

SIDLEY AUSTIN BROWN & WOOD LLP

BEIJING
BRUSSELS
CHICAGO
DALLAS
GENEVA
HONG KONG
LONDON

1501 K STREET, N.W.
WASHINGTON, D.C. 20005
TELEPHONE 202 736 8000
FACSIMILE 202 736 8711
www.sidley.com
FOUNDED 1866

LOS ANGELES
NEW YORK
SAN FRANCISCO
SHANGHAI
SINGAPORE
TOKYO
WASHINGTON, D.C.

210306

WRITER'S DIRECT NUMBER
(202) 736-8538

WRITER'S E-MAIL ADDRESS
phemmersbaugh@sidley.com

March 15, 2004

By Hand Delivery

The Honorable Vernon A. Williams
Secretary
Surface Transportation Board
1925 K Street, N.W.
Washington, D.C. 20423-0001

ENTERED
Office of Proceedings
MAR 15 2004
Part of
Public Record

MAR 15 2004
RECEIVED

Re: STB Docket No. 42069, Duke Energy Corp. v. Norfolk Southern Railway Co.

Dear Secretary Williams:

Enclosed for filing on behalf of Norfolk Southern Railway Company ("NS") in the above-referenced proceeding are a signed original and ten (10) copies of Defendant Norfolk Southern Railway Company's Reply to Complainant's Petition for Reconsideration ("Petition"). Additionally, this filing includes three (3) floppy disks containing electronic versions of the Petition.

Please acknowledge receipt of this submission for filing by date-stamping the enclosed duplicate paper copy and returning it to our messenger.

If you have any questions concerning this filing, please contact one of the undersigned. Thank you for your attention to this matter.

Sincerely,

G. Paul Moates

Terence M. Hynes

Paul A. Hemmersbaugh

Enclosures

cc: Counsel for Complainant (w/encls.)

BEFORE THE
SURFACE TRANSPORTATION BOARD

MAR 15 2004
RECEIVED

DUKE ENERGY CORPORATION,

Complainant,

v.

NORFOLK SOUTHERN RAILWAY COMPANY,

Defendant.

STB Docket No. 42069

210 306

DEFENDANT NORFOLK SOUTHERN RAILWAY COMPANY'S REPLY TO
COMPLAINANT DUKE ENERGY'S PETITION FOR RECONSIDERATION

ENTERED
Office of Proceedings

MAR 15 2004

Part of
Public Record

James A. Hixon
James A. Squires
George A. Aspatore
Norfolk Southern Corporation
Three Commercial Place
Norfolk, Virginia 23510-2191
(757) 629-2657

G. Paul Moates
Terence M. Hynes
Ronald S. Flagg
Paul A. Hemmersbaugh
Sidley Austin Brown & Wood LLP
1501 K Street, N.W.
Washington, D.C. 20005
(202) 736-8000

Counsel for Defendant Norfolk Southern Railway Company

DATED: March 15, 2004

TABLE OF CONTENTS

	Page
I. Duke's "Preliminary Points" Provide No Cognizable Basis for Changing the Decision.	1
II. Alleged Failure to Enforce the "Conrail Condition"	3
III. The Decision's Use Of The RCAF-U To Index Operating Costs Is Appropriate And Fully Consistent With The Board's Precedent And Practice Of Applying That Index Unless More Specific Productivity Data Is Available.....	5
A. Contrary To Duke's Claims, The Board Did Not Use The RCAF-A To Index Operating Expenses In Any Decision Issued Before Duke Filed This Case.....	6
B. The SARR Would Have Little Potential for Increased Productivity.....	8
IV. Duke Provides No Sound Reason To Change The Cost Of Capital Two Years After The SARR Would Have Completed Construction And Incurred The Vast Preponderance Of Its Capital Expenditures.	10
A. The Board's Standard Practice Of Using The Average Cost Of Capital Over The Period In Which The SARR Would Be Constructed Is Entirely Logical And Consistent With Sound Principles Of Finance And Economics.....	10
B. Board Precedent Precludes Duke's Argument.....	11
C. Duke's "Mismatch" Argument is Fallacious..	12
V. The Board's Decision To Reject Duke's Operating Plan Is Supported By Established Precedent and The Record Evidence.	13
VI. The Board's Adoption of NS' Proposed Operating Plan Is Consistent With the Record Evidence and Board Precedent.	17

BEFORE THE
SURFACE TRANSPORTATION BOARD

MAR 15 2004
RECEIVED

DUKE ENERGY CORPORATION,

Complainant,

v.

NORFOLK SOUTHERN RAILWAY COMPANY,

Defendant.

STB Docket No. 42069

**DEFENDANT NORFOLK SOUTHERN RAILWAY COMPANY'S REPLY TO
COMPLAINANT DUKE ENERGY'S PETITION FOR RECONSIDERATION**

Norfolk Southern Railway Company ("NS") submits this reply to the Petition for Reconsideration filed in the above-captioned proceeding on February 23, 2004 by Complainant Duke Energy Corporation ("Duke") (the "Duke Petition"). Because Duke's Petition provides no sound basis to alter the Board's November 6, 2003 Decision, it should be denied in its entirety.

I. Duke's "Preliminary Points" Provide No Cognizable Basis for Changing the Decision.

Duke's "preliminary points" discussion is confused and untethered to the record or relevant legal authority. The opening section of Duke's Petition makes no citation to the pleadings, the record or the Decision. Nor do its fleeting, unsupported criticisms even specify what – if any – relief Duke is seeking. See Duke Petition 1-2. In sum, Duke's preliminary section is little more than unsupported carping, devoid of both factual support and legal argument.

