

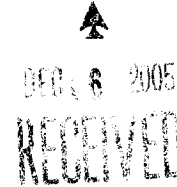
STEPTOE & JOHNSON LLP
ATTORNEYS AT LAW

215295

Samuel M. Sipe, Jr.
202.429.6486
ssipe@steptoe.com

1330 Connecticut Avenue, NW
Washington, DC 20036-1795
Tel 202.429.3000
Fax 202.429.3902
steptoe.com

December 6, 2005



Via HAND DELIVERY

PUBLIC VERSION

The Honorable Vernon A. Williams
Secretary
Surface Transportation Board
1925 K Street, NW
Washington, DC 20423

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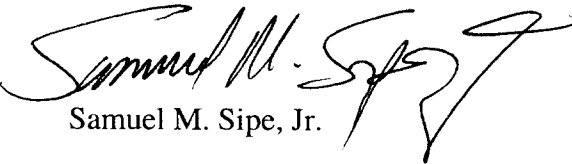
Re: **STB Docket No. 42088, *Western Fuel Association, Inc. and Basin Electric Cooperative, Inc. v. BNSF Railway Company***

Dear Secretary Williams:

Enclosed for filing in the above-captioned matter are the original and ten copies of the Public version of the Final Brief of BNSF Railway Company. Also enclosed is a CD containing a PDF version of this filing. A Highly Confidential version of this Final Brief is being filed under separate cover.

Please date stamp the extra copy of this cover letter and return it to the messenger who delivered this filing.

Sincerely,


Samuel M. Sipe, Jr.

Enclosures

cc: Counsel for Complainant

PUBLIC VERSION

**BEFORE THE
SURFACE TRANSPORTATION BOARD
STB Docket No. 42088**

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**WESTERN FUELS ASSOCIATION, INC. AND
BASIN ELECTRIC POWER COOPERATIVE, INC.
v.
BNSF RAILWAY COMPANY**

Final Brief of BNSF Railway Company

Richard E. Weicher
Michael E. Roper
BNSF RAILWAY COMPANY
2500 Lou Menk Drive
Fort Worth, TX 76131
(817) 352-2353

Samuel M. Sipe, Jr.
Anthony J. LaRocca
Linda S. Stein
STEPTOE & JOHNSON LLP
1330 Connecticut Ave, N.W.
Washington, DC 20036
(202) 429-3000

Attorneys for BNSF Railway Company

December 6, 2005

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TABLE OF ABBREVIATIONS

AAR	Association of American Railroads
Basin	Basin Electric Power Cooperative
BNSF	BNSF Railway Company
DCF	Discounted Cash Flow
EIA	Energy Information Administration
ICC	Interstate Commerce Commission
LRR	Laramie River Railroad
MOW	Maintenance of Way
MSP	Modified Straight-Mileage Prorate
OE	Operating Expense
PRB	Wyoming Powder River Basin
RAM	Revenue Allocation Method
RCAF-A	Rail Cost Adjustment Factor-Adjusted for Changes in Productivity
RCAF-U	Rail Cost Adjustment Factor-Unadjusted for Changes in Productivity
RSAM	Revenue Shortfall Allocation Method
RTC	Rail Traffic Control
R/VC	Revenue-To-Variable Cost
SAC	Stand-Alone Cost
SARR	Stand-Alone Railroad
STB or Board	Surface Transportation Board
UP	Union Pacific Railroad
URCS	Uniform Rail Costing System
WFA	Western Fuels Association, Inc.
WFA/Basin	Western Fuels Association, Inc. and Basin Electric Power Cooperative
WRPI	Western Railroad Property, Inc.

CASE NAMES

<i>APL</i>	<i>Arkansas Power & Light Co. v. Burlington Northern R.R.</i> , 3 I.C.C.2d 757 (1987)
<i>Guidelines</i>	<i>Coal Rate Guidelines, Nationwide</i> , 1 I.C.C.2d 520 (1985)
<i>Ex Parte No. 270 (Sub-No. 4)</i>	<i>Ex Parte No. 270 (Sub-No. 4), Investigation of Railroad Freight Rate Structure Coal</i> , 344 I.C.C. 71, 227 (decided Dec. 3, 1974).
<i>FMC</i>	<i>FMC Wyoming Corp. v. Union Pacific R.R.</i> , STB Docket No. 42022 (served May 12, 2000)
<i>Nevada Power</i>	<i>Bituminous Coal – Hiawatha, Utah, to Moapa, Nevada</i> , 10 I.C.C.2d 259 (1994)
<i>OPPD</i>	<i>Omaha Power District v. Burlington Northern R.R.</i> , 3 I.C.C.2d 123 (1986)
<i>PPL</i>	<i>PPL Montana, LLC v. The Burlington Northern and Santa Fe Ry. Co.</i> , STB Docket No. 42054 (served Aug. 20, 2002)
<i>TMPA</i>	<i>Texas Municipal Power Agency v. The Burlington Northern and Santa Fe Ry. Co.</i> , STB Docket No. 42056 (served Mar. 24, 2003)
<i>WPL</i>	<i>Wisconsin Power & Light Co. v. Union Pacific R.R. Co.</i> , STB Docket No. 42051 (served Sept. 13, 2001)
<i>Xcel</i>	<i>Public Service Company of Colorado D/B/A Xcel Energy v. The Burlington Northern and Santa Fe Ry. Co.</i> , STB Docket No. 42057 (served June 8, 2004)
<i>Xcel II</i>	<i>Public Service Company of Colorado D/B/A Xcel Energy v. The Burlington Northern and Santa Fe Ry. Co.</i> , STB Docket No. 42057 (served Jan. 19, 2005)
<i>Xcel III</i>	<i>Public Service Company of Colorado D/B/A Xcel Energy v. The Burlington Northern and Santa Fe Ry. Co.</i> , STB Docket No. 42057 (served May 3, 2005)

This is the Final Brief of defendant BNSF Railway Company ("BNSF"), filed pursuant to the Board's October 20, 2005 and November 15, 2005 orders in this proceeding.

