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

Re: STB Ex Parte No. 665 (Sub-No. 2) – *Expanding Access to Rate Relief*

Dear Ms. Brown:

Pursuant to the Advance Notice of Proposed Rulemaking served on August 31, 2016 in the above docketed proceeding, Norfolk Southern Railway Company respectfully submits the enclosed reply comments.

Sincerely,

A handwritten signature in black ink, appearing to read 'A. Thamodaran', written over a horizontal line.

Aarthy S. Thamodaran
Counsel for Norfolk Southern Railway Co.

Enclosures

**UNITED STATES OF AMERICA
SURFACE TRANSPORTATION BOARD**

STB Ex Parte No. 665 (Sub-No. 2)

EXPANDING ACCESS TO RATE RELIEF

**REPLY COMMENTS OF
NORFOLK SOUTHERN RAILWAY COMPANY**

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Dated: December 19, 2016

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

STB Ex Parte No. 665 (Sub-No. 2)

EXPANDING ACCESS TO RATE RELIEF

**REPLY COMMENTS OF
NORFOLK SOUTHERN RAILWAY COMPANY**

On November 14, 2016, Norfolk Southern Railway Company (“NS”) filed its opening comments (“Opening Comments”) in this proceeding to emphasize that the Surface Transportation Board (“STB” or “Board”) must maintain the sound economic principles of its rate regulatory regime, namely, demand-based differential pricing. NS described how the STB’s proposed fourth rate reasonableness methodology (“Proposed Test”) would directly threaten the railroads’ ability to engage in lawful and necessary differential pricing, thus compromising the financial health of the rail industry and minimizing the overall welfare of rail shippers. In its Opening Comments, NS also established that the STB’s existing rate regulatory regime is accessible to and cost-effective for shippers of all sizes; and, this conclusion is not altered by the fact that relatively few shippers find the need to bring rate cases, which merely serves as evidence that the STB’s rate regulatory regime is functioning properly and motivating railroads to offer reasonable rates to shippers.

NS now submits these reply comments, in the face of shipper comments designed to lead the STB down the path of disavowing differential pricing, as summarized in Section II below, in

order to provide the STB with additional clarity regarding the need to maintain the principles of differential pricing at the core of its rate regulatory regime. Differential pricing is consistent with sound economic principles as well as the STB's mandates from Congress. As the Proposed Test would directly violate the principles of differential pricing, it must be rejected. NS also joins in support of the reply comments filed by the Association of American Railroads.

I. Differential Pricing Is Necessary in the Rail Industry To Protect the Interests of Both Railroads and Shippers.

The STB's regulation of rail rates is guided by the economic principles of Constrained Market Pricing ("CMP").¹ CMP was designed to approximate Ramsey pricing.² Ramsey pricing is "a widely recognized method of differential pricing, that is, pricing in accordance with demand."³ Under Ramsey pricing, each price contains a markup over cost where such markup bears an inverse relationship to the customer's elasticity of demand. Put simply, a customer with a relatively higher demand elasticity (or greater price sensitivity) should receive a price with a smaller markup than a customer with a lower price sensitivity, and vice versa.

Ramsey pricing, as reflected in CMP, is required in the rail industry due to the industry's inherent structure. As explained by leading economist Dr. Robert Willig, the rail industry exhibits economies of scale, scope, and density because (1) the rail industry provides various services to different shippers with distinct demand profiles but (2) these various services are

