

SK Snavelly King Majoros O'Connor & Lee, Inc.
Economic and Management Consultants

October 12, 2005

214902

VIA HAND DELIVERY

Mr. Vernon A. Williams, Secretary
Surface Transportation Board
1925 K Street, N.W., 7th Floor
Washington, DC 20423-0001

ENTERED
Office of Proceedings

OCT 12 2005

Part of
Public Record



Re: STB Ex Parte No. 658; The 25th Anniversary Of The Staggers Rail Act
Of 1980: A Review And Look Ahead

Dear Secretary Williams:

Enclosed are an original and 11 copies of Snavelly King's comments in the
Board's October 19th Public Hearing on Ex Parte 658; The 25th Anniversary Of
The Staggers Rail Act Of 1980: A Review And Look Ahead.

We have also enclosed a computer disc with copies of the filing in Word and pdf
formats

Please acknowledge receipt and filing of the enclosed comments by date
stamping and returning the copy provided for that purpose.

Thank you,

Tom O'Connor
Tom O'Connor

Enclosures

STB Ex Parte No. 658

1220 L St NW Washington, DC, 20005
202 371-9149 ■ Fax 202 842-4966 ■ email skmoltom1@aol.com



Progress Since the Staggers Rail Act of 1980:

**A Retrospective Review and a
Win-Win Action Plan**

**For Consideration by the
Surface Transportation Board**

In

STB Ex Parte No. 658

The 25th Anniversary of The Staggers Rail Act of 1980:

A Review and a Look Ahead

ENTERED
Office of Proceedings

OCT 12 2005

Part of
Public Record

**Tom O'Connor
Snavelly King Majoros O'Connor & Lee
1220 L St NW
Washington, DC
20005**

October 12, 2005

STB Ex Parte No. 658

Table of Contents

I. A RETROSPECTIVE	3
II. REGULATORY RESPONSE	6
III. A PROSPECTIVE ACTION PLAN	7
IV. BENEFITS OF THE SK ACTION PLAN.....	8
V. IMPLEMENTATION OF THE SK ACTION PLAN.....	8
VI. RECOMMENDATION.....	14

I. A Retrospective

My name is Tom O'Connor. I am Vice president of Snavely King Majoros O'Connor & Lee, Inc. (Snavely King or SK). Snavely King is an economic and management consulting company focusing on transportation and utilities. Snavely King has been in business for more than 35 years, serving transportation clients including railroads, shippers and government agencies, in the United States, Canada and Europe.

A. Summary

Since passage of the Staggers Rail act in 1980, rail rate regulation has receded from its former dominant status and is now a rarity. The rail rate process has shifted increasingly toward reliance on market forces. In recent years rail mergers have led to consolidation of the industry and the widespread disappearance of rail to rail competition. As reliance on market forces has increased the presence of market competition has diminished. This creates recurring and persistent imbalances in the rail marketplace and reinforces the appropriateness of the STB policy goal of ensuring that rates are reasonable.

While we do not advocate increased regulation we do advocate more rail-to-rail competition as a means of increasing price competition and improving service. Deregulation has generally performed well, and the additional freedoms the railroads have enjoyed have been helpful.

We do not advocate re-regulation of railroad pricing in general, but we do see repeated occurrence of very aggressive pricing in situations where the railroad perceives that the shipper doesn't have a competitive alternative. This pervasive problem requires access to appropriate regulatory rate reasonableness review.

To help solve this problem, we recommend railroad management support of STB provision of mediation in rate case disputes, such as Small Shipment Rate Reasonableness cases. Both Rail and shipper management can recognize the benefits of using mediation as a flexible and effective form of rate reasonableness review. Providing and facilitating such mediation is an important and valid role for the STB. STB mediation can help resolve disputes that, if left unresolved, could lead to resurgence of prolonged litigation or result in legislation that railroads and others would find less appealing.