I. INTRODUCTION

In this proceeding, Western Fuels Association, Inc. ("WFA") and Basin Electric Power Cooperative, Inc. ("Basin") (collectively referred to as "WFA/Basin") have challenged rates for the transportation of coal to the Laramie River station that are among the lowest coal transportation rates, on a dollar per ton basis, charged by BNSF. Their strident claim that the challenged rates are "outrageously high" is out of touch with reality.¹ Indeed, WFA/Basin present an exhibit on rebuttal showing that, on a dollar per ton basis, the Laramie River common carrier rates were lower than { } percent of the rates paid by BNSF's customers for coal transportation in 2004.² Significantly, if the \$3.37 rate proposed by WFA/Basin for 4Q04 were prescribed by the Board,³ it would not even appear on the exhibit -- it would be far lower, on a dollar per ton basis, than *any* of the rates charged by BNSF for coal transportation to *any* shipper in 2004.

WFA/Basin want the Board to perpetuate through regulation the extremely low rates that WFA/Basin previously received under a 20-year transportation contract entered into in settlement of antitrust litigation in 1984. Under that contract, rates went down { } percent in inflation-adjusted dollars from 1984 to 2004. BNSF Opening Nar. at II-26. As a result of the extraordinarily low coal transportation rates under that expired contract, the Laramie River plant

¹ See, e.g., WFA/Basin Opening Nar. at I-4, 5; WFA/Basin Reply Nar. at I-1.

² WFA/Basin Reb. Exh. III-H-2 (Laramie River common carrier rates are listed as number { } out of 393 rates.) This exhibit lists the same plant multiple times. If this duplication is eliminated, only { } plants are shown on the exhibit to have lower rates, on a dollar per ton basis, than the common carrier rates to Laramie River.

³ WFA/Basin Reb. Nar. at III-H-43, Table III-H-5.

became one of the lowest cost producers of electricity in the nine-state area served by Basin Electric. *Id.* at II-27. Basin was able to provide \$140 million in credits to its members over the five-year period 1999 to 2003. *Id.* In 2003, Basin's CEO boasted that "there is no doubt; we are in good times." *Id.*

WFA/Basin have no right to expect to extend the windfall they received under the 1984 contract in today's rail transportation market. Demand for PRB coal transportation is at an all time high and is expected to grow. Rail capacity in the PRB is becoming increasingly constrained, as demand for access to PRB mines outstrips the ability of the railroads to serve those mines. Large scale investment is needed to expand PRB rail capacity, and the funds for that investment must come from the shippers who benefit from the rail infrastructure.

WFA/Basin ship over 8 million tons of PRB coal per year, making them one of the largest PRB coal shippers and one of the largest beneficiaries of BNSF's PRB infrastructure. The Board cannot allow them to avoid responsibility for contributing to the growing costs of maintaining and replacing that infrastructure.

By any objective measure, the rates at issue here are commercially reasonable. The amount of contribution generated under the challenged rates -- the revenues per ton in excess of variable costs -- is actually *less* than the contribution generated by the rates prescribed by the Board in the *Xcel* case.⁴ While WFA/Basin complain that the challenged rates are high on a mills per ton-mile basis,⁵ contribution is a far more meaningful benchmark than mills per ton-mile, since contribution is a direct measure of the revenues that will be available for reinvestment

⁴ Using BNSF's variable cost calculations, the contribution provided by the common carrier rates in 4Q04 ranges from \$4.52 to \$4.67 depending on the mine origin. *See* BNSF Reb. Nar. at II-29, Table II.A-3. Using the STB's variable cost calculations, the contribution provided by the *Xcel* prescribed rates for aluminum and steel cars is \$4.74 and \$4.69, respectively, in 2003. *Xcel* at 120-121 (cost calculation); *Xcel III* at 4 (prescribed rate).

⁵ WFA/Basin Reb. Nar. at III-H-7 to 8.

in PRB capacity. BNSF has the capacity to originate only a limited volume of coal traffic from the PRB and the demand for that capacity is growing. BNSF incurs an opportunity cost in using this capacity on low contribution traffic when higher contribution traffic is available. Holding down the revenue provided by a high volume shipper like WFA/Basin that uses a large portion of BNSF's constrained PRB capacity would limit BNSF's ability to expand capacity to meet that demand.

BNSF's economic witness, Professor Kalt, of the Kennedy School of Government, Harvard University, further explained that even with an increase in transportation costs produced by the challenged rates, the Laramie River plant continues to be well below the average of other power producers, in terms of variable production costs, in the nine-state region served by Basin.⁶ BNSF's Assistant Vice President of Coal Marketing West, Mr. Brautovich, explained that BNSF established rates for the Laramie River plant from three PRB origin regions at levels that were not expected to affect demand for coal, and that BNSF took those rates up to the targeted levels in three steps which, consistent with the phasing constraint in the *Guidelines*, would avoid any economic dislocations from the rate increase. BNSF Reply Exh. III.A-5.

The R/VC ratios produced by the challenged rates are also fully consistent with the need for BNSF to differentially price its transportation service to achieve revenue adequacy. The Board's predecessor, the ICC, recognized that "the cost structure of the railroad industry necessitates differential pricing of rail services." *Guidelines*, 1 I.C.C. 2d at 526. Under a regime of differential pricing, shippers with inelastic demand, like WFA/Basin, pay relatively higher rates than shippers with more elastic demand. The Board promulgates a benchmark, the RSAM, to identify the average level of rates expressed in terms of R/VC ratios that a railroad must be

⁶ BNSF Opening Nar. at II-28 and Exhibits II.C-2 and II.C-3.

allowed to charge shippers with inelastic demand to generate adequate revenues.⁷ Because the RSAM is an average, some shippers with highly inelastic demand, like WFA/Basin, should expect to pay rates that generate R/VC ratios significantly in excess of the RSAM. The challenged rates in this case generate R/VC ratios of 320 to 361,⁸ which are only slightly higher than the average RSAM of 323 that the Board has calculated for BNSF for the years 2000 through 2003.⁹

Of course, the Board does not evaluate the commercial reasonableness of the challenged rate in a rate reasonableness proceeding or use the RSAM as the measure of rate reasonableness. Instead, the Board applies the principles of Constrained Market Pricing set out in the *Guidelines*, including the SAC test. BNSF showed in its evidentiary filings that the challenged rates do not exceed reasonable maximum rates under the SAC test. The principal methodological issue in this case, like in other recent SAC litigation, is the proper treatment of cross-over traffic. WFA/Basin rely heavily on cross-over traffic. The only traffic that is handled by the LRR for its full end-to-end movement is the issue traffic. The LRR's cross-over traffic moves on average only a very short distance on the LRR yet it is assumed to generate enormous revenues.