NS' evidence amply demonstrated that Duke has no basis for its "gaming" allegation. NS established the challenged rates based on its assessment of business and commercial conditions, guided by sound economics and appropriately constrained by the principles established by the Coal Rate Guidelines and applied by the ICC and the Board in subsequent decisions. See, e.g., NS Open. Parts I, IV-A to IV-C; NS Reply I-2 to I-5, I-12 to 18, I-45 to I-46, Part III.I, Apps. D to J; NS Brief at 1-8. The initial Decision in this case supported this conclusion, finding the challenged rates reasonable in their entirety. The preliminary adjustments the Board made in its February 3, 2004 Decision (correcting

arithmetic errors and implementing a new revenue calculation methodology) would result in SAC rates that are very close to the challenged rates. Even if that result stands – and NS believes that, after the Board makes appropriate adjustments on reconsideration, its final Decision will again hold the challenged rates reasonable in their entirety – the fact that NS’ market-based rates closely approximate the SAC rate further supports NS’ showing that the rates at issue are fully consistent with the Board’s regulations, SAC principles, the Coal Rate Guidelines and the sound economic theory and principles upon which they are founded, and precludes a finding of “gaming.”

Without any citation to authority or any support whatsoever, Duke baldly asserts that “by the time the Board considers this petition, NS will have become revenue adequate.” Duke Pet. at 2. There is nothing in the record, nor in Duke’s Petition, or even in the workpapers submitted with that Petition, to support such a claim. Despite Duke’s assertion of clairvoyance, the fact is that neither Duke nor anyone else knows at this juncture what the Board’s annual determination of the cost of capital and return on investment calculations will show for calendar year 2003. This is yet another example of Duke’s unfair strategy of raising new arguments – which in this case amount to nothing more than bare unsupported speculation – for the first time long after the time for raising them has passed.

Moreover, even if the Board were to find that, in 2003, NS earned a return on investment that was equal to or slightly higher than its cost of capital, this would provide no basis to conclude that NS is revenue adequate. As the Board and its predecessor have repeatedly made clear, revenue adequacy is a long term concept that cannot be assessed in the context of a single year. *See, e.g., Coal Rate Guidelines*, 1 I.C.C.2d at 536 (“We emphasize that revenue adequacy is a long-term concept that calls for a company, *over time*, to average return on investment equal to its cost of capital . . . Our concept is simply that a railroad not use differential pricing to consistently earn, over time, a return on investment above the cost of capital.”) As a matter of fact and of law, Duke’s newfound revenue adequacy claim provides no basis to reduce the Decision’s maximum reasonable rates.

II. Alleged Failure to Enforce the “Conrail Condition”

Straying even farther afield from matters properly at issue in this proceeding, Duke claims that the Board’s Decision in this case constitutes a “refusal to enforce [a] condition” that Duke asserts the Board imposed when it approved NS’ and CSXT’s acquisition of Conrail. Duke Pet. at 3. The premise for Duke’s allegation – that the decision approving the Conrail transaction imposed a condition requiring NS and CSXT not to increase rates to “captive” shippers – is erroneous. As the present Decision made clear, the Board did not condition its approval of the Conrail transaction on a “pledge to indefinitely maintain steady rate levels to all NS’s captive shippers irrespective of how market conditions might change.” Decision at 10, n. 2. Regardless, as demonstrated below, the Board adequately considered and rejected Duke’s contention that NS established the challenged rates to pay for its acquisition of Conrail.

After reviewing Duke’s evidentiary submissions, claims and arguments, the Board concluded that it “has no evidence, and Duke has presented none here, to suggest that the rate increases imposed on Duke were necessitated by NS’s acquisition of Conrail.” Decision at 9. The fact that the Decision does not expressly discuss one piece of evidence submitted by Duke (the testimony of its witness Mr. Whitehurst, Duke Reply Exhibit II-B-1) is of no moment.¹ An agency like the Board is not obligated to expressly discuss every argument and every specific piece of evidence proffered by the parties in a complex and lengthy adjudicatory proceeding, particularly where the evidentiary record of that proceeding contains hundreds of thousands of pages. *See, e.g., Pharaon v. Board of Governors of Fed. Res. System*, 135 F.3d 148, 155 (D.C. Cir. 1998); *Simpson v. Young*, 854 F.2d 1429, 1434-1435 (D.C. Cir. 1988) (agency “is not required to address every argument advance by petitioners . . . no matter how minor or inconsequential the argument may be”). Of necessity, the Decision expressly discusses only a small proportion of all of the specific and detailed arguments and evidence submitted by the parties.

¹ Duke’s characterization of Mr. Whitehurst as “NS’ chief financial witness in the Conrail proceeding” (Petition at 3) is, to put it charitably, misleading. NS’s Chief Financial Officer, Mr. Henry C. Wolf, was NS’ chief financial witness in that case. *See CSX/NS-18*, Volume 1 of 8, pp. 484-495. Mr. Whitehurst did not even testify on behalf of NS in its primary application. Along with others, he submitted a rebuttal statement on behalf of CSX and NS to refute claims of an “acquisition premium.”

In this specific instance, where: (i) the Board rejected Duke's contention that it had imposed a "condition" prohibiting future rate increases; and (ii) NS' Rebuttal evidence thoroughly refuted Whitehurst's analysis (showing that it contained so many fundamental flaws that it was meaningless and had no probative value), it was not necessary for the Board to expressly discuss and reject the exhibit submitted by Mr. Whitehurst. *See* NS Reply II-B-1 to 24.² The Board indicated that, even if Duke had shown some correlation between the challenged rate increases and unanticipated costs attributable to the Conrail transaction – which it emphatically did not – this alone would not violate any condition of the Board's approval of the Conrail transaction: "In any event, the Board's representations condition in *Conrail* was not, and could not have been, meant to freeze NS's then-existing rates indefinitely, depriving the carrier of the ability to adjust its rates to react to changing market conditions." Decision at 9-10.

