forces to constrain railroad transportation rates, STB rate regulation comes into effect when a shipper faces a combination of circumstances

²⁰ To conduct this analysis and the other analyses discussed herein, I accepted the variable cost, revenue by segment and other data in the record developed by other parties. I did not seek to go behind to evaluate the assumptions.

²¹ *Coal Rate Guidelines, Nationwide*, 1 I.C.C. 2d 520 (1985).

²² The revenue adequacy constraint ensures that a captive shipper will “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.” *Coal Rate Guidelines*, 1 I.C.C. 2d at 535-536.

including: (1) market dominance, and (2) a challenged rate over 180% of RVC ratio that exceeds the price that a stand-alone hypothetical least-cost most-efficient railroad would charge in a contestable market. Under these circumstances, a shipper can contest the reasonableness of the railroad rate. Rate relief will be provided to such shippers, upon a demonstration that rates are higher than necessary because of inefficiencies in the pricing practices, investments or operations of the carriers.

Since the STB's trackage rights fee that NECR earns from PAS's use of its tracks represents no objective measure of the economic cost of the track, the STB cannot be assured that NECR is earning adequate revenues. Another measure is required.

VI. REPLACEMENT COST IS THE TOUCHSTONE OF RELIABLE ECONOMIC EVIDENCE AND A REASONABLE ESTIMATE OF RCNLD IS THE BEST AVAILABLE INDICATOR OF REPLACEMENT COST

There is only one independent and objective measure, a cost-based measure, of an appropriate economic value of the NECR track segments that is available on the record to inform the appropriate trackage rights compensation level. It is RCNLD. RCNLD is an objective and standard methodology used for ratemaking by the STB.²³ RCNLD evidence is in the case record and could have been used by the STB to determine the reasonable trackage rights fee to compensate NECR for PAS's use of its tracks. RCNLD provides an estimate of the cost to duplicate the railroad assets in their present position and assuming the parties would build the asset today to serve existing traffic. As discussed below, an interest rental component based on a legitimate RCNLD measure of the replacement cost of the tracks would be substantially higher

²³ "The principal objective of the SAC [stand-alone cost] constraint is to restrain a railroad from exploiting market power over a captive shipper by charging more than it needs to earn a reasonable return on the replacement cost of the infrastructure used to serve that shipper." *Simplified Standards for Rail Rate Cases*, Docket No. EP 646 (Sub-No. 1), slip op. at 13 (STB served Sep. 5, 2007).

than what the STB prescribed. Historically, the Board has concluded that replacement costs are the appropriate economic measurement to use in ratemaking. RCNLD is a reasonable proxy for replacement cost, which is the proper economic measure of costs, if technology has not changed materially since the line was constructed.

A railroad rate based on the reconstruction costs provides an objective standard for ratemaking routinely used by the Board. RCNLD is an acceptable approach to measure replacement costs. An independent assessment of the RCNLD of NECR was conducted in connection with Genesee & Wyoming Inc.'s ("G&W") 2012 acquisition of RailAmerica (which included the acquisition of the NECR). In order to comply with acquisition accounting and Generally Acceptable Accounting Principles, Duff and Phelps conducted an analysis of the RCNLD of NECR.²⁴ In Table 1 below, I show the RCNLD quantified by Duff and Phelps for the NECR, which approximates \$ [REDACTED].²⁵ I also calculate an estimated RCNLD for the Line based on a mileage proration which yields approximately \$ [REDACTED] of value attributed to the Line.²⁶ This cost-based measure can be used to develop the appropriate trackage rights compensation, as discussed below.

While I rely exclusively on the RCNLD cost-based measure to develop the appropriate trackage rights compensation for PAS's use of NECR's railroad assets, I recognize that Duff and Phelps also quantified a fair market value by making an adjustment to RCNLD to account for

²⁴ Genesee & Wyoming Inc. Determination of the Fair Value and Remaining Useful Life of Certain Identifiable Tangible and Intangible Assets of RailAmerica, Inc. as of October 1, 2012, Duff and Phelps (Nov. 14, 2013) ("Duff and Phelps").