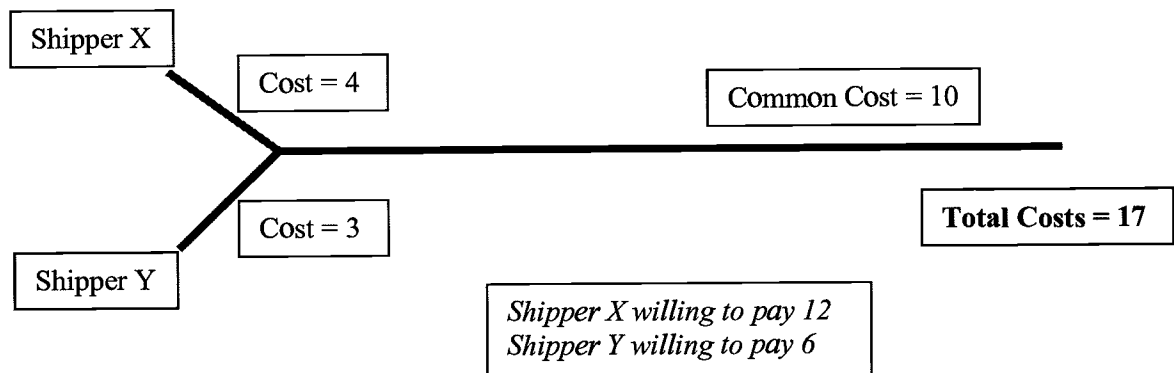
¹ See, e.g., *Coal Rate Guidelines, Nationwide*, Ex Parte No. 347 (Sub-No. 1), 1985 ICC LEXIS 254, at *19 (ICC served Aug. 8, 1985) ("*Coal Rate Guidelines*").

² See *id.* at *17-18 (concluding that it would not be practical to apply pure Ramsey pricing as a rail regulatory requirement given that Ramsey pricing is "based on a mathematical formula which requires both the marginal cost and the elasticity of demand to be quantified for every movement in the carrier's system"). See also Jeffrey R. Church and Roger Ware, *Industrial Organization: A Strategic Approach*, UNIVERSITY OF CALGARY, at 795 (2000) (describing that "Ramsey pricing rules provide useful principles for regulators interested in setting welfare-maximizing prices").

³ *Coal Rate Guidelines*, at *16.

linked, to some degree, by the substantial common costs incurred by the rail industry.⁴ For example, a railroad serves both Shipper X and Shipper Y using Track T.

As a result of these economies, if a railroad were to set prices equal to costs, it would not recover its total costs. Dr. Willig provides the following illustration to demonstrate this point:⁵



Under fully-allocated costing, Shipper X would receive a price of 9 and Shipper Y would receive a price of 8.⁶ Thus, fully-allocated costing would price Shipper Y out of the rail market, forcing Shipper Y to seek transportation via other modes. In turn, the railroad would be forced to choose between two evils: (1) recover its total costs from Shipper X with a price that exceeds Shipper X's willingness to pay, likely driving Shipper X out of the rail market; or (2) forgo recovery of its total costs with a price that falls within Shipper X's willingness to pay, likely driving the

⁴ Robert Willig, *The Role of Economic Theory in the "Deregulated" Rail Industry*, Presentation, Railroad Economics Symposium at McDonough School of Business (June 5, 2015). See also Jeffrey R. Church and Roger Ware, *Industrial Organization: A Strategic Approach*, UNIVERSITY OF CALGARY, at 55 (2000) (explaining the economies of scale in the rail industry, because "[n]o matter how small the volume of freight, shipment on a railway between Boston and New York requires a right-of-way, at least two rails, a locomotive, one rail car, and one engineer. Moreover, additional freight can be shipped (within limits) without having to expand the size of the right-of-way, the number of locomotives, or the number of engineers.").

⁵ Robert Willig, *The Role of Economic Theory in the "Deregulated" Rail Industry*, Presentation, Railroad Economics Symposium at McDonough School of Business (June 5, 2015).

⁶ *Id.*

railroad out of the rail market. Thus, applying fully-allocated costing to the rail industry “is contrary to the interests of both carriers and shippers.”⁷

In contrast, differential pricing seeks to maximize shipper welfare while allowing railroads to recover their total costs.⁸ Under demand-based differential pricing, Shipper X would receive a price of 11.5 and Shipper Y would receive a price of 5.5.⁹ The railroad benefits because it recovers its total costs without losing shippers, creating a sustainable operating environment. Shipper Y benefits because it clearly receives a lower price with differential pricing than with fully-allocated costing. Shipper X also benefits because it ultimately receives a lower price with differential pricing, as the railroad can now recover its total costs from *both* Shipper X and Shipper Y.¹⁰ As summarized by economist Ioannis Kessides, “[d]ifferential prices benefit all shippers, because lower prices for some shippers generate revenue that otherwise would have to be raised from those with the strongest demand for rail transportation.”¹¹

⁷ Ioannis Nicolaos Kessides, *Reforming Infrastructure: Privatization, Regulation, and Competition*, Policy Research Report, WORLD BANK, at 193 (2004).