Duke's claim that NS "repeatedly increased" Duke's coal rates following the Conrail transaction is inaccurate and misleading. The evidence showed that, in the two decades after the Staggers Act, the inflation-adjusted rates NS charged to transport coal to the solely served issue plants declined, steadily and significantly. *See, e.g.*, NS Open. IV-A-5 to 9; *id.*, Exhibit IV-A-1. There have been only two rounds of rate negotiations between NS and Duke following the Board's approval of the *Conrail* transaction. In the first, in 1999, NS and Duke negotiated a contract that, for the first time in nearly twenty years, provided for a modest increase in those rates. *See* NS Op. Part IV. Those contract rates were not "imposed" by NS – Duke bargained for those rates and voluntarily entered a coal transportation contract that was in effect until January 1, 2002. Finally, the evidence shows – and Duke does not contest – that in the parties' most recent contract discussions (in late 2001), Duke flatly refused to entertain any proposal that did not entail a rate decrease. The Decision's SAC results and maximum rate

²By concluding that Duke presented "no evidence" that the rate increases at issue were necessitated by the Conrail transaction, the Decision implicitly rejected the testimony of witness Whitehurst purporting to show that NS's Conrail-related debt was a "driving force" behind these rate increases (Duke Reply Ex. II-B-1). The Board had ample reason to reject this testimony. In addition to its other flaws (described in NS' Rebuttal), Whitehurst's testimony failed to show a causal connection between the Conrail transaction and the rates at issue. Although the Decision did not explicitly address this testimony, the Board correctly gave no weight to Whitehurst's unsupported assertion.

reasonableness findings demonstrate beyond dispute that a substantial rate increase was appropriate and justified, and that Duke's intransigent insistence on a rate reduction was not a reasonable bargaining position.

III. The Decision's Use Of The RCAF-U To Index Operating Costs Is Appropriate And Fully Consistent With The Board's Precedent And Practice Of Applying That Index Unless More Specific Productivity Data Is Available.

Duke erroneously claims that Board precedent requires the application of the RCAF-A, instead of the RCAF-U, to index SARR operating expenses. In fact, the opposite is true – the Board's established precedent is to index operating expenses using the RCAF-U, unless some more specific productivity-adjusted index is available.³ Prior to the Board's decision in *WPL v. Union Pacific* in 2001, the Board (and before it the ICC) consistently used the projected RCAF-U (i.e., the "unadjusted" RCAF) to index SARR operating expenses over the 20-year DCF period. In *WPL*, the Board indexed SARR operating costs using a specific index developed by defendant UP in the normal course of business, which included projected "productivity increases associated with [UP]'s coal transportation." *Wisconsin Power & Light Company v. Union Pacific Railroad Co.*, STB Docket No. 42051, Decision at 106 (served Sept. 13, 2001) ("*WPL*"). The Board made clear that it adopted UP's more precise index because it "relate[d] specifically to coal movements in the [SARR] traffic group and, therefore, should provide more reliable projections than the more broad-based RCAF-U." *WPL* at 106. Thus, consistent with the Board's well-established preference for specific relevant data and analyses over general, *WPL* simply clarified that, where a defendant railroad maintained specific productivity-based projections for the costs of the coal traffic at issue in a case, the Board would accept those SARR traffic-specific cost projections rather than the general overall industry average projection embodied in the RCAF. *See id.* In

³ *See, e.g., Arizona Public Service Co. v. The Atchison, Topeka and Santa Fe Railway Co.*, 1 S.T.B. 367, 441 (1997); *see also FMC Wyoming Corp v. Union Pacific RR Company*, STB Doc. No. 42022 (May 10, 2000) (rejecting complainant's request to use RCAF-U to escalate revenues, in favor of growth rate derived from defendant's internal forecasts); *TMPA v. BNSF*, STB Doc. No. 42056, Decision, at 161 (March 24, 2003) (rejecting RCAF-A, and adopting RCAF-U to index operating expenses); *CP&L v. Norfolk Southern Railway Co.*, STB Doc. No. 42072, Decision at 28 (Dec. 23, 2003); *Duke Energy v. CSXT*, STB Doc. No. 42070, Decision at 30 (Feb. 3, 2004) ("the potential effect of [SARR productivity] improvements is far less than it would be for existing railroads, which make changes incrementally as older-technology assets wear out").

this case, the Board faithfully applied its consistent rule – because there was no more specific index available, the Board properly indexed operating expenses using the RCAF-U.

A. Contrary To Duke’s Claims, The Board Did Not Use The RCAF-A To Index Operating Expenses In Any Decision Issued Before Duke Filed This Case.

Duke claimed in its evidence that the Board had used the RCAF-A to adjust expenses in *WPL*. See Duke Op. at III-G-5. NS demonstrated in its Reply that this was incorrect, citing the *WPL* decision. See NS Reply III-G-2; *WPL* at 106. In the face of the clear text of *WPL* rejecting the RCAF in favor of a traffic-specific index, Duke maintained its denial, claiming that *WPL* “plainly used the RCAF-A to adjust future operating expenses.”⁴ Duke Reb. III-G-3 (repeating this claim despite NS Reply citation to *WPL* decision showing this was incorrect).⁵ Because Duke has muddied the waters, it is important that the record be clear on this point: *WPL* did not use the RCAF-A to index operating expenses. There is no indication in the record that either party even argued that the Board should use the RCAF-A for that purpose – the entire discussion of cost inflation indices does not even mention the RCAF-A. See *WPL* at 106. The Board considered the RCAF-U and a UP-coal-traffic-specific cost inflation projection and decided to use the more specific, directly applicable projection prepared by UP in its normal course of business. See *id.* Thus, contrary to Duke’s newly minted reconsideration argument, the Decision did not create a new rule: it merely applied the existing rule to the facts and circumstances of this case. Here, as in every other published maximum rate reasonableness decision (other than *WPL*), there was no more specific cost inflation evidence available, and the Board followed its standard practice by using

⁴ Duke also claims that the Board used the RCAF-A to adjust operating expenses in *FMC*. The text of the *FMC* decision does not address this question, but the cost consultant for the defendant railroad in that case recalls that the Board used the RCAF-U to adjust operating expenses. See NS Reply at III-G-2. Because the Board’s decision workpapers are subject to a protective order and not available to NS or to Duke, the parties to this case cannot conclusively show what index the Board used. There is nothing in the text of the publicly available decision, however, to indicate that *FMC* departed from the Board’s standard practice of applying the RCAF-U to escalate operating expenses, and Duke has not shown otherwise.