²⁵ Duff and Phelps at Exhibit 2.25. Excludes rolling stock; RCNLD is apportioned to each segment based on the proportion of miles to the total system.

²⁶ The RCNLD developed by Duff and Phelps is higher than the VIP estimates proposed by NECR in the opening evidence.

economic obsolescence. This fair market value estimate (with the economic obsolescence adjustment) is not economically sound. This is because, as discussed above, an estimate of market value is not the cost-based measure required to ensure that NECR earns adequate revenues associated with the trackage rights fee.²⁷ Further the Duff and Phelps fair market value (RCNLD less economic obsolescence) is a circular application of the old, too low, trackage rights fee to determine expected cash flows in the future. Accordingly, the STB's trackage rights fee on the Line will not provide NECR with a proper compensation level consistent with an independent and objective assessment of the cost of the tracks.

27

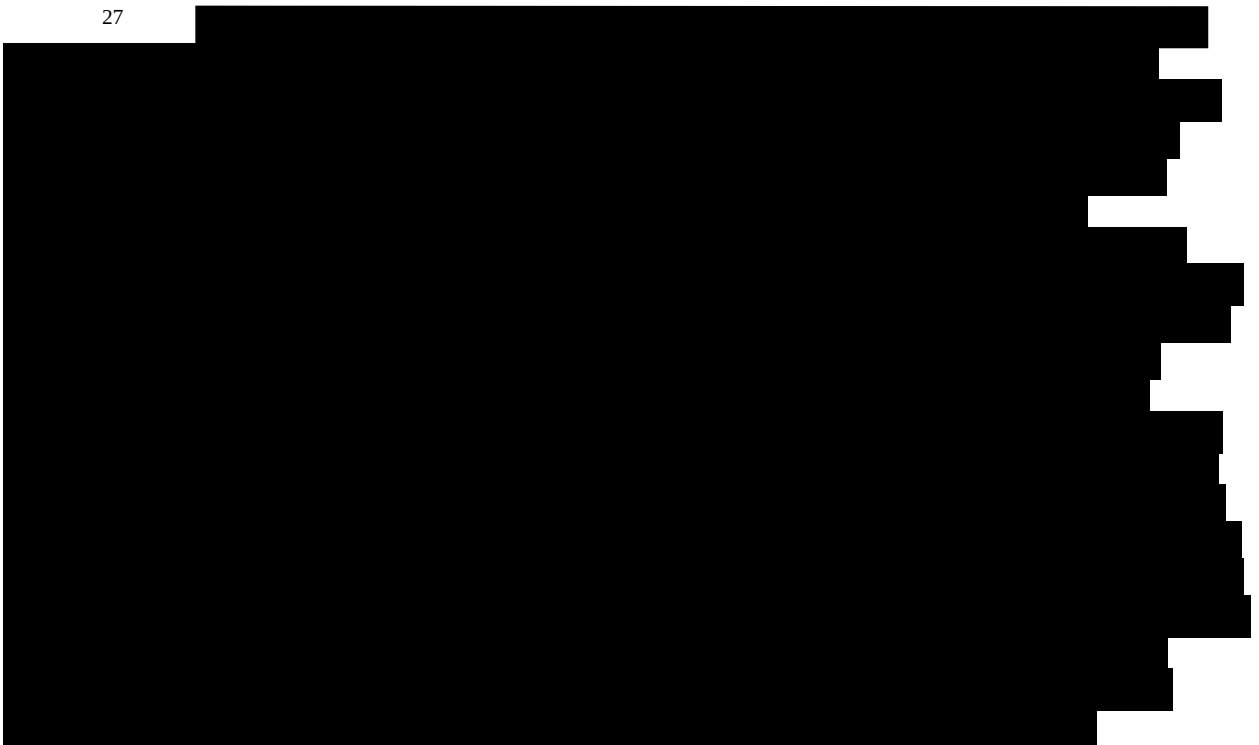


Table 1
Reconstruction Cost New Less Depreciation of the NECR and Segments
(\$ thousands)

	Miles	Proportion of Miles	Reconstruction Cost Less Depreciation-RCNLD
NECR	394.0	100.0%	
South Segment	10.6	2.7%	
Middle Segment	48.8	12.4%	
North Segment	13.4	3.4%	
Total Relevant Segments	72.8	18.5%	