B. Pre Deregulation Period - Early 1970's

As a staff economist at the Interstate Commerce Commission (ICC), the predecessor agency to the Surface Transportation Board (STB), my duties included review and analysis of filings in General Rate Increase Cases. During

this period rail rates involved published tariffs, and contracts had virtually no role. The rail industry sought broadly applicable percentage increases of existing rates in General Rate Increase Cases. The rate increases were typically based on cost increases. During this period the ICC had a very significant role in determining rail rates and rate increases.

Status of the Rail Industry

During this same time period, the rail industry in the Northeast was approaching a historic collapse which culminated in the bankruptcy of the Penn Central and other Northeast Railroads.

C. Rail Reorganization and Restructuring - Mid 1970's

As Manager of Local Rail Service Planning for the U.S. Railway Association I was a member of a team tasked with analyzing the rail bankruptcies and creating a viable entity from the assets of those corporations. In this project of unprecedented scope and historic impact, at USRA we developed, computerized, and implemented the light density lines cost analysis system, which helped define Conrail. We worked closely with the Rail Services Planning Office, within the ICC. The USRA systems were used to analyze and help reach line service decisions for over nine thousand miles of railroad, in a 17 state Region of the US including some US railroad lines in Canada.

Status of the Rail Industry

During this time period, the rail industry in the Northeast emerged from the ashes of bankruptcy. This process made clear that alternatives to traditional economic regulation merited more consideration. Conrail, which had been created out of the bankrupt railroads, was gaining its footing.

D. Rail Reorganization and Restructuring - late 1970's

At the Consolidated Rail Corporation (Conrail) as Assistant Director, Cost & Economics, along with my staff and managers, we were tasked with management and regulatory cost analyses in both freight and passenger areas. To help rebuild profitability we designed, installed and managed a computerized internal management economic analysis system at Conrail. The system used specific management accounting data to develop economic costs and was used to help guide virtually all transportation management decisions, including service design, equipment acquisition, strategic initiatives, line abandonments and service discontinuance.

We developed and managed profit maximization and plant rationalization programs. Much of this was based on computerization and improvement of a

wide range of economic and cost analysis systems which were used to help manage and turn around this multi-billion dollar corporation

Status of the Rail Industry

During this time period, initially Conrail and gradually the entire rail industry began to turn away from reliance on rate regulation seeking a better understanding of, and more reliance on, the marketplace.

E. Rail Deregulation – early 1980's

At the Association of American Railroads as Assistant Vice President, Economics, initially my duties included preparation, review and analysis of filings in General Rate Increase Cases. Subsequently, at the AAR we conducted economic analyses to help formulate industry economic policy positions which led to the Staggers Rail Act of 1980. After the passage of Staggers, working with ICC staff, we participated in helping shape the most significant rail industry Costing System project in 40 years, the Uniform Rail Costing System (URCS).

We also helped direct development and installation of a commercial computerized economic and market analysis system subsequently used by virtually all major US railroads.

Status of the Rail Industry

During this time period, the rail industry, deregulated by the Staggers Rail Act of 1980, adopted market based management and pricing policies. Rate regulation was limited and was implemented reflecting other policy goals including revenue adequacy.

F. Rail Deregulation – mid 1980's and beyond

In 1982 as Vice President of DNS Associates, we participated in rail merger analyses, transportation infrastructure analyses, plant and network rationalization and feasibility studies. Which fore-shadowed the re-shaping of the rail industry, as it moved toward greater consolidation. As the rail industry and the ICC moved toward the marketplace we advised the U.S. Rail Accounting Principles Board on the costing aspects of regulatory reform policies. Is part of this process I provided expert testimony in Stand Alone Cost rate cases before the ICC.

Status of the Rail Industry

During this time period, the rail industry adopted Constrained Market Pricing and Stand Alone Costs as the principal rate regulation method. Reliance on transportation contracts grew and access to rate regulation became more limited and narrow.