⁵ Duke’s brief does not even mention use of the RCAF-A to index operating expenses. Apparently, at the time of final briefing on this case, Duke did not think its RCAF argument was particularly important or compelling.

the general railroad industry index, the RCAF-U.⁶ The Board's subsequent decisions in *TMPA* and the three Eastern cases applied the same longstanding rule, as clarified in *WPL*.⁷

Duke misapprehends the *TMPA* decision, claiming the Board announced a new rule which cannot be applied in this case. Rather, *TMPA* simply further explained and applied the Board's consistent rule, which fully supports the Decision in this case. In *TMPA*, the complainant argued that the Board should index operating expenses using the RCAF-A, rather than the RCAF-U. See *TMPA v. BNSF*, STB Docket No. 42056, Decision at 161 (served March 21, 2003). The Board explained that the RCAF-A is a broad general estimate that projects railroad industry productivity improvements across all railroad traffic and lines of business. *Id.* In *TMPA*, as in this case, there was no coal-traffic specific productivity projection in the record. Because there was no such specific evidence in the record, the Board applied its consistent rule to the facts of the case and adopted the RCAF-U. *Id.* The *TMPA* decision neatly summarized the Board's consistent rule and its rationale:

We have no evidence, and we find it unrealistic to assume, that projected industry-wide productivity adjustments would result primarily from the transportation of coal. In the absence of evidence showing specific productivity improvements for unit coal train operations that would affect the [SARR], we use the RCAF-U to index operating expenses . . .

TMPA at 161 (distinguishing *WPL*, which indexed operating costs based on a specific regular-course-of-business projection of cost increases for moving coal over a system that included the SARR).

The two cases Duke cites are inapposite, because they involved an agency's application of an entirely new rule for the first time. See *Hatch v. FERC*, 654 F.2d 825, 826 ("It is certainly within an agency's discretion to change rules and reinterpret statutory mandates in the course of adjudication," but affected parties must be given notice and an opportunity to comment); *Consolidated Edison Co v. FERC*, 315 F.3d 316 (repeating rule, but finding that agency not required to apply new policy to case commenced prior to adoption of that policy). Here, in contrast, the Board is simply applying the same

⁶ Contrary to Duke's suggestion, NS did not withhold such information from discovery. NS told Duke in discovery that NS does not maintain such statistics, and therefore had nothing to produce.

⁷ In *PPL Montana*, the Board used RCAF-A, but only to show that, even if the Board were to use the assumptions advocated by the complainant, the railroad would still prevail.

consistent rule to the facts and circumstances of this case. *See generally, University Health Services, Inc. v. HHS*, 120 F.3d 1145 (11th Cir. 1997) (agency has considerable latitude to apply existing rules to specific circumstances).

B. The SARR Would Have Little Potential for Increased Productivity.

Duke has offered very little evidence to demonstrate that the optimally efficient SARR would be able to realize significant gains in productivity, and no evidence that even remotely supports its suggestion that the SARR could achieve the same level of productivity savings projected for real world Class I railroads. From its inception, the SARR is assumed to be a least cost, optimally efficient railroad. As a result, the SARR is effectively assumed to have achieved and absorbed the benefits of productivity improvements that real world railroads may be able to realize in the future. The RCAF-A (and by extension projections of the index's future levels) is designed to adjust inflation calculations to account for productivity improvements of real world railroads, not hypothetical railroads that are so highly efficient that any future productivity gains would be negligible.

The SARR would not have same opportunity to increase productivity as real world railroads because most of its assets are new, and would not be replaced during the 20-year DCF period. Duke claims "that most railroad productivity improvements come from technological improvements that occur over time as assets are replaced." Duke Reb. III-G-3. Real world railroads obtain their assets gradually over a long period of time, and those assets eventually wear out and require replacement. In contrast, the SARR acquires virtually all of its assets at essentially the same point in time. Because most of the SARR's investment is in assets with lives exceeding 20 years, most of its assets would not be replaced during the 20-year DCF period.⁸ As a result, the SARR would not benefit from what Duke claims is the primary source of productivity improvements for real railroads, the replacement of assets. Duke makes no attempt to prove that, in the absence of replacement of assets, the SARR could achieve

⁸ Even for assets that may have useful lives of less than 20 years, Duke did not specify when they would be replaced, how (or by how much) such replacement would increase productivity, nor (with the exception of a very small investment to make limited upgrades to certain computer equipment) include in its SAC presentation any significant additional investment costs to purchase replacement assets.

significant additional productivity improvements during the DCF period, much less when (or how) any such hypothetical improvements might occur.⁹

Duke raises several arguments regarding productivity adjustments for the first time on reconsideration, fifteen months after the close of the evidentiary record, and fully twenty-one months after the proper time to raise them – in Duke’s Opening evidence filed in May 2002. What Duke’s new arguments ignore is that Reconsideration Petitions may address either material errors or significant new evidence. Duke’s new claims are neither. Under any reasonable notion of timeliness, finality, and orderly adjudication, these new arguments must be precluded. For example, Duke claims for the first time in its Reconsideration Petition that the SARR should be assumed to obtain all productivity gains of the railroad industry, but share in none of its losses, and therefore should “exceed the industry average” productivity improvement. This new argument is not only untimely, it has no evidentiary support in the record.¹⁰

Significantly, Duke’s evidence offered no specific explanation of how the SARR would improve its productivity. Nor has Duke made any attempt whatsoever to quantify the result of any efforts to achieve productivity improvements. *See* Duke Op. Part III-G-5 to 6; Duke Reb. III-G-3 to 4 (noting only that *WPL* found that the SARR in that case might achieve some productivity improvements because it would replace certain information technology systems; but failing entirely to show that it assumed the ACC would make similar investments, or if so, the amount by which Duke contends such investments

⁹ Contrary to Duke’s contention, the Board’s DCF does assume the SARR benefits from productivity increases. The Decision assumes that the volumes carried by the SARR would increase over time, but that a number of operating expenses (including Operating Materials and Supplies, *Ad Valorem* Taxes, Operating Managers, General and Administrative and Maintenance of Way expenses) would not grow correspondingly. The result is that the revised Decision implicitly assumes the SARR would achieve some productivity growth over time.