I have quantified the interest rental component by using the RCNLD by Duff and Phelps for NECR as applied to the Line (as discussed above). Specifically, I determined the annual revenue requirement associated with the RCNLD that provides the return of and return on the investment. The revenue requirement accounts for the impact of cash flows over twenty years and taxable income impacts from both depreciation and taxable income associated with debt financing. I assumed a straight line depreciation schedule. I also assumed a capital structure consistent with the STB's most recent railroad industry WACC (along with G&W's consolidated tax rate) and consistent with the approach used by the STB in this matter. My approach to developing the interest rental component is economically consistent with the STB's methodology for quantifying the capital recovery component in the rate reasonableness disputes.²⁸ The STB's methodology develops a future annual capital requirement for railroad property adjusted for

²⁸ See *Total Petrochemicals & Refining USA, Inc. v. CSX Transp., Inc.*, Docket No. NOR 42121, slip op. at Appendix D, Tables D-1 and D-2 (STB served Sept. 14, 2016) (“TPI/CSX”); Opening Evidence of Total Petrochemicals & Refining USA, Inc. at Exhibit III-H-1, Table I, TPI/CSX (filed Feb. 18, 2014) (“TPI Opening”).

taxes to derive the required future cash flow associated with that capital requirement, which is converted to a present value.

Reliance on the Duff and Phelps RCNLD yields an interest rental component equal to \$ [REDACTED] per car mile as the necessary rate to recover the capital investment and return on that investment. The schedules and calculations underlying this analysis are presented in Exhibit 2. I also conducted a sensitivity analysis that excludes the grant monies and the appraised easement value objected to by PAS.²⁹ Adjusting the Duff and Phelps RCNLD to exclude the contested components yields an interest rental component equal to \$ [REDACTED] per car mile as the rate to recover the capital investment and a return on that investment.³⁰

VII. OTHER ISSUES IDENTIFIED IN THE RECORD

In this section I address a few remaining points.

A. Another Potential Approach to Test the Reasonableness of the Fee

Another approach that could have been used to test the reasonableness of the trackage rights fee would have been a stand-alone cost analysis. The SAC test relies on a hypothetical least cost, most efficient railroad as the economic standard applied to evaluate the reasonableness of railroad rates. It specifically utilizes a DCF analysis and compares the revenues of the stand-alone railroad to the costs (capital and operating costs). This approach would allow the STB to determine the rate and revenue level required to ensure that the trackage rights fee provides

²⁹ [REDACTED]

³⁰ At this time, I am not opining as to whether it is economically appropriate to make these adjustments. I accepted at face value the data in the record and did not seek to go behind to evaluate the assumptions. Rather, my analysis is included to demonstrate the impact.

compensation consistent with the hypothetical least cost, most efficient railroad.³¹ In this case, the trackage rights fee is reported for separate components, including: interest rental fee, variable dispatch and maintenance expense. The SAC methodology incorporates all three components along with other operating costs, and reports the capital requirement for the railroad separately from the operating expenses.³²

Absent evidence that there is a significant likelihood of a materially different outcome using a SAC test from the outcome using a legitimate RCNLD approach, there would appear to be no need to use the SAC approach here. And I saw nothing in the record that would suggest such a materially different outcome, at least not one that PAS would be likely to support.

B. Term of Agreement

It is a very dynamic time period within the railroad transportation industry. A 20-year locked term before either party can renegotiate the compensation level does not enable the parties to address changing economic circumstances. Substantial changes have occurred since this agreement went into place. Customer agreements today are seldom if ever made for that long of a term, and we expect shorter terms in the future throughout the industry. Indeed, a ten-year term is a very long time period in the current market climate to assume no changes to the economic circumstances will occur from the current state of the world. Technological change is also accelerating, which could impact all modes of transportation over a twenty and ten year interval. PAS is unlikely to enter customer agreements for more than five years because neither

³¹ Most cases that utilize a stand-alone cost analysis involve shipper rate disputes. In these cases there are primarily independent market rates determined by negotiations between the railroads and shippers which comprise a substantial portion of the SARR traffic volumes and revenue. In these instances the stand-alone cost test provides an independent check on the reasonableness of the rate instead of determining what the appropriate rate should be.