⁸ See Jeffrey R. Church and Roger Ware, *Industrial Organization: A Strategic Approach*, University of Calgary (2000) (describing that “Ramsey prices maximize total surplus subject to a breakeven constraint”).

⁹ Robert Willig, *The Role of Economic Theory in the “Deregulated” Rail Industry*, Presentation, Railroad Economics Symposium at McDonough School of Business (June 5, 2015).

¹⁰ See, e.g., William J. Baumol and Robert D. Willig, *Pricing Issues in the Deregulation of Rail Rates*, in *Economic Analysis of Regulated Markets*, at 12 (J. Finsinger ed. 1983) (describing that differential pricing “principles result in lower prices for shippers generally by establishing a set of rates which encourages the purchase of more transportation services by more shippers than artificial fully distributed cost based pricing, thereby creating a larger traffic base over which unattributable costs can be apportioned”).

¹¹ Ioannis Nicolaos Kessides, *Reforming Infrastructure: Privatization, Regulation, and Competition*, Policy Research Report, WORLD BANK, at 193 (2004).

Thus, demand-based differential pricing is required by the underlying structure of the rail industry; and, differential pricing best protects the interests of both railroads and shippers. Accordingly, sound economic principles dictate that the STB's rate regulatory regime must continue to allow railroads to engage in differential pricing.

Preserving differential pricing in the rail industry also is consistent with the STB's mandates from Congress. The Staggers Act specifically "permitted the railroads to charge lower rates to their customers who operate in a competitive environment and higher rates to customers who are 'captive' to one railroad carrier for transportation service."¹² Similarly, the Rail Transportation Policy directs the STB "to allow, to the maximum extent possible, competition and *demand for services* to establish reasonable rates for transportation by rail."¹³ Most recently in the STB Reauthorization Act of 2015, Congress specified that rate reasonableness disputes, even those resolved in arbitration, must be resolved with "due consideration to the need for differential pricing."¹⁴ Thus, the principles of differential pricing must remain at the core of the STB's rate regulatory regime.

II. Substantially Expanded Comparison Group of the Proposed Test Directly Violates the Principles of Differential Pricing.

Any rate reasonableness methodology which proposes to compare the challenged rates against a comparison group represents only a crude approximation of CMP, as the STB itself has

¹² S. REP. NO. 114-52 at 1-2 (2015).

¹³ 49 U.S.C. 10101(1) (emphasis added). *See also* William J. Baumol and Robert D. Willig, *Pricing Issues in the Deregulation of Rail Rates*, in *Economic Analysis of Regulated Markets*, at 12-13 (J. Finsinger ed. 1983) (noting that "differential pricing is entirely consistent with the hallmark of deregulation: that market forces, rather than regulation, should control rates for transportation services").

¹⁴ 49 U.S.C. 11708(c)(3).

recognized.¹⁵ However, the Proposed Test is more than just crude. The Proposed Test would directly violate the sound economic principles of differential pricing by comparing the challenged rates against an inappropriate comparison group.

In their opening comments filed in this proceeding, a few shipper groups support the use of a substantially expanded comparison group in the Proposed Test. For example, the National Grain and Feed Association (“NGFA”) “do[es] not believe the Board should limit the initial comparison group only to rail traffic priced at or above the 180 percent of revenue-to-variable cost (R/VC).”¹⁶ Similarly, the Alliance for Rail Competition et al. (“ARC”) recommends including in the comparison group “traffic moving at R/VC percentages below 180,” “contract traffic,” and “non-defendant carrier rates.”¹⁷ ARC claims that “[w]hen more railroads, more commodities, more R/VC percentages (above and below 180%), and more mileages are available for comparison, railroads must look more closely at the reasonableness of their own pricing practices.”¹⁸

Reading between the lines, these shipper groups intend to use a substantially expanded comparison group in order to force railroads to price at economically sub-optimal levels. This myopic approach ignores the economic truth that lower rates for a select shipper do not necessarily maximize overall shipper welfare, as illustrated above in Section I. In fact, use of the substantially expanded comparison group, as envisioned by NGFA and ARC, directly threatens the railroads’ ability to engage in differential pricing, thus minimizing overall shipper welfare.