¹⁰ Duke’s Petition also raises for the first time the new argument that, because future cost increases are difficult to project accurately, the Board should “truncate the DCF analysis” to some (unspecified) shorter period. Duke Pet. at 8. Not only is this claim untimely, the record is devoid of evidence the Board would need to make the myriad adjustments to various SAC elements that would be necessitated by adopting some shorter period. In any event, projections of future costs are no more “speculative” than projections of future SARR traffic volumes and revenues, about which Duke apparently has no complaint.

would increase SARR productivity). Duke's evidence thus failed even to attempt to meet its burden of proof with respect to either: (i) a qualitative showing of how the SARR would increase its productivity without making significant additional capital expenditures; or (ii) a quantitative analysis of how much the SARR's productivity would improve as a result of those unspecified efforts. *See* Duke Op. Part III-G; Duke Reb. Part III-G. There is thus no evidence whatsoever in the record upon which to base a finding that the SARR would achieve any specific amount of additional productivity savings. Duke's wholesale failure of proof on these points fully supports the Decision's use of the RCAF-U – adoption of the RCAF-A to index operating expenses would have been wholly unsupported, arbitrary, and capricious.

IV. Duke Provides No Sound Reason To Change The Cost Of Capital Two Years After The SARR Would Have Completed Construction And Incurred The Vast Preponderance Of Its Capital Expenditures.

Duke claims, for the very first time in its Reconsideration Petition, that the Board should “update” the cost of capital to reflect post-construction period changes. The Board cannot “reconsider” what Duke did not ask it to consider in the first place – Duke's new argument is extremely untimely and should be rejected for that reason alone. Moreover, because construction of the SARR would be completed at the end of 2001, there is no sound reason for the Board to reach outside the record and revise its cost of capital calculation at this very late date. In all events, Duke's belated request is foreclosed by Board precedent.

A. The Board's Standard Practice Of Using The Average Cost Of Capital Over The Period In Which The SARR Would Be Constructed Is Entirely Logical And Consistent With Sound Principles Of Finance And Economics.

Consistent with the Board's well-established, sound, and entirely logical practice, the Decision used the average cost of capital that prevailed during the time that Duke assumed the SARR would be constructed. *See* Decision at 37. Of course, the SARR must arrange financing before it actually commences construction; it cannot wait until after construction is completed to seek to finance the huge capital investment required to build an entirely new railroad. Consistent with this common sense proposition, the Decision accepted Duke's proposal that the SARR's cost of capital should be a

weighted average of the years in which the SARR would be constructed, 1999-2002. *See id.* This was the approach Duke advocated in its evidence and acknowledged was “in accordance with [Board] precedent.” Duke Open. III-G-3 to 4. The Decision adopted exactly the cost of capital Duke advocated. *See Decision* at 39; Duke Reb. III-D-95 (asserting that cost of capital should be the industry’s cost, averaged over the years in which SARR would be constructed). Nonetheless, Duke now asks the Board (raising this claim for the very first time in its Reconsideration Petition) to change a finding that Duke has advocated throughout this case!¹¹ There should be no real debate on this point: Duke’s new argument, raised for the very first time on Reconsideration, is both time-barred and estopped by Duke’s own evidentiary submissions.

B. Board Precedent Precludes Duke’s Argument

The Board has consistently rejected very similar arguments for post-construction period changes to the cost of capital in previous cases. For example, when the defendant railroad sought an adjustment to reflect increasing costs of capital in *McCarty Farms*, the Board refused, finding that “[s]ubsequent fluctuations in the cost of debt, reflecting post-construction market conditions, are irrelevant, because the [SARR] would not need to raise appreciable amounts of debt capital in the years immediately following construction.” *McCarty Farms*, 2 STB 460, 523 (1997); *see Coal Trading v. Baltimore & Ohio Railroad et al*, 6 I.C.C.2d 361 (rejecting request for post-construction change in cost of debt, concluding that the SARR’s “cost of debt is equal to the current cost of debt faced by the industry during the time period the incremental investment is added.”) (emphasis added); *Nevada Power* 6 I.C.C.2d 1 (to same effect).

¹¹ Duke’s new argument – which the Board can be certain Duke would not have asserted if the cost of capital had increased after the close of the record – is that the SARR could refinance its debt, or take advantage of “floating interest rates.” The availability of refinancing and floating interest rates was well known when Duke filed its Opening evidence in May 2002. If Duke wished to assert that the SARR would finance its construction through debt that provided for floating interest rates or facilitated refinancing, it was incumbent upon Duke to disclose this intention (and to include the costs of such non-standard debt) on Opening, or at the very latest, in its Reply Evidence.

C. Duke's "Mismatch" Argument is Fallacious.

Duke claims that because the Board decided to adopt the EIA's 2003 traffic and revenue forecasts, it has created a "mismatch" between the SARR's cost of capital and its revenues. Duke Pet. at 9. This is nonsense. There is no reason to assume that the SARR's cost of capital would vary with either coal traffic volume or coal transportation rates. For example, it defies logic to suggest that the volume of coal mined and shipped in Central Appalachia has anything to do with the industry cost of debt or equity. Similarly, there is no basis to suggest that the SARR's cost of capital would be any different if the Board used revenue projection numbers calculated in 2002, 2003, or 2004. These variables are entirely independent of one another and there is no evidence in the record to suggest any linkage between changes in them.