In 1988 as Vice President of Snavelly King and Associates, now known as Snavelly King Majoros O'Connor & Lee, Inc. the focus on rail continued. Paralleling the changes in the transportation industry, our transportation practice evolved from being largely geared toward regulation and litigation to being primarily geared toward marketplace solutions. We produced a series of guidelines on transportation negotiations and contracting and facilitated transportation negotiations and contracting seminars for a wide range of clients. At the same time, the firm's officers and staff also provided expert witness testimony in successful transportation rate litigation.

We analyzed dozens of rail merger scenarios including merger cases which have re-shaped the rail marketplace.

Status of the Rail Industry

During this time period, the rail industry moved toward ever increasing consolidation and concentration through mergers and acquisitions. While more short line and regional railroads came into existence, the increase in competitive options in the marketplace was limited. Unless the short line had access to competing Class I railroad connections it tended to have a limited effect on rail to rail competition. Calls for rate reasonableness review became more prevalent as rail to rail competition dwindled.

II. Regulatory Response

The ICC had established Coal Rate Guidelines in 1985. This met the needs of a relatively small segment of the rail market. The ICC and STB responded to the unmet needs by instituting a proceeding to develop non-coal rate reasonableness guidelines in 1995. The objective, to develop a feasible and practicable method that can help produce more reasonable railroad rates, benefits both railroads and shippers.

Specifically the Small Shipment Rate Reasonableness cases address rail rates that generate Revenue Cost Ratios (RCR) which:

- ☐ Exceed 180 percent and
- ☐ Exceed the levels given by measures such as those advanced by the ICC and STB in Ex Parte No. 347 (Sub-No.2) Rate Guidelines – Non Coal Proceedings.¹

¹ In the Action Plan we consider all three STB parameters; RCR comp; RCR>180 and Revenue Shortfall Allocation Method (RSAM).

Ultimately, resolving these situations benefits both shippers and railroads since Such rates present three sets of issues:

1. Higher rail costs erode the rail shipper's profitability and could cause the shippers' decline or demise
2. In the global market, higher rail costs could erode competitive strengths for the shipper in its product markets.
3. Diminished competitiveness for such shippers can erode the rail traffic base and threaten rail profitability.

The action plan we recommend builds on what has already been accomplished to design and implement effective strategies to achieve more reasonable rail rates.

The action plan involves coordinated use of both the Surface Transportation Board (STB) Constrained Market Pricing, Maximum Rate "Stand Alone Cost" (SAC) concepts and the small shipper rate reasonableness approach.

The STB's "stand-alone cost" ("SAC") test seeks to determine the lowest cost at which a hypothetical, efficient, "stand-alone railroad" ("SARR") could provide the transportation service needed by a complaining shipper. Under the SAC test, the complaining shipper designs a hypothetical railroad specifically tailored to serve its needs and the needs of other traffic it designates. The costs of building and operating such an efficient SARR are then compared to the revenues that such a system could expect to earn. If the involved shipper demonstrates that the SARR would earn more than necessary to cover all of its costs (including a reasonable return on investment), the shipper is entitled to rate relief.

III. A Prospective Action Plan

The Action Plan consists of the following steps:

1. Select rail lanes for which rail or other modal competition is not available or not economically or commercially practical. This clears the market dominance hurdle enroute to seeking Surface Transportation Board (STB) regulatory rate relief.
2. Demonstrate that the rail shipper is eligible to pursue Surface Transportation Board Maximum Rate Relief for the traffic at issue under the STB regulations.
3. Demonstrate that the rail rates at issue would be found as excessive using small shipment guidelines such as those promulgated in Ex Parte No. 646

4. Develop and apply a flexible synthesized solution based on STB small shipper guidelines applied within mediation facilitated by the STB.