¹⁵ See, e.g., Simplified Standards for Rail Rate Cases, Ex Parte No. 646 (Sub-No. 1), 2007 STB LEXIS 516, at *108 (STB served Sept. 5, 2007)

¹⁶ Opening Comments of the National Grain and Feed Association and Other Interested Agricultural Parties, Ex Parte No. 665 (Sub-No. 2), at 14 (filed Nov. 14, 2016).

¹⁷ Opening Comments of Alliance for Rail Competition et al., Ex Parte No. 665 (Sub-No. 2), at 20-21 (filed Nov. 14, 2016).

¹⁸ *Id.* at 21.

In any comparison-based rate reasonableness methodology, it is critical to use a comparison group consisting of “rates that are truly comparable” in order to even crudely approximate CMP and preserve some degree of differential pricing.¹⁹ As NS explained in its Opening Comments, “Ramsey pricing principles would indicate that traffic with identical conditions and a common price elasticity (price sensitivity) would pay similar markups on variable cost.”²⁰ Thus, if the challenged traffic is judged against a comparison group which includes traffic with different transportation conditions and varying demand elasticities, the comparison group offers no meaningful insight as to the appropriate markup over cost for the challenged traffic. This improper comparison could result in an artificial reduction of rates—inconsistent with the sound economic principles of differential pricing.

The substantially expanded comparison group, as envisioned by NGFA and ARC, would include rates that clearly are not comparable to the challenged rates. Accordingly, as described in more detail below, this substantially expanded comparison group would severely distort the economic analysis as to the appropriate markup over cost for the challenged rates.

First, the comparison group must not consist of non-defendant carrier traffic. As illustrated above in Section I, differential pricing is a function of a particular railroad’s costs and revenue opportunities based on its specific network and business mix. For example, if Railroad A’s rates are compared against Railroad B’s rates, assuming Railroad B has more potentially captive traffic than Railroad A, *ceteris paribus*, Railroad A’s rates on its potentially captive traffic will be artificially reduced. Why? Because Railroad B has a larger base of potentially captive traffic, less differential pricing—less markup over cost, per rate—is needed to recover

¹⁹ *Id.* at 53.

²⁰ InterVISTAS Consulting Inc., *An Examination of the STB’s Approach to Freight Rail Rate Regulation and Options for Simplification*, at 49 (Sept. 14, 2016).

Railroad B's total costs. Comparing the challenged traffic to non-defendant carrier traffic thus interferes with the sound economic calculus of differential pricing.

Second, the comparison group must not consist of contract traffic. The STB has acknowledged that "it may be feasible for the parties to negotiate a contract which will leave both parties better off than at the Ramsey price."²¹ For example, as NS hypothesized in its Opening Comments, in exchange for a lower contract rate, a shipper may agree to provide the railroad with consideration in the form of a longer duration for such rate, volume commitments, and/or more favorable liability provisions. Common carrier rates lack any additional consideration flowing to the railroad; and, the lack of such consideration makes it economic to price only at the Ramsey price. Comparing the challenged traffic to contract traffic thus interferes with the sound economic calculus of differential pricing.

An accurate common carrier adjustment factor could mitigate this harm. NGFA misconstrues the STB's previous statement that "ideally, the Board would not accept a 'common carrier adjustment.'"²² Ideally, the Board would not accept a common carrier adjustment because the comparison group would exclude traffic moving under contract and consist only of truly comparable common carrier rates. In *U.S. Magnesium v. Union Pacific R.R. Co.*, the Board accepted a common carrier adjustment factor because: (1) insufficient waybill data warranted the inclusion of contract rates in the comparison group; and (2) such contract rates were, on average, substantially lower than the corresponding common carrier rates. Thus, to the extent the STB is

²¹ *Coal Rate Guidelines* at *18.