The Board has rejected in past cases BNSF's position that the use of cross-over traffic is fundamentally inconsistent with the revenue/cost comparison that is at the heart of the SAC test. The Board has accepted the use of cross-over traffic as a simplification technique even though it acknowledges the "imprecision" in SAC results that flows from having to allocate through revenue between two segments of a through movement. The Board has also rejected BNSF's

⁷ *Rate Guidelines - Non-Coal Proceedings*, 1 S.T.B. 1004, 1011 (1996).

⁸ BNSF Reb. Nar. at II-1, II-29.

⁹ *Rate Guidelines - Non-Coal Proceedings*, STB Ex Parte No. 347 (Sub-No. 2), slip op. at 3 (served June 22, 2005).

density-based approach to allocating revenues on cross-over traffic on grounds that BNSF had not sufficiently identified the impact of density on costs. Thus, BNSF presents in this case a new approach to the use of cross-over traffic in the SAC analysis that allows for simplification without arbitrary allocations of the incumbent's through revenue to determine the revenues that cross-over traffic would contribute to the SARR.

As explained further below, BNSF proposes that revenues on cross-over traffic be based on contestable market rates rather than imprecise approximations of non-existent rates on segments of through movements. If contestable market rates are used on cross-over traffic, then the Board is able to focus the SAC inquiry on the question whether the incumbent's rates on through traffic, including the issue traffic, are cross-subsidizing other traffic. This approach therefore offers an equitable and economically rational solution to two of the most vexing problems in recent SAC cases -- how to use cross-over traffic without gross distortions of SAC results and how to determine the proper level of the issue traffic rate if SAC revenues are found to exceed SAC costs.

II. TRAFFIC AND REVENUE

The parties agree on most matters regarding the volumes to be transported by the LRR. They agree on the plants to be included in the stand-alone network, the base year volumes shipped to those plants and the index that should be used to project traffic volumes (and revenues) for the years 2005 and for the years 2010 to 2024. The main volume issue on which the parties disagree involves the index that should be used to adjust LRR volumes from 2006 through 2009. As explained in BNSF's Reply Narrative, the Board should use the BNSF Macro Coal forecast rather than the EIA forecast.¹⁰

¹⁰ BNSF Reply Nar. at III.A-17 to 18. WFA/Basin's reliance on the *Xcel* decision to support the use of the EIA forecast rather than the BNSF Macro Coal forecast is misplaced. In

In contrast, the parties have fundamental disagreements about the revenues that the LRR can be assumed to earn. Those revenue issues drive the results of the SAC analysis and are therefore discussed in detail below.

A. Revenues Available to the LRR from Cross-Over Traffic

WFA/Basin, like other complainants in recent SAC cases, rely heavily on cross-over traffic in their stand-alone network. The only movement served by the LRR for the full journey from the mine to the plant is the issue traffic. Moreover, the average length of haul for the LRR's cross-over traffic is less than 70 miles, and the average length of haul for more than 71 million tons of cross-over traffic exiting the LRR at Donkey Creek or Campbell is only 15.6 miles. BNSF Reply Nar. at III.A-56; BNSF Reply Exh. III.A-7. The use of the MSP methodology with 100-mile origination credits to allocate revenues on this short-haul cross-over traffic distorts the SAC results in favor of the shipper. The origination credit alone accounts for almost *90 percent* of the cross-over revenue allocated to the LRR on the shortest-haul traffic exiting the LRR at Donkey Creek or Campbell. On this traffic, the LRR receives 12.2 percent of the revenue even though the LRR handles only 1.8 percent of the total miles. BNSF Reply Exh. III.A-7.

Contestability Approach. BNSF presents in this case a new methodology for determining the revenues that a SARR would earn on this cross-over traffic. As explained by BNSF's expert Professor Kalt, BNSF's contestability pricing approach to cross-over traffic

Xcel, the complainant did not use the BNSF forecast for any purpose, while in this case, WFA/Basin use the BNSF Macro Coal forecast to determine when to add or delete coal plants from the LRR traffic group from 2005 through 2009. *See* WFA/Basin Opening workpapers 01025-01027. Moreover, BNSF's Coal Macro forecast is a better predictor of future LRR volume (and revenue) growth than the EIA forecast because it is BNSF-specific (and most BNSF coal business is from the PRB), as compared to the EIA forecast which, although PRB specific, includes UP projections.

addresses railroads' concerns about the possibility of gaming the SAC analysis through the use of cross-over traffic and shippers' concerns about defendants' possible gaming of the rate reduction methodology. BNSF's contestability pricing approach addresses both issues in a single framework that is consistent with fundamental principles underlying constrained market pricing and the SAC test.

The Board thinks of the SAC test as a test for cross-subsidy on a subset of the defendant railroad's network. In this framework, the Board compares the revenues expected from the defendant's current rate structure for the traffic selected against the costs incurred to build and operate a SARR to handle that traffic. The problem with this construct when cross-over traffic is involved is that there are no existing rates charged by the defendant railroad for portions of movements that correspond to the cross-over movements on the SARR.¹¹ The revenue assigned or allocated to the SARR cross-over movement is at best an approximation of what such a rate might be. The approximation is unavoidably "imprecise" as the Board has acknowledged.¹²

The use of a contestable market rate for cross-over movements as BNSF advocates would replace an imprecise approximation of an existing rate (that does not really exist) with the rate an efficient SARR would realize on a cross-over movement in a contestable market. It is not necessary to guess or approximate what this contestable rate would be; it can be determined with precision by calculating the defendant's avoided cost for the cross-over movement. This is not a rate that might be too high at existing levels and therefore might need to be reduced; it is the rate that the SARR would expect to realize in a contestable market and it is therefore, by definition, a

¹¹ The *Guidelines* "assume that the revenue contribution of other (i.e. non-complaining) shippers will be at the level of their current rates." 1 I.C.C. 2d at 544. But there are no existing rates for cross-over traffic.