³² *TPI/CSX* at Appendix D, Tables D-1 and D-2; *TPI Opening* at Exhibit III-H-1, Table I.

party will believe that the economic circumstances are static. Consequently, it is reasonable to establish rates only for a period of ten years or less under these circumstances, and any term should be qualified by incorporating an additional provision to allow a reopener based on materially changed circumstances.

VIII. CONCLUSIONS

It is my opinion that the CE approach as applied by the Board is economically unreliable because it is not a cost-based measure. It is also circular because of reliance on the critical input based on the old trackage rights fee as opposed to an independent market rate.

The result of these flaws is that the trackage rights compensation deemed to be payable by PAS to NECR set forth in the Decision is too low.

PUBLIC VERSION
BEFORE THE
SURFACE TRANSPORTATION BOARD

Docket No. FD 35842

NEW ENGLAND CENTRAL RAILROAD, INC.
—TRACKAGE RIGHTS ORDER—
PAN AM SOUTHERN LLC

VERIFIED STATEMENT OF EDWARD FOLEY

I am Edward Foley. Currently, I am employed by Genesee & Wyoming Railroad Services, Inc. as the Vice President, Marketing and Sales for the Northeast Region railroads of Genesee & Wyoming Inc., which includes the New England Central Railroad (“NECR”). I oversee corporate marketing, planning, and strategy for the NECR, which includes the trackage rights line segments over which Pan Am Southern LLC (“PAS”) operates and which are at issue in the above-referenced matter (the “Line”). I am familiar with NECR’s customers, revenue, and competition on the Line.

In light of the Board’s decision served October 31, 2017 (“Decision”), I was asked by counsel for NECR to identify what percentage of NECR traffic on the Line is subject to competition from PAS.

Based on my review and calculation, nearly █% of NECR’s traffic system wide and more than █% of NECR’s traffic on the Line, in car miles, was subject to competition from PAS in 2016. 2016 was a typical year in terms of traffic volumes and distributions across the three segments that encompass the Line. One indicium of PAS’s strength as a competitor is the

growth in PAS's market share. PAS's share of traffic on the Line has been increasing: total PAS car miles on the Line grew by a factor of [REDACTED], or approximately [REDACTED] percentage points, from 2012 through 2016. Total traffic on the Line has also increased in recent years: total car miles grew [REDACTED] percent from 2014 through 2016, from [REDACTED] to [REDACTED].

CERTIFICATE OF SERVICE

I certify that I have this 29th day of December, 2017, caused true copies of the foregoing letter to be served upon the parties listed below by email.

Eric R. Benson
Vermont Rail Systems
1 Railway Lane
Burlington, VT 05401
bensonpatentlaw@comcast.net

Jeremy R. Fischer
Drummond Woodsum
84 Marginal Way, Suite 600
Portland, ME 04101
jfischer@dwmlaw.com

Judge Steven A. Glazer
Federal Energy Regulatory Commission
888 First Street, NE
Washington, DC 20426
steven.glazer@ferc.gov

Eric M. Hocky
Clark Hill, Plc
One Commerce Sq.
2005 Market Street, Suite 1000
Philadelphia, PA 19103
ehocky@clarkhill.com

Victoria F. Sheehan
P.O. Box 483
Concord, NH 03302-0483
vsheehan@dot.state.nh.us

Robert B. Culliford
Pan Am Railways
1700 Iron Horse Park
North Billerica, MA 01861
rculliford@panam.com

Joe Flynn
Secretary
Vermont Agency of Transportation
One National Life Drive
Montpelier, VT 05633-5001
joe.flynn@vermont.gov

Chop Hardenbergh
Atlantic Northeast Rails & Ports
PO Box 357
Freeport, ME 04032
editor@atlanticnortheast.com

William A. Mullins
Baker and Miller PLLC
Suite 300
2401 Pennsylvania Ave, N.W.
Washington, D.C. 20037
wmullins@bakerandmiller.com

/s/ Spencer R. Leroux