Relying on a single case, Duke misleadingly claims that, in the past, the Board adjusted the cost of capital to reflect changes from the construction period through the date of decision. Duke Pet. at 9 (citing *Bituminous Coal –Hiawatha, Utah to Moapa, Nevada*, 6 I.C.C.2d 1 (1989) ("*Nevada Power*")). As Duke's own Petition concedes, however, even in *Nevada Power*, the Board followed the same standard approach to the cost of debt that it followed in this case. That is, the Board fixed the cost of debt at the level that prevailed during the period in which the SARR would be constructed, and did not make any subsequent adjustment. See Duke Pet. at 9.¹² Duke thus invites the Board to reach outside the record and consider information generated several months after its submission of what Duke itself called its "Post-evidentiary Brief" for one reason and one reason only – doing so would reduce SAC costs and

¹² With respect to the cost of equity, *Nevada Power* is distinguished by its unusual circumstances. Unlike the present case, *Nevada Power* involved a number of years of actual historical data. The *Nevada Power* SARR commenced operations in 1978, and the ICC decision issued in 1989. There were thus eleven years of actual history from which the Board could obtain actual costs of equity. Here, there is no reason to believe the 2002 cost of equity is a more accurate predictor of the cost of equity over the twenty-year DCF period than the average of 3 previous years, which the Board used in the Decision, and Duke offers no argument to the contrary. Moreover, although the Decision rejected the use of a 3% financing fee because NS did not incur such a fee when it originally raised capital (Decision at 38), the SARR (like NS) would incur that cost if it wished to raise additional capital in the modern finance market. Thus, if the Board were to make any adjustment to the SARR's cost of capital for later years, it would be necessary to include the additional fees associated with such refinancing.

thereby favor Duke. The Board should refuse Duke's request to change the cost of capital asserted by Duke's own evidence and adopted by the Decision.

V. The Board's Decision To Reject Duke's Operating Plan Is Supported By Established Precedent and The Record Evidence.

Duke claims that the Board committed material error when it rejected Duke's supposedly "modern, efficient, least-cost SARR operating plan." Duke Pet. 10. This claim is without merit. Duke's Petition mischaracterizes the Board's findings in the Decision, ignores the record evidence – including Duke's own submissions – and conflicts with Board precedents establishing that a complainant may not unilaterally change the level of service provided to shippers.

Duke acknowledges that it did, in fact, alter both the size of the trains operated, and the origins of the coal that moved, during the "peak week." Duke Pet. 14-16. But it contends that the Board "erred grievously" in finding that these unilateral changes in shipment patterns violate the well-established principle that a SARR's operations must be consistent with the practices and preferences of shippers and connecting carriers. *See, e.g.,* Docket No. 42022, *FMC Wyoming Corp. v. Union Pacific R.R.*, (Decision served May 12, 2000) at 38; *McCarty Farms*, 2. S.T.B. 460, 476 (1997); *West Texas Utilities Co. v. Burlington Northern R. Co.*, 1 S.T.B. 638, 667 (1996). The arguments proffered by Duke in support of this claim are unpersuasive, and fail to establish that the Board committed any error in rejecting Duke's operating plan.

As NS' evidence demonstrated, it is simply not possible to meet the needs of the customers selected by Duke with "unit train only" service. If it were, NS would be operating only unit trains in the real world today. NS described several factors that dictate the size of customers' real world coal shipments. NS also identified limitations on the ability of certain mines to load and ship coal in trainload lots. *See* NS Reply III-C-8 to 9; NS Op. II-23 to 26, IV-D). While NS utilizes unit trains wherever possible, fully 18 percent of the traffic selected by Duke must be transported in smaller shipments. NS Reply III-B-22 to 23. Duke's operating plan simply failed to conform to this commercial reality.

Nevertheless, Duke argues that the Board erred in disallowing its unilateral changes to peak-week train sizes because (according to Duke) “the record is devoid of any evidence as to what train sizes the SARR customers prefer.” Duke Pet. 12. This assertion is wrong. The record evidence includes detailed traffic data for the peak week, which show clearly the sources of coal moved by NS during the peak week, the number of cars shipped from each origin, and the number of trains actually operated by NS from each mine origin to each destination. *See* NS Reply Elec. WP “SMNSMB01.xls.” Customers’ real world shipment patterns are *prima facie* proof of their practices and preferences – if customers wanted to ship (or receive) their coal in the manner proposed by Duke, they would have done so. The Board correctly held that Duke has the burden to show that any changes to the train size, coal origins or service frequency reflected in real world traffic data would be acceptable to the selected shippers. Decision at 31, 35. Duke made no such showing here.¹³ Based upon the record before it, the Board properly rejected Duke’s attempt to impose such changes unilaterally.

Duke’s claim that the Board committed error by “extrapolat[ing] from a peak week basis . . . to an annual basis to reach findings on total mine loadings or shipper receipts” (Duke Pet. 15, n.14.) is also wrong. As both Table 1 and the accompanying text of the Decision (at 32-35) clearly show, the Board’s rejection of Duke’s operating plan was based upon a finding that Duke improperly manipulated train sizes and coal origins “in the peak week”. *See Decision* 33-35 (repeated references to impact of Duke’s changes “in the peak week”). Based upon its analysis of the ACC’s peak week data – the only period for which Duke proffered any evidence regarding the ACC’s proposed train sizes and service frequency – the Board correctly held that Duke’s operating plan does not comport with customer requirements.

Duke argues next that the Board’s references to various reasons why customers would not be likely to agree to the service changes required by Duke’s operating plan are not supported by the record. Duke Pet. 15. Once again, Duke is wrong. As stated above, NS’ evidence identified a variety of factors that make it impracticable to handle all of the coal traffic selected by Duke in unit trains. *See* NS Reply

¹³ Duke asserts – for the first time in its Petition – that Duke itself would accept the proposed changes in service to its Catawba facility. This proffer is too late (as to Duke’s traffic) and much too little (as it does not satisfy Duke’s burden with respect to the vast majority of the ACC’s traffic, which involves shippers other than Duke).

III-C-8 to 9; NS Op. II-23 to 26, IV-D). Other factors cited by the Board (*e.g.*, the differences between high/low sulfur coals) are matters well within the agency's knowledge and expertise. In any event, it is Duke – not the Board – that had the burden of demonstrating that its proposed changes to shipment patterns were consistent with customer requirements.

Duke's suggestion that certain other statements in the Decision regarding the impact of altering train sizes, coal origins and service frequency are "sheer speculation" (Duke Pet. 14) is unfounded. Duke's evidence provided no explanation whatsoever as to how the ACC proposed to transform disparate small shipments originating at multiple mines into homogeneous unit trains. In considering the feasibility of Duke's proposal (and in the absence of any explanation by Duke), the Board correctly concluded that the ACC could not realistically shuttle a single train between multiple mines to "build" a unit train, nor could it build trains at local gathering yards because Duke elected not to construct such facilities. Decision 32. Since those options clearly were not feasible under Duke's operating plan, the Board observed that "Duke's unstated assumption" might have been that the origin of these small shipments would change, so that all of the cars moving on a particular day would originate at a single mine. *Id.* Duke's Petition confirms that, where Duke's workpapers showed tons from multiple mine origins being moved in a single train during the peak week, Duke did in fact assume that those tons would originate at one mine, rather than at multiple mines as they did in the real world. Duke Pet. 14-15. Thus, the Board's observation that Duke might have intended to alter the origin of certain peak week shipments was not "speculation", but rather was a correct surmise about what Duke intended.