¹² Moreover, it seems fundamentally unfair for the Board to test the reasonableness of a set of rates that do not exist.

reasonable, market-determined rate. Accordingly, these contestable cross-over rates are not subject to reduction in the rate reduction phase of a SAC analysis.

The contestable rate approach for cross-over traffic would permit cross-over traffic to be used as a simplification measure while avoiding the distortions (potentially gross distortions) of having the vast majority of SARR revenues based on approximations. This "restraint" on the use of cross-over is the only equitable way proposed to date to balance the interests of shippers, who want to realize the benefits of traffic densities, and railroads, who want to avoid having their rates reduced because of imprecise revenue allocations on cross-over traffic. Complaining shippers are free to include as much through traffic at the incumbent's existing rate levels as they wish in the SARR, as long as they build the necessary facilities to handle the through movements. It is up to the shipper to determine whether it will benefit more from the inclusion of the through movement or from the contribution to unattributable SARR costs that its optimally efficient SARR will realize on contestable cross-over rates. This contribution results from the fact that the SARR's attributable costs for any given cross-over movement will be lower than the defendant's URCS variable costs for that portion of the real-world through movement to the extent that the SARR is more efficient than the real-world defendant.

The use of contestable prices on cross-over movements eliminates or substantially reduces the perceived problem of gaming in connection with the application of the percentage rate reduction. Since the cross-over rates are set at the contestable level to begin with, they should not be subject to rate reduction. Hence the only rates that will be reduced in the event that the present value of revenues exceeds the present value of costs are the rates on through movements that have been included in the SAC analysis at their actual (and projected) levels.

Where the issue traffic is the only through movement, the rate on that traffic is entitled to the entirety of the rate reduction.

WFA/Basin's principal criticism of BNSF's contestability approach is that it supposedly assumes a retaliatory competitive response by the incumbent to the prospect of new entry, which would be an entry barrier. WFA/Basin Reb. Nar. at III-A-33 to 38. WFA/Basin are wrong. BNSF's contestability approach identifies the rate that would be set for a new, non-existent service -- the partial cross-over movement -- based on the principles of contestability. The incumbent is not assumed to reduce, increase or otherwise adjust in any way its existing rates to preclude entry -- there is no existing rate on the partial movement. BNSF's approach simply identifies the rate that the SARR would set on a cross-over movement in a competitive market that is free of entry and exit barriers. For this reason, BNSF's contestability approach is not inconsistent with the ICC's reasoning in the *Nevada Power* decision, which focused on an incumbent's efforts to preclude new entry. Moreover, the *Nevada Power* decision did not even consider the relationship between the assignment of cross-over revenue and the rate reduction methodology. BNSF's contestability pricing approach offers a new paradigm for dealing with both issues using a consistent economic framework.

MSP With Modified Origin Blocks. If the Board declines to adopt BNSF's contestability approach for determining revenues on cross-over movements and continues to use the MSP methodology, the Board must modify the origination/termination blocks used in the MSP methodology to reflect more accurately the incumbent's relative on-SARR and off-SARR costs. The 100-mile origination/termination block used by WFA/Basin, based on some prior SAC cases, is unnecessarily imprecise. The purpose of including an origination block in a cost-based revenue allocation methodology like MSP is to give the originating railroad revenue credit

to cover the costs of originating traffic. But use of a 100-mile origination credit in allocating through revenues on movements of coal in unit-train operations -- where huge efficiencies are gained precisely because origination costs are reduced -- overstates the revenues needed to cover the cost of originating unit trains. The revenue overstatement from the use of 100-mile origination credits is particularly significant on short-haul movements, like those that dominate the LRR.

BNSF presented substantial evidence demonstrating that a 25-mile rather than a 100-mile origination/termination credit for movements in shipper-owned cars more accurately reflects the relative cost of originating and terminating coal in unit trains. BNSF Reply Nar. at III.A-53 to 55.¹³ The 25-mile credit is directly based on the Board's own URCS adjustments, set out in *Ex Parte No. 270 (Sub-No. 4)*, that account for the relative efficiency and lower costs of originating and terminating traffic in unit trains. BNSF performed three additional analyses to confirm the reasonableness of the 25-mile credit for originating coal unit-train movements in shipper cars. First, BNSF examined the relationship between unit-train line-haul costs and unit-train origination costs as determined by URCS.¹⁴ Second, BNSF examined the variable cost evidence submitted by BNSF for Laramie River movements in this case to determine the relationship between line-haul costs and origin/termination costs and determined that origination costs are the equivalent of 21 to 23 miles of line-haul costs under this analysis. *Id.* Third, BNSF examined WFA/Basin's SAC evidence to determine the relationship inherent in that evidence between line-haul costs and origination/termination costs and determined that origination costs are the equivalent of about 14 miles of line-haul costs. *Id.* at III.A-54 to 55.

¹³ BNSF also presented evidence that a 57-mile credit would be appropriate for movements in railroad-owned cars. Most of the movements transported by the LRR are in shipper-owned cars.

¹⁴ BNSF Reply Nar. at III.A-54, BNSF Reply Exh. III.A-6.

WFA/Basin present *no* evidence suggesting that the 100-mile origination credit accurately reflects the costs of originating coal in unit trains. Instead, they make two arguments. First, they claim that the results of using a 25-mile credit are unacceptable -- regardless of the validity of the underlying calculations -- because a 25-mile credit produces revenues at or near the incumbent's variable costs and, thus, does not generate enough revenue for the SARR to cover its costs. WFA/Basin Reb. Nar. at III-A-42 to 43. But the complainant has no *entitlement* to revenues from non-issue traffic sufficient to cover the SARR's costs. Moreover, BNSF demonstrated that WFA/Basin's contention is wrong as a factual matter. When the calculation is done correctly, without including the substantial costs for a non-existent interchange, it is clear that the 25-mile credit provides revenues far in excess of the incumbent's variable costs to provide service over the lines replicated by the LRR. *See* BNSF's October 20, 2005 Motion at Klick/Fisher V.S., pages 15-18.