IV. Benefits of the SK Action Plan

□ Benefits for The Rail Shipper

The rail shipper benefits by achieving rate relief on key lanes and resolving impasses with the railroads. The rail shipper also benefits by avoiding the cost and risk of a major rate case. The first use of this process occurred in the BP-Amoco – Norfolk Southern case which was successfully concluded through STB mediation in June 2005.² Snavelly King served as the witness and Leboeuf Lamb Greene and MacRae served as counsel to BP-Amoco

□ Benefits for The Railroads

The railroads benefit by demonstrating that the small shipper guidelines mechanism they have been advocating for over a decade can actually work. This mutes the demand for more stringent rail regulation. The railroads also benefit by resolving impasses with the involved shippers and avoiding the cost and risk of major rate cases. As noted above, this process was successfully applied in the BP-Amoco – Norfolk Southern case.

□ Benefits for The STB

The STB benefits by demonstrating that the small shipper guidelines they have been working on since the early 1990's can work effectively. However, the guidelines work only when combined with innovative mediation techniques such as those advocated by the STB and implemented in the BP-Amoco – NS case. This was the first small shipment case ever brought before the STB and was settled in June 2005, facilitated by STB mediation.

V. Implementation of the SK Action Plan

Our approach uses proven methods in logistics, systems analysis, negotiation strategy, and regulatory policy. Each of the steps, as defined by SK, is outlined below.

1. Select specific rail lanes with Revenue Cost Ratios well above the regulatory threshold on lanes for which rail or other modal competition is not available or not economically or commercially practical. Meeting these two conditions satisfies the market dominance prerequisite for accessing

² See STB Docket NOR 42093 for public filings on this pathbreaking case.

Surface Transportation Board (STB) regulatory rate relief and indicates that regulatory rate relief may be appropriate.

- Based on extensive SK analyses of rail lanes over recent years, numerous rail lanes exceed the regulatory threshold and also meet the market dominance prerequisite.
- Many such lanes carry relatively small amounts of traffic, making the cost of a Stand Alone Cost Case under Ex Parte No. 347 (Sub-No. 1) economically infeasible.

Such lanes should be eligible for regulatory rate relief under STB Ex Parte No. 646 Rail Rate Challenges in Small Cases

Overall, SK has found numerous instances in which rail shippers are paying rates, which SK analyses indicate are:

- Producing RCR's greater than the regulatory threshold
- Producing RCR's greater than those on comparable traffic
- Producing RCR's greater than the STB Revenue Shortfall Allocation Method (RSAM) benchmarks³

2. Demonstrate that small rail shipments are eligible to pursue Surface Transportation Board Maximum Rate Relief under the STB regulations in Ex Parte 347 Sub No. 1.

Having established eligibility for regulatory relief, the strategy is to move first to the STB small shipper guidelines and then to STB-assisted mediation of those guidelines.

Under the Interstate Commerce Act, as revised by the ICCTA, the ICC and its successor agency the STB were charged with protecting individual captive shippers from unreasonably high and unfair rate levels.⁴ In doing so, the STB

³ The recommended reliance on STB RSAM and similar parameters requires open access to the underlying data and calculations to ensure the credibility and effectiveness of the process.

⁴ This section draws on excerpts from a series of STB decisions in Ex Parte 347 (Sub No.2) ranging from 1995 through 2004.

was specifically directed to consider three so-called Long-Cannon factors⁵, set forth in 49 U.S.C. 10701(d) (2). These factors are:

- **Long-Cannon- 1**; the amount of traffic transported at revenues which do not contribute to going concern value and the efforts made to minimize such traffic
- **Long-Cannon- 2** the amount of traffic which contributes only marginally to fixed costs and the extent to which, if any, rates on such traffic can be changed to maximize the revenues from such traffic; and
- **Long-Cannon- 3** the carrier's mix of rail traffic to determine whether one commodity is paying an unreasonable share of the carrier's overall revenues.

In determining reasonable rates, the STB is also directed to ensure that carriers have the opportunity to earn revenues that are adequate to cover costs, allow replacement of needed assets, and provide a fair return on investment. The mediation process is particularly appropriate for meeting these combined challenges.

Under the Ramsey pricing principles adopted by the ICC and STB, railroads price traffic in inverse proportion to demand elasticity, up to the point at which a reasonable, adequate profit level is attained. In other words, a railroad prices its traffic differentially so as to recover a greater percentage of its unattributable costs from the traffic with greater dependency on its service.