Duke's Petition attempts to create the impression that the Board's rejection of its operating plan was based on an "erroneous understanding as to how Duke's operating plan works." Duke Pet. 15, n.14. Specifically, Duke claims that, notwithstanding its admitted "jury-rigging" of peak week shipments, "during the course of the year, the SARR and NS deliver the same quantities of coal from the same origins." Duke Pet. 14, 15-16. In other words, Duke contends that its operating plan would, in fact, conform to shipper requirements "over time." Duke Pet. 14. This post-hoc attempt to salvage Duke's operating plan is unavailing, for several reasons:

First, this “explanation” of Duke’s operating plan appears for the first time in Duke’s Petition. Nowhere in its Evidence or Brief did Duke ever suggest that the ACC would attempt to “true-up” the volumes of traffic moving between particular origins and destinations over the course of a year, by “offsetting” the changes that it made to peak week shipments with countervailing changes to the ACC’s train sizes and coal origins in prior or subsequent weeks. To the contrary, Duke’s evidence never disclosed the substantial modifications that it made to the ACCs peak week train sizes and coal origins – those changes were buried in Duke’s workpapers. See Duke Open Elec. WP “Revised string chart data for NS.xls,” worksheet “sorted data.” NS (and the Board staff) were required to ferret out those changes in order to “understand” Duke’s operating plan.

Second, Duke’s assertion that the ACC would make such offsetting changes in train sizes and coal origins is utterly inconsistent with the methodology that Duke used to calculate ACC operating statistics. Duke developed operating statistics for the “peak week” period from its String Diagram Program, and multiplied those statistics by 52, to estimate the ACC’s annual operating statistics (and corresponding locomotive, car and crew requirements). See Duke WP “Exhibit_III-C-2.123”, cell E18 and footnote 3 (cell B35); cells H16 and J 16 and footnote 2 (cell B34). This methodology – which necessarily assumes that “peak week” train operations are representative of operations in other weeks – is fundamentally at odds with Duke’s new claim that ACC train sizes, shipment origins and service frequency would vary constantly over the course of the year, as the ACC attempted to match total annual shipments from each mine with the volumes actually handled by NS in the real world. Indeed, if one accepts Duke’s latest “explanation” of its operating plan, then Duke’s operating statistics (which are based solely upon the service pattern for the peak week) are clearly invalid.¹⁴

Third, even if it were possible to rearrange an entire year’s traffic so that the ACC could operate only unit trains – and Duke has not shown that this would be possible – such a radical alteration in real world train sizes, origins and service frequency is not permitted, absent proof that the involved customers and connecting carriers would consent to such changes. Duke is not entitled to assume (as it

¹⁴ By contrast, NS developed its ACC operating statistics by flowing the actual trains that the ACC would handle each week of the year through the FTI spreadsheet. NS Reply III-C- 4 to 6.

does) that customers would agree to receive their coal shipments at different times and in different quantities simply because those shipments might balance out “over time.”

Duke also complains that the Board declared Duke’s operating plan “unworkable” on the basis of a finding that the plan “calls for the staging or assembly of trainloads formed from cars from separate mines when, in fact, Duke’s SARR has no ‘staging or gathering yards’ to make up trains with cars from different mines.” Duke Pet. 13. This assertion flatly mischaracterizes the Board’s findings. The Board clearly understood that “under Duke’s proposal, after loading, each ACC train would operate as a single train from origin to destination.” Decision 31. The Board did not, as Duke asserts, “find” that Duke’s operating plan “called for” the assembly of small shipments into unit trains at a gathering yard. To the contrary, considering how the ACC might be able to transform shipments from multiple origins into a single unit train, the Board explicitly noted that such gathering operations would not be possible under Duke’s plan because Duke did not include the required gathering facilities in the ACC system. Decision 32.

Finally, Duke argues that the Board’s rejection of Duke’s jury-rigged operating plan would “preclud[e] the very optimization and rationalization that are the theoretical underpinnings of the SAC standard.” Duke Pet. 16-17. This argument is specious. SAC principles do not allow a SARR to ignore commercial reality simply because doing so might produce greater operational efficiency (and more favorable expense calculations for Complainant). To the contrary, the Board has consistently required Complainants to present an operating plan that is capable of handling the selected traffic in a manner that is both operationally feasible and which takes into account the practices and preferences of customers and connecting carriers. The Decision correctly concluded that Duke’s proposed operating plan was inconsistent with this “core SAC principle.” Decision 31.

VI. The Board’s Adoption of NS’ Proposed Operating Plan Is Consistent With the Record Evidence and Board Precedent.

Duke contends that the Board, having rejected Duke’s fatally deficient operating plan, committed further error by adopting NS’ proposed operating plan. Duke Pet. 18. Duke’s criticisms of

NS' operating plan are without merit, and the Board's decision to adopt it is supported by the record evidence.

As an initial matter, upon finding Duke's operating plan deficient, the Board could have elected to dismiss Duke's Complaint for failure of proof. A finding by the Board that both Duke's and NS' proposed operating plans were infeasible would likewise warrant dismissal of the Complaint. However, rather than dismiss Duke's Complaint on account of its failure to present a feasible operating plan, the Board – consistent with past practice (*see e.g.*, Docket No. 42056, *Texas Municipal Power Agency v. BNSF*, (Decision served March 24, 2003) at 76, 80, n.134, 84) – adopted NS' operating plan.

NS' operating plan was based upon the specific size and frequency of shipments from particular mine origins that actually occurred during the study year. In developing ACC operating statistics, witness Fisher flowed through his spreadsheet model the correct number (and size) of trains as they would occur in each week throughout the peak year. Thus, unlike Duke's operating plan, NS' plan comports with the prevailing practices and preferences of the involved customers, and therefore is consistent with well-established SAC requirements.

Nevertheless, Duke attacks NS' operating plan with a number of baseless allegations: Duke claims that the Board committed error in adopting NS' operating plan because "NS's entire evidentiary presentation on SARR operations is predicated on the output of its RDCAM computer program" which was not submitted to the Board. Duke Pet. 19-20. This statement is utterly false, as Duke knows full well. As Duke itself acknowledged on Rebuttal (at III-C-27), NS did not use the RDCAM in formulating its operating plan for the ACC. Rather, all elements of that plan were developed by witness Kimbrough, based upon his 32 years of experience on the NS system, personal inspection of every mine origin and destination plant served by the ACC, and information provided by NS field personnel. The RDCAM model was used by NS only to test the capacity of the ACC's main lines – branch line and yard capacity were separately evaluated by witness Kimbrough (*see* NS Reply III-B-37 to 66) – and to identify average ACC train speeds (based upon the track configuration proposed by NS and adopted by the Board) for use in calculating ACC locomotive hours and car hours. All other operating statistics used in developing the ACC's operating expenses – including locomotive unit miles, freight car miles,

train crew starts, crew taxi and overnight requirements, and gross ton miles – were developed on the basis of the specific operations defined by witness Kimbrough, not from outputs of the RDCAM model. See NS Br. 23, n.46.

Duke also complains that the ACC's handling of small shipments under NS' proposed operating plan would be less efficient than NS' real world operations. Duke Pet. 18-19. As an initial matter, Duke failed to make this argument in its evidence or brief, and therefore cannot properly assert it in a petition for "reconsideration." Moreover, any purported inefficiency in the handling of such traffic under NS' operating plan is the direct result of Duke's decisions (i) to select substantial volumes of less-than-trainload traffic; (ii) not to build the network of local gathering yards that NS uses to handle such shipments; and (iii) to operate all trains directly from origin to destination. In the absence of gathering yards throughout the ACC's mine service area – which Duke vociferously argued were not needed (Duke Reb. III-B- 20 to 32, III-C-6 to 7) – the ACC cannot handle these shipments as NS does today (*i.e.*, by moving them from mine to a local gathering yard, and consolidating them into unit trains for shipment to points beyond). Nor would it have been efficient for NS to operate small trains in the manner prescribed by Duke's operating plan – *i.e.*, directly from the mine to destination. In these circumstances, rather than proposing the construction of multiple additional gathering yards (at great expense to the ACC), NS' operating plan moved smaller shipments from the mine to one of the few yards included in the ACC system (*e.g.*, Devon) for consolidation with other small shipments. This alternative represented the least cost, most efficient solution to the problems caused by Duke's selection of a significant volume of less-than-trainload traffic, and its failure to provide the facilities necessary to serve that traffic.¹⁵

Finally, Duke's assertion that NS' plan provides for an ACC operation that is "worse than reality" (Duke Pet. 10) is false. As NS' evidence showed, the ACC's overall operations (under NS' plan) would be significantly more efficient (and lower cost) than NS' current system and operations.

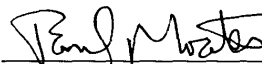
¹⁵ Duke's assertion that the handling of 800,000 tons of coal traffic in trains of 20 cars or less demonstrates the "massive inefficiency" of NS' plan (Duke Pet. 18) lacks merit. The 800,000 tons represents only 1% of the ACC's traffic. In any event, these small movements are necessitated by Duke's traffic selections.

For example, while NS has an average of 2.41 tracks per mile between Devon, WV and Roanoke, VA, NS' proposed configuration for the ACC (which the Board adopted) included only 1.48 tracks per mile on that segment (which accounts for most of the ACC's main line). *Compare* NS Reply WP "doubletrack.xls" (NS tracks) *with* NS Supp. WP "III-F-Construction Total No Reroute.xls" (ACC tracks). In other words, the ACC (as proposed by NS) would have only one-third of the second track/siding capacity that NS currently has on that line. Moreover, the average train velocities achieved by the ACC under NS' plan are faster than those achieved by NS' real world operations. *Compare* NS Reply WP III-C-0015 to 0020 and "mph.xls" (NS velocities) *with* NS Reply WP "Line Haul Cycle Time KML New.xls" (ACC velocities). Finally, NS' proposed staffing for the ACC was substantially "leaner" than NS' real world organization. *See* NS Reply III-C-34 to 38, Table III-C-4.) By any measure, NS' operating plan provided for the least-cost, most efficient SARR that would realistically be capable of meeting the needs of the customers selected by Duke. The Board's decision to adopt NS' operating plan (rather than dismissing Duke's Complaint outright) is supported by substantial record evidence.

CONCLUSION

The Board should deny Duke's Petition, grant NS' Reconsideration Petition in its entirety, and revise the Decision to find that the challenged rates are not unreasonable.

Respectfully submitted,



G. Paul Moates
Terence M. Hynes
Ronald S. Flagg
Paul A. Hemmersbaugh
Sidley Austin Brown & Wood LLP
1501 K Street, N.W.
Washington, D.C. 20005
(202) 736-8000

James A. Hixon
James A. Squires
George A. Aspatore
Norfolk Southern Corporation
Three Commercial Place
Norfolk, Virginia 23510-2191
(757) 629-2657

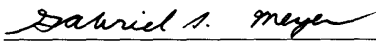
Counsel for Defendant Norfolk Southern Railway Company

Dated March 15, 2004

CERTIFICATE OF SERVICE

I hereby certify that, on this 15th day of March, 2004, I served the foregoing
“Defendant Norfolk Southern Railway Company’s Reply to Complainant’s Petition for
Reconsideration” by causing five (5) copies thereof to be delivered, via hand delivery, to:

William L. Slover
Robert D. Rosenberg
Christopher A. Mills
Andrew B. Kolesar III
Slover & Loftus
1224 Seventeenth Street, N.W.
Washington, D.C. 20036



Gabriel S. Meyer