WFA/Basin's second argument is that MSP should not be viewed as a cost-based revenue allocation mechanism but rather as a proxy for a market-based revenue allocation procedure. WFA/Basin Reb. Nar. at III-A-43 to 46. Under this logic, it does not matter if the 100-mile credit inaccurately reflects the costs to originate unit coal trains because the origin credit is not supposed to reflect costs. But if MSP is actually a market-based revenue allocation procedure, then it should not be used at all in the SAC analysis since, contrary to WFA/Basin's claims, the Board's recent pronouncements on this subject emphasize that "the revenue allocation [on cross-over traffic] should reflect, to the extent practicable, the defendant carrier's relative costs of providing service over each of the two segments." *Xcel* at 17. If MSP were not an attempt to measure

relative costs, then it would have no role in the SAC test.¹⁵ In fact, it is clear that the Board views MSP and its origination/termination credits as a proxy for cost-based revenue divisions.¹⁶

B. Revenues Available to the LRR from Issue Traffic

WFA/Basin also attempt to have the Board disregard the challenged rates in carrying out the SAC analysis on grounds that BNSF had a “regulatory incentive to publish high tariff rates.” WFA/Basin Reply Nar. at I-7. WFA/Basin urge the Board to: (1) ignore the fuel surcharge included in the challenged rate; (2) ignore the three-year step increases in the rates; and (3) ignore the level of the challenged rates in setting a prescribed rate if SAC revenues are found to exceed SAC costs. But the Board cannot ignore the common carrier rates established by BNSF in performing the SAC analysis. The governing statute gives BNSF the right to set rates and it gives the Board jurisdiction to review the rates that have been set by a market dominant railroad, not some fictional substitute for those rates. 49 U.S.C. §§ 10701(c), 10704(a).

WFA/Basin argue that the rate adjustment procedure, including the three-step rate increase and fuel surcharge, that applies to and is included in the challenged rates, can be disregarded as an “unreasonable practice.” WFA/Basin Opening Nar. at III-A-13 to 14. But there is nothing unreasonable about implementing a rate increase in three annual steps, as BNSF did here. Such a staged increase is consistent with the logic of the *Guidelines*’ phasing constraint. Similarly, there is nothing unreasonable about BNSF’s use of a fuel surcharge. The fuel surcharge mechanism at issue here is the same mechanism that BNSF uses in its other

¹⁵ Under those circumstances, BNSF’s density-based revenue allocation used in past cases would be the only cost-based revenue allocation procedure available to determine cross-over revenues.

¹⁶ As the Board has explained: “Under the MSP approach, revenue from cross-over traffic is allocated based on the total mileage hauled by the SARR and the residual carrier, while retaining a 100-mile additive for originating and terminating the traffic *to reflect the additional costs associated with providing those services.*” *Xcel* at 17 (emphasis added).

common carrier movements as well as recent non-regulated contract movements of coal. BNSF Reply Exh. III.A-6-7. Moreover, as BNSF demonstrated in its October 20, 2005 Motion, there is no risk that BNSF's fuel surcharge mechanism will permit an over-recovery of fuel costs.

C. Elimination of Cross-Subsidy from Northern PRB Movements

Twenty-three percent of the 2005 LRR coal volumes originate at mines north of Donkey Creek and never touch the primary LRR facilities south of Donkey Creek. Given the extremely rich revenue allocation that WFA/Basin assume for those short-haul movements, it is clear that those movements are included in the SARR shipper group to pay for LRR facilities south of Donkey Creek that the traffic never uses. BNSF Reply Nar. at III.A-63 to 66. To avoid this cross-subsidy, BNSF excluded from its SAC analysis the cost of constructing the north-of-Donkey Creek facilities, thereby reducing total SAC costs considerably, and also excluded all revenues and costs associated with traffic using only those northern facilities. In effect, BNSF's SAC model gives the LRR's southbound traffic free use of the LRR's north-of-Donkey Creek facilities as a trade-off for eliminating any cross-subsidy by the northern LRR traffic.

WFA/Basin argue that the Board rejected such a cross-subsidy approach in *PPL*. But BNSF is not arguing here that a cross-subsidy exists because the northern LRR traffic is contributing revenues in excess of the northern LRR SAC costs, or that the revenues contributed by the northern LRR traffic should be limited to the northern LRR SAC costs, which is the position that the Board rejected in *PPL*. *PPL I* at 9-10. BNSF is using a straightforward and conservative mechanism to ensure that a discrete set of traffic that shares virtually no facilities with the issue traffic is not being asked to pay for the facilities that are used by the issue traffic. BNSF's approach is fully consistent with the cross-subsidy analysis in *PPL* and it should be applied in this case.

III. COST ISSUES

There is broad agreement between the parties on the LRR's network configuration and capacity. Differences as to total track and route miles are small. *See* BNSF Reply Nar. at III.B-1 to 6. There is also broad agreement as to how the LRR will conduct its operations and as to many operating parameters. Among other things, the parties agree on train sizes, number of locomotives per train, locomotive types, maximum speeds for empty and loaded coal trains, helper districts, number of helper locomotives, dispatching districts, and inspection locations and procedures. *See* BNSF Reply Nar. at III.C-4 to 8, 11, 19.

BNSF's Reply Exhibits III.F.1 and III.F.2, together with WFA/Basin's Reb. Exhibit III-F-1, provide a detailed comparison of the parties' construction cost assumptions and identify areas where there is agreement and dispute. With adjustments made by WFA/Basin on rebuttal, the parties now agree on the total costs for lateral drainage, road surfacing, rail lubricators, snow fences, roadway signs and grade crossing warning devices. They also agree on the unit costs (but not quantities) for common excavation and borrow and the use of and unit cost for concrete crossings at at-grade crossings. For other items, such as rip rap, seeding/topsoil, environmental compliance, and switch heaters, the differences are driven only by the small difference in total route miles. The parties also agree on the percentages applied for mobilization (3.5%), engineering (10%) and contingencies (10%), although they disagree on the proper way to apply the contingency allowance.