If there is a challenge to the reasonableness of a rail rate charged for captive traffic, the regulatory task is to determine whether the degree of differential pricing--i.e., the amount by which the revenues derived from the traffic at issue exceed the long-run marginal cost (LRMC) of handling that traffic--is reasonable. This determination should be carried out in light of the three Long-cannon factors.

The STB is guided by Ramsey pricing principles and fundamental fairness in carrying out this regulatory task. But LRMC, attributable costs and elasticities of demand are economic concepts that are typically not directly measurable, and notions of fairness can be subjective. The STB challenge is to reflect these economic and equitable principles, in a practical, readily administered test.

The Coal Rate Guidelines, adopted in 1985, provided the regulatory framework,

⁵ The Long-Cannon Factors were named for the two Senators who introduced the amendment that added these provisions to the Staggers Rail Act of 1980 (Staggers Act), which deregulated the rail industry.

known as Constrained Market Pricing (CMP), now used for analyzing rail rate challenges in major rail rate cases.

CMP has been approved by the courts and applied in a number of cases, most often using a stand-alone cost (SAC) analysis. However, the STB recognized that a SAC analysis or other CMP presentation could be quite expensive and thus not feasible where the amount of money at issue does not justify the expense.

Accordingly, the ICC initiated a proceeding to determine rate reasonableness guidelines for small shippers. This was intended to determine maximum rail rates where CMP (particularly SAC) is too costly or traffic too infrequent and dispersed for a Stand Alone Cost analysis.

The STB recognized that a simpler method would necessarily be cruder than the CMP applied in major rate cases. Accuracy is sacrificed for simplicity. This trade-off is necessary to ensure that shippers are not foreclosed from exercising the statutory right to challenge the reasonableness of rates charged on its captive traffic.

Under STB regulations (49 U.S.C. 10707(d) (1)), the reasonableness of a rate cannot be challenged if any of the following conditions hold:

- ❑ The revenues generated by that rate are less than 180% of the variable costs associated with handling the traffic involved.
- ❑ In addition, under 49 U.S.C. 10709(c), the reasonableness of a contract rate cannot be challenged.
- ❑ Similarly, rates for traffic or services that are exempted from regulation pursuant to 49 U.S.C. 10502 or its predecessor (former 49 U.S.C. 10505) are free from challenge.
- ❑ The qualitative market dominance limitation of 49 U.S.C. 10707(a)-(b) rules out traffic with access to effective transportation competition.
- ❑ Finally the grandfather provision of section 229 of the Staggers Act, which conferred regulatory immunity upon the rate levels that were in place at that time and not successfully challenged by a certain date

We have identified many lanes that meet all of these tests.

3. Demonstrate that the small shipment rates at issue would be found as excessive in rate reasonableness analyses using the STB small shipper guidelines in Ex Parte 347, Sub No. 2.

As noted above, the STB Constrained Market Pricing (CMP) rail rate guidelines were developed in the mid 1980's for use in coal rate cases in ICC proceeding Ex Parte No. 347 (Sub-No. 1).⁶ Subsequently, on December 27, 1996, in Ex Parte No. 347 (Sub-No. 2) Rate Guidelines -- Non-Coal Proceedings, the Board adopted simplified evidentiary guidelines. These were designed to be used in proceedings to determine the reasonableness of challenged rail rates charged on captive traffic where the Constrained Market Pricing guidelines used in major maximum rate cases cannot practicably be applied.

As of 1996 these simplified guidelines used three revenue-to-variable cost (R/VC) benchmark figures as starting points for a case-by-case reasonableness analysis.

- ❑ The RSAM benchmark reflects the defendant carrier's particular revenue needs (by examining the average markup that the carrier might charge its potentially captive traffic to meet those needs).
- ❑ The R/VC_{COMP} benchmark reflects demand-based differential pricing principles (by measuring the markups applied to similar traffic).
- ❑ The R/VC_{>180} benchmark tests whether the traffic at issue bears a disproportionate share of the carrier's revenues (by examining the markups applied by the carrier to its other potentially captive traffic).