²² Opening Comments of the National Grain and Feed Association and Other Interested Agricultural Parties, Ex Parte No. 665 (Sub-No. 2), at 17 (filed Nov. 14, 2016) (citing *U.S. Magnesium v. Union Pacific R.R. Co.*, Docket No. 42114, at 18 (STB served Jan. 28, 2010)).

forced to include contract rates in a comparison group due to insufficient waybill data,²³ an accurate common carrier adjustment factor is the most practicable way to preserve some degree of differential pricing. Even if incorporating a common carrier adjustment factor “would build additional costs and complexity into future cases,” as NGFA laments,²⁴ this is not adequate justification to depart from sound economic principles.²⁵

Third, the comparison group must not consist of traffic moving at R/VCs below 180%. As described above in Section I, the key tenet of differential pricing is that R/VCs should inversely correlate to demand elasticity. Highly price-sensitive traffic should receive a lower markup over cost than less price-sensitive traffic. If the challenged rates with R/VCs above 180% are compared to rates with R/VCs below 180%, the challenged rates will be artificially reduced despite the relatively demand inelasticity of the challenged traffic. Comparing the challenged traffic to traffic moving at R/VCs below 180% thus interferes with the sound economic calculus of differential pricing.

In sum, the substantially expanded comparison group supported by some shipper groups would impermissibly interfere with the railroads’ ability to engage in lawful and necessary differential pricing, thus compromising the financial health of the rail industry and minimizing the overall welfare of rail shippers. In fact, use of this substantially expanded comparison group

²³ As noted in its Opening Comments, NS supports an expansion of the waybill sampling rate. *See, e.g.*, Opening Comments at 13.

²⁴ Opening Comments of the National Grain and Feed Association and Other Interested Agricultural Parties, Ex Parte No. 665 (Sub-No. 2), at 18 (filed Nov. 14, 2016)

²⁵ *See, e.g.*, Section 15(a)(3), Surface Transportation Board Reauthorization Act of 2015, PUB. L. NO. 114-110, 129 Stat. 2228 (requiring the STB to report only on alternative rate reasonableness “methodologies, which exist or could be developed, that are *consistent with sound economic principles*”) (emphasis added).

would represent a return, of sorts, to the rate equalization regime that reigned prior to the Staggers Act and that gravely threatened shippers' ability to obtain competitive rail service.

NS reiterates that the comparison group, in any comparison-based rate reasonableness methodology, must consist only of rates that are "truly comparable" in order to preserve some degree of differential pricing. Accordingly, an economically sound comparison group must consist only of defendant carrier traffic, common carrier traffic, traffic moving at R/VCs of at least 180%, traffic of the same commodity (using the most specific Standard Transportation Commodity Code), and traffic with other similar transportation conditions such as distance, volume, line type, equipment type, service level, time of year, and other handling characteristics.

Conclusion

For the foregoing reasons, NS again urges the STB to reject the Proposed Test. Consistent with Congress's directives, the STB's existing rate regulatory regime conforms to sound economic principles—albeit most strictly with the Stand-Alone Cost Test, less strictly with the Simplified Stand-Alone Cost Test, and most tenuously with the Three-Benchmark Test. In contrast, the Proposed Test would directly violate the sound economic principles of differential pricing by comparing the challenged rates to a substantially expanded comparison group that severely distorts the analysis as to the appropriate markup over cost.

Differential pricing remains necessary in the rail industry to allow railroads to recover their total costs while maximizing shipper welfare and to ensure the "continuation of a sound rail transportation system . . . to meet the needs of the public."²⁶ A reduction in rates for a particular shipper that lacks effective competition, where such reduction is not based on the sound economic principles of differential pricing, ultimately will result in higher rates for the remaining

²⁶ 49 U.S.C. 10101(4).

shippers that lack effective competition or will result in an unsustainable operating environment for railroads. Either outcome is inconsistent with the public interest and the STB's mandates from Congress.

Respectfully submitted,

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Dated: December 19, 2016