Notwithstanding these areas of agreement, the parties' cost assessments differ significantly. The most important differences between the parties are addressed briefly below.

A. Operating Costs

RTC Modeling. There is a critical flaw in WFA/Basin's RTC model analysis that renders their RTC evidence unusable. WFA/Basin assume that LRR trains experience 5.5 hours

of loading time, which reflects the real-world loading time at PRB mines but does not account for *any* time that is spent waiting to enter the mine as a result of the presence of UP trains at the mines. BNSF Reply Nar. at III.B-8 to 16. WFA/Basin cannot adequately account for the presence of UP trains merely by providing extra empty-train staging capacity near the mines so that trains can be held if mine loading slots are unavailable. WFA/Basin Reb. Nar. at III-C-28 to 29. The RTC model needs to reflect the presence of the UP trains to assess their impact on capacity requirements and cycle times, but WFA/Basin's model assumes no UP trains are present. BNSF's RTC analysis included UP trains at the PRB mines consistent with their real-world use of mine loading slots. BNSF's analysis showed that the extra capacity did accommodate the staging of LRR trains into mines when UP trains were present, but it also showed that the cycle times on LRR trains would be longer as a result of the staging. BNSF's RTC analysis is the only evidence reflecting the impact of UP trains on LRR operations and the Board should use it in assessing LRR operations.

Locomotive Expenses. One result of WFA/Basin's understatement of LRR train cycle times is that their locomotive count is understated. WFA/Basin also understated LRR locomotive requirements by refusing to apply a peaking factor, which the Board applied in *Xcel II*. WFA/Basin Reb. Nar. at III-C-11. WFA/Basin's argument that they should not have to acquire locomotives that would be "shrink wrapped" for all but the peak week ignores the fact that high-volume periods occur frequently over the course of a year. Moreover, WFA/Basin fail to explain how service to LRR shippers could be provided during peak periods if the LRR does not have the necessary locomotives. The SAC methodology requires an assessment of the full costs to provide service, and by ignoring peak period requirements, WFA/Basin has failed to comply with this fundamental SAC principle.

As to the lease cost of LRR locomotives, BNSF accepted on reply WFA/Basin's opening assumption of the annual lease cost per road locomotive even though that cost was significantly less than the weighted average lease cost calculated by WFA/Basin for 2004 in their variable cost evidence. BNSF Reply Nar. at III.D-1. Nevertheless, BNSF accepted WFA/Basin's opening lease cost assumption because it was consistent with the lease costs assumed by the Board in *Xcel*. *Xcel* at 60. On rebuttal, however, WFA/Basin proposed a new, much lower lease cost assumption. But the Board's rules make it abundantly clear that when a defendant has accepted a complainant's opening assumptions, the complainant cannot then turn around and change its opening evidence on rebuttal. *TPMA* at 125.

Crew Count and Salary. A critical flaw in WFA/Basin's crew count is their impossible assumption that each turn crew can serve both an empty and a loaded train on each shift. BNSF's reply evidence demonstrated that, even during the busiest periods, 44% of the LRR's turn crews would not be able to locate a loaded train to serve on their return trip from the mines. BNSF Reply Nar. at III.D-21 to 22. WFA/Basin quibbled with BNSF's train matching methodology, but they made no effort to conduct their own analysis or to provide evidence establishing that trains would be available for turn crews.

As to crew salary, WFA/Basin posit that the LRR could require its crew members to work 270 shifts per year, far *more* than the average on real world railroads, but then pay those crew members *less* than the average wages paid to real world workers.¹⁷ WFA/Basin's criticism of BNSF's evidence of real world wages paid to comparably productive workers -- that the sample size of BNSF's real world crews working 270 shifts is small -- does not undermine the obvious conclusion that their salaries are far higher than average. See BNSF Reply Nar. at III.D-

¹⁷ See BNSF Reply Nar. at III.D-24 to 29.

29 to 30. A minor error that WFA/Basin identify in BNSF's salary calculations in which certain credits payments were added rather than subtracted from crew salaries does not invalidate BNSF's evidence, which is the only evidence that reflects the impact of work rules for the SARR that impose a far heavier workload than exists in the real world.¹⁸

Fuel Costs. WFA/Basin assume that LRR trains would consume fuel at a rate consistent with BNSF's system-average fuel consumption on all trains system wide. Based on a wealth of data, collected in cooperation with complainants in other SAC cases, the Board has already found that this assumption is erroneous for unit coal trains, which burn fuel at a rate significantly in excess of system-average consumption rates. *TPMA* at 58, 82; *Xcel* at 60, 137-38. BNSF presented additional evidence in this case on the actual fuel consumption rate on trains of the type that would be handled by the LRR. WFA/Basin's criticisms of BNSF's fuel consumption study are unfounded, as discussed in BNSF's rebuttal evidence. BNSF Reb. Nar. at II-7 to 21.

WFA/Basin argue that the Board should use BNSF's system-average fuel price despite evidence by BNSF that the system-average fuel price dramatically understates the actual prices paid by BNSF for fuel in the PRB. On opening, WFA/Basin argued that the Board should ignore location-specific fuel prices because a hypothetical pipeline would likely be built to supply fuel to the LRR at prices below what BNSF has to pay, even though the LRR's fuel requirements would be comparable to those of the existing BNSF. On rebuttal, WFA/Basin change course and offer the entirely different argument that the LRR's ability to hedge against fuel price increases

¹⁸ The single example given by WFA/Basin shows that the error only overstates wages by about 9 percent, meaning that the BNSF salary figure would be reduced to { }, which is still far above the \$59,517 WFA/Basin propose. See WFA/Basin Rebuttal electronic workpaper "Sample TE Employees.xls," worksheet "Credit Record Error."

would allow the LRR substantially to reduce fuel expenditures.¹⁹ As BNSF explained in its October 20, 2005 Motion, WFA/Basin's hedge assumption allows them improperly to build into the DCF model an extraordinary, one-time BNSF Fourth Quarter 2004 hedging benefit -- thereby starting off at a 24 percent discount to location-specific prices -- which is perpetuated throughout the DCF period by indexing the discounted starting price. The distortions produced by such an assumption are obvious. A defendant's historical hedging experience has no place in the SAC analysis. BNSF's evidence concerning location-specific fuel prices in the PRB is the best evidence of the costs the LRR would incur and it should be accepted by the Board.

Railcars. WFA/Basin understated the LRR's car requirements by inaccurately identifying the shippers for whom the LRR would need to provide cars and by using inappropriate spare margin and peaking factor assumptions. WFA/Basin criticize BNSF's evidence on shipper-specific car supply arrangements based on a single example of a car "swap" arrangement. *See* WFA/Basin Reb. Nar. at III-C-21 to 22. A single example that affects only one shipper cannot be generalized to invalidate BNSF's entire approach. The Board is faced with a choice between WFA/Basin's abstract approach which relies entirely on their interpretation of the transportation contracts and BNSF's much more detailed approach that uses the traffic tapes and the direct experience of BNSF's marketing personnel to reflect BNSF's actual car supply arrangements. Only BNSF's evidence reflects the operational realities that a SARR would face. With respect to spare margin and peaking, BNSF used the spare margin approved in *Xcel* and calculated the railcar peaking factor in the manner accepted by the Board in *Xcel*. BNSF Reply Nar. at III.C-16. WFA/Basin have not demonstrated that the Board should adopt a different approach here.

¹⁹ Contrary to their assertion in reply to BNSF's October 20, 2005 Motion, WFA/Basin never even referred to the practice of hedging prior to their rebuttal evidence.

Maintenance of Way. WFA/Basin vastly understate the costs to maintain a heavy-haul, unit train coal railroad operating in the PRB. Their evidence relies heavily upon vague and undocumented claims by their operating witness, Richard McDonald, regarding WRPI's practices and experiences some two decades ago. Mr. McDonald's recollections cannot be verified by the Board and are, in many cases, implausible. For example, Mr. McDonald asserts that there were "no slow orders on WRPI, and there were a total of only eight rail failures requiring emergency action during the first five years of its operation." WFA/Basin Reb. Exh. III-D-1, 5. WFA/Basin provide no supporting data regarding the referenced failures or indeed concerning the scope of WRPI operations during the period in question. It is therefore impossible for the Board even to begin to evaluate WFA/Basin's claims.

By contrast, BNSF's MOW evidence is based on a detailed and well documented analysis of real-world maintenance costs over the same lines that would be replicated by the LRR. WFA/Basin attempt to discredit BNSF's MOW costs by comparing those costs to what WFA/Basin assert the Board accepted in *Xcel*. WFA/Basin Reb. Nar. at I-31, Table I-5. In fact, BNSF's base year operating expenses per track mile are in line with the Board's *Xcel* decision while WFA/Basin's costs are grossly understated. WFA/Basin made two critical errors in performing their comparison. First, they used the wrong number for base year MOW operating expense: \$22.75M instead of the \$25.8M that the Board actually accepted in *Xcel*.²⁰ Second, they failed to update the 2001 base year *Xcel* costs for inflation before comparing them to 2004 base year LRR costs. Any comparison of BNSF's \$40,654 per track-mile MOW costs and WFA/Basin's \$22,630 per track-mile costs to corresponding costs in *Xcel* would have to account for inflation by using either the RCAF-U or the AAR's "Materials, Prices, Wage Rates and

²⁰ See *Xcel* at 58. The \$22.75M used by WFA/Basin does not include the Board's calibration to accommodate the Jeffrey Energy Center traffic.

Supplements Combined Excluding Fuel,” indices, and by using the correct MOW operating expense.²¹

B. Construction Costs

It is not possible to address the parties’ numerous and complex construction cost disputes in this brief. However, it is possible to show the extent to which WFA/Basin seek to understate real-world construction costs in their SAC presentation because BNSF presented in this case substantial evidence of the actual costs it incurs to build rail lines of the type that would be required by the SARR. These real-world costs do not include any costs related to entry barriers, such as costs associated with regulation of new entry or land acquisition costs. BNSF showed that, in the real world, the cost to construct Class I rail lines for heavy axle loading unit coal trains out of the PRB is approximately \$2.5 million per track mile. BNSF Reply Nar. at III.F-4 to 8. WFA/Basin’s rebuttal costs of \$1.8 million per track mile (including yard and set-out tracks) and \$2.0 million for mainline track, fall far short of this real-world benchmark.²²

WFA/Basin urge the Board to discount BNSF’s real-world construction costs as applicable to a railroad that would handle higher tonnages than the SARR. WFA/Basin Reb. Nar. at III-F-4. But WFA/Basin’s argument is based on the false and unsupported premise that BNSF is spending additional amounts on track construction today to construct rail lines capable

²¹ A comparison of MOW costs per track mile may be meaningful since the labor and equipment that drive MOW costs are related to the number of track miles to be maintained. However, a comparison of overall operating costs on a track mile basis, *see* WFA/Basin Reb. Nar. at I-29, is meaningless as a basis for comparing operating costs across cases. Direct operating costs like fuel and crew costs are more related to ton-miles or train-miles than to the miles of track. Indeed, high aggregate operating costs per track mile may simply reflect the efficient operation of a large number of trains over limited track capacity.

²² By contrast, BNSF’s construction costs, when adjusted to exclude certain retaining wall costs, are \$2.3 million (including yards) and \$2.6 million (mainline track only) per track mile. Substantial additional costs for retaining walls result from WFA/Basin’s insistence on limiting the ROW to 100 feet on average. WFA/Basin Open. Nar. at III-F-3.

of handling much higher traffic volumes that will exist in the future. In fact, BNSF is building tracks capable of handling today's traffic volumes -- which on a tons per track mile basis are comparable to those that would be handled by the LRR. When traffic increases in the future, the number of tracks will be increased to handle the higher traffic volumes. BNSF's track construction standards would be followed by any prudent railroad seeking to handle high-density, heavy axle load unit coal trains.