Our approach uses each of these STB R/VC to ascertain whether rail shippers on small volume lanes would qualify for and should receive rate relief.

G. Combined R/VC or RCR Benchmarks

Taken together the three RCR benchmarks substantially meet the requirements of the Long-Cannon Factors and Constrained Market Pricing. In combination, these measures provide a solid base on which to determine whether a given rate or set of rates exceeds a reasonable level.

The combined benchmarks include all of the factors that must be looked at in a rate reasonableness analysis:

⁶ Coal Rate Guidelines--Nationwide, 1 I.C.C.2d 520 (1985)

- The RSAM measure addresses revenue adequacy and managerial efficiency (at least as reflected in the Long-Cannon-1 and Long-Cannon-2 tests),
- The R/VC_{COMP} measure addresses demand-based differential pricing, and
- The R/VC_{>180} measure addresses basic principles of fairness (as reflected in the Long-Cannon-3 test),

Accordingly, the three r/vc or RCR benchmarks in combination provide a solid base for rate reasonableness analysis.

4. SK recommends a synthesized alternative: a solution based on STB small shipper guidelines and mediated by the STB.

In recognition of the ongoing need to improve the Simplified Small Shipper Rate Guidelines to make them effective and available, we recommend continued and broadened use of STB facilitated mediation. The recent successful use of mediation, facilitated by the STB, shows that the STB, railroads and shippers can use this technique effectively.

SK has participated successfully in both mediation and arbitration in rail and other industries. The widespread use of mediation and arbitration techniques indicates their effectiveness.

Some of the benefits associated with mediation can be summarized as follows:

- **Effectiveness.** Mediation works. It is an effective means of dispute resolution for disputes not requiring judicial or third party determination. It provides a forum and an atmosphere in which parties gain understanding, become understood, and work together to explore options for resolution. By resolving disputes in mediation, parties determine for themselves what is important and, ultimately the outcome of the situation.
- **Communication.** In hearing and being heard in the mediation forum, parties gain the understanding of the other parties' point of view, and an enhanced opportunity to be heard and understood themselves.
- **Speed:** In resolving or narrowing disputes through mediation, parties avoid the delay of a third party or judicially decided outcome.
- **Economy:** In resolving or narrowing areas of disputes through mediation parties save an enormous amount of time, energy, and expense associated with protracted conflict or litigation.

- ❑ **Confidentiality:** While lawsuits are generally matters of public record, what transpires at a mediation can be kept confidential by agreement. Whether a mediation occurs before or after filing of a lawsuit, any form of communication generated at a mediation is normally inadmissible evidence.
- ❑ **Quality Of Settlement:** Parties entering into voluntary agreements through mediation are more likely to adhere to and fulfill commitments made in such agreements than they are with judicially imposed resolutions.
- ❑ **Win-Win:** Through mediation, parties avoid both the "win-lose" and "lose-lose", outcomes associated with litigation. Many parties who "win" in protracted litigation find that the time, energy, and monetary commitment associated with litigation comes at an enormous cost. Those who lose in litigation fare even worse. Mediation can spare parties from all of this and enable them to move forward from disputes efficiently and effectively.

These are just some of the benefits provided by mediating disputes. Moreover, there is seldom any serious downside to mediation. Mediation works not only because it focuses on the parties' own interests and agendas, but also because it provides the opportunity for parties to move beyond disputes to chart a better solution.

VI. Recommendation

SK recommends continued rail rate reasonableness review based on the STB Small Shipper Guidelines combined with STB-facilitated mediation; such as outlined in this Action plan. This approach combines the decades of ICC and STB rail rate reasonableness analyses with the proven strengths of mediation in resolving fact finding and other issues.

SK has successfully used all of the techniques recommended in this plan.