

212046



September 20, 2004

The Honorable Roger Nober
Chairman
Surface Transportation Board
1925 K Street, N.W., Suite 810
Washington, D.C. 20423-0001



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Re: Ex Parte No. 655, Powder River Basin Site Visit

Dear Chairman Nober:

I write in response to a letter you received from the Western Coal Traffic League ("WCTL") that was placed into the public record in the above-referenced proceeding on September 8, 2004. The letter attached a calculation purporting to demonstrate that The Burlington Northern and Santa Fe, CSXT, Norfolk Southern, and Union Pacific collectively receive revenues from coal transportation services that substantially exceed the railroads' fully allocated costs.

WCTL's calculation does not reflect Union Pacific's experience. As we explained during the Board's recent site visit to the Powder River Basin, Union Pacific has seen a steady erosion in the revenue we receive in relation to the costs we incur for transporting coal. If that erosion continues, Union Pacific will find it even more difficult to fund the investments necessary to meet projected demands for transportation of coal and all the other commodities that move over our shared network.

WCTL's suggestion that Union Pacific and other railroads are nonetheless earning excessive revenues on their coal traffic is incorrect for two reasons. First, WCTL's calculation does not address whether the railroads are earning revenues from coal sufficient to support investment in their networks. Second, WCTL's calculation is itself flawed in several respects.

WCTL's calculation does not address whether railroads are earning disproportionate revenues from coal traffic. Coal traffic should make a significant contribution to cover the total fixed costs of the portion of Union Pacific's network that it shares, given the increasing demand for western coal and its dependence on rail transportation. WCTL's approach, which assigns a proportionate share of the Union Pacific network's fixed costs to a coal based on URCS variable costs of handling coal, is not a valid method for determining whether coal is being asked to contribute more than its fair share to the network.

J. Michael Hemmer
Sr. Vice President - Law and General Counsel

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Even if it were correct to ignore the contribution that coal must make to a network it shares with other traffic, WCTL's calculation does not address whether railroad returns are sufficient to support future new investments and re-investment in the portions of the network that carry coal traffic. It uses URCS costs, which are based on historical, depreciated costs of assets, rather than the type of forward-looking costs that are relevant to future investment decisions. It assumes that coal should bear only a proportionate share of fixed costs. It also uses system-average costs, which do not reflect the substantial investments that Union Pacific has recently made in its coal routes. And it does not reflect the high maintenance costs that we are discovering arise from transporting heavy wheel load coal traffic, including bridge damage, rail wear, fouling of subgrades, signal insulation problems, and incident recovery. We described these emerging costs during the site visit.

Moreover, to the extent that WCTL's approach has any value, when the calculations are performed correctly, they reinforce the concerns we raised during the site visit.

We have reproduced WCTL's approach, focusing on data for Union Pacific. As shown in the attached exhibit, Union Pacific's revenue/cost ratio is not in the 1.20 range suggested by WCTL. Instead, it has declined from 1.03 in 2001 to 1.00 in 2003. In other words, even applying WCTL's inapposite approach, Union Pacific's revenue/cost ratio indicates that coal revenues are sufficient only to cover the sum of variable and an arbitrary allocation of fixed costs (even based on historic costs), and the coverage ratio is declining below the level that would support reinvestment.

WCTL asserts that its calculations are based on data from the STB Costed Waybill Sample. We have been unable to replicate those calculations precisely. We note, though, that many railroads, including Union Pacific, "mask" revenue data to safeguard the confidentiality of contract rates when submitting revenue data for the waybill sample. When the Board releases these data, it warns recipients that the "masked revenue figures are typically larger than actual contract revenues," and thus that use of "revenue data from the Carload Waybill Sample in any type of comparison could lead to wrong or misleading results."¹ We thus replicated WCTL's approach using actual, publicly reported revenue data.

As we explained during the site visit, Union Pacific's coal revenues are by no measure excessive, and they have been falling relative to costs. If this trend continues, investments in some of the

¹ See, e.g., Letter from Leland L. Gardner, Director, Office of Economics, Environmental Analysis, and Administration, to Michael L. Rosenthal, Esq., dated Dec. 22, 2003.

facilities necessary to meet projected future demand will not be justified. If that happens, customers who depend on Union Pacific for coal transportation will inevitably face capacity constraints. Union Pacific does not want to find itself in that position.

Sincerely,

A handwritten signature in black ink, appearing to read "Mike Hemmer". The signature is fluid and cursive, with a large loop at the end.

Enclosure

cc: Hon. Francis P. Mulvey
Hon. Douglas Buttrey
Hon. Vernon A. Williams
Mr. Matthew K. Rose
Mr. Mark W. Schwartz

Comparison of Revenues to Fully-Allocated Costs (including Cost of Capital) for Coal Traffic
Handled by the Union Pacific Railroad

<u>Description</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>
Coal Traffic Revenue ¹	\$2,353,598,139	\$2,287,765,412	\$2,355,138,785
Coal Total Variable Costs ²	\$1,702,479,780	\$1,638,131,007	\$1,752,853,595
Constant Cost Markup Ratio ⁴	1.34	1.34	1.34
Coal Fully-Allocated Costs (including Cost of Capital) ³	\$2,276,913,483	\$2,191,786,525	\$2,345,283,053
Revenue to Fully-Allocated Costs (including Cost of Capital) ⁶	1.03	1.04	1.00

Notes

Data source: 2001 and 2002 Carload Waybill Sample and 2001, 2002, and 2003 Union Pacific Railroad Annual Reports.

1. Coal Traffic Revenue for 2001 and 2002 calculated as total revenue from Energy Commodities (coal and coke) revenue figures from Union Pacific's 2001, 2002, and 2003 Annual Reports, multiplied by the ratio of coal revenue to coal + coke revenue in the 2001 and 2002 Carload Waybill Samples. The 2002 coal ratio is used in 2003 calculation because the 2003 Carload Waybill Sample is not yet available.
2. Total Variable Costs for UP for 2001 and 2002 from 2001 and 2002 Carload Waybill Samples. 2003 Total Variable Cost adjusted from 2002 figure using unadjusted RCAF because the 2003 Carload Waybill Sample is not yet available. 2003 costs are also adjusted for changes in total energy ton-miles from 2002 to 2003, based on the 2003 Union Pacific Annual Report.
3. Calculated as Coal Traffic Revenue / Total Variable Cost.
4. UP Constant Cost Markup Ratio from URCS WT D8L627C1. Value for 2003 estimated by assuming no change from 2002 to 2003.
5. Calculated as Total Variable Cost for coal multiplied by the Constant Cost Markup Ratio.
6. Calculated as Coal Traffic Revenue / Fully-Allocated Costs (including Cost of Capital).