WFA/Basin's understatement of SARR construction costs results from numerous assumptions that ignore real-world circumstances. For example, WFA/Basin assert that the LRR would not need to incur union labor costs in the SARR's track construction despite the abundant evidence to the contrary. Moreover, as an alternative to BNSF's real-world track-labor costs, WFA/Basin offer a made-for-litigation price provided by a Pennsylvania contractor that does not even conduct business in the West and that obviously has no expectation that it would be called upon to actually perform the work at quoted prices. An additional example of WFA/Basin's disregard for real-world conditions is that their transportation costs for materials are based on an assumption that certain portions of the LRR will be built early so they can be used to transport materials, while no provision was made to transport the materials necessary to construct those early segments. WFA/Basin Reb. Nar. at III-F-88, n.11. BNSF's construction costs are consistent with real-world requirements and they are the best evidence in the record.

IV. DCF ISSUES

Two issues relating to proper application of the Board's DCF model warrant discussion in this brief. The first involves the impact of possible productivity on the inflation index used in the DCF. The index advocated by WFA/Basin has two fundamental problems. First, the index is an unabashed attempt merely to split the difference between the RCAF-A and the RCAF-U. It has no evidentiary support. Second, WFA/Basin apply their arbitrary index from day one of

SARR operations, even though the SARR is supposed to be a least cost railroad that employs the most productive equipment and operating techniques currently available in the market.

WFA/Basin's halfhearted argument that the LRR is not, in fact, more efficient than BNSF is implausible. WFA/Basin Reb. Nar. at III-G-12, n. 33. In any case, their claim is based on using the wrong URCS cost figure in calculating the LRR's productivity gain over the existing BNSF.²³ It is clear that any attribution of productivity gains for the SARR must be deferred until well into the DCF period, which is the approach that BNSF has proposed. *See* BNSF Reply Nar. at III.G-13 to 17.

With respect to debt amortization, WFA/Basin seek to change the Board's established use of a 20-year debt amortization schedule by assuming that the SARR would take out an unprecedented 50-year loan. WFA/Basin buried this assumption in a workpaper on opening, without a single word in the Narrative explaining why this departure from established practice was justified, thus giving BNSF no arguments to address on reply. *See* BNSF Reply Nar. at III.G-19 to 20. The Board therefore cannot even entertain such a dramatic change in DCF methodology on the record in this case. Even if it were plausible to assume that such a loan would be available, the assumption of 50-year debt has numerous implications for the DCF calculations, such as the impact on the proper interest rate and on the DCF's perpetuity calculations, that have not been explored as a result of WFA/Basin's hide-the-ball strategy.

²³ BNSF filed an errata on August 25, 2005, which indicated that the "2004 URCS costs" used in its reply evidence were, in fact, for the year 2003. The errata updated the URCS costs calculations in the workpapers to use the correct 2004 data. WFA/Basin nevertheless continued to use the 2003 URCS cost data to perform their productivity calculation. The BNSF fully allocated 2004 URCS costs for serving LRR traffic were \$212.9 million, not \$194.2 million as WFA/Basin state in their rebuttal Exhibit III-G-2. *See* BNSF Errata workpaper "LRR Coal Move Inputs.xls," worksheet "Traffic Summary," cell Y153.

BNSF continues to amortize the debt over 20 years. This approach reflects the Board's longstanding practice in SAC cases and it should be followed in this case as well.

V. RATE PRESCRIPTION ISSUES

BNSF explained above how the use of contestability pricing in establishing cross-over revenues also solves the question of how to identify a maximum reasonable rate for the issue traffic in a case, like this, where the only through movement handled by the SARR is the issue traffic. That discussion is not repeated here. If the Board declines to adopt BNSF's contestability approach, the Board should apply its rate reduction methodology. WFA/Basin urge the Board to abandon the rate reduction methodology because of the supposed "regulatory incentives" BNSF had to publish high common carrier rates. But inquiries into the subjective intent of a carrier have no place in SAC analysis, particularly where, as here, the objective evidence demonstrates that the rates were commercially reasonable.

BNSF urges the Board to make one adjustment to the traditional rate reduction methodology to account for WFA/Basin's overwhelming reliance on cross-over traffic. The percentage reduction methodology is intended to preserve a defendant's existing rate structure, which reflects the defendant's assessment of the relative demand elasticity of its shippers. But when cross-over traffic is used in a SAC analysis, the only way to eliminate any overcharge determined in the SAC analysis while preserving existing rate relationships is to (1) divide the overcharge by the sum of the issue traffic revenue plus the *through* revenue of cross-over movements and (2) apply the resulting percentage to the *through* rates of each shipper to determine the amount of the total overcharge for which each shipper is responsible. BNSF Reply Nar. at III.H-11 to 18. Otherwise, as Professor Kalt explained, through rates on the issue traffic would be reduced by a much higher percentage than through rates on cross-over movements, thus distorting the defendant's existing through rate structure. BNSF Reply Nar. at III.H-11 to

12. WFA/Basin's claim that BNSF's approach fails to eliminate the entire overcharge is wrong. WFA/Basin Reb. Nar. at III-H-39. BNSF demonstrated with a detailed example, which WFA/Basin ignored, how the calculations would be made using BNSF's approach and why those calculations would eliminate the overcharge in its entirety while preserving the existing relationships of through rates among shippers in the SARR shipper group. BNSF Reply Nar. at III.H-15 to 17.

While WFA/Basin object to the use of the percent reduction methodology, whether the traditional methodology or as adjusted by BNSF, they fail to offer a viable alternative. WFA/Basin's "Revenue Allocation Method" ("RAM") purports to be a bottom-up methodology that allocates responsibility for SAC costs based on the relative demand elasticity of the SARR shippers. But the RAM methodology is fatally flawed. RAM assumes that the joint and common costs of the SARR can be covered by charging all so-called "captive" shippers an equal amount per gross ton-mile over variable costs. There are two problems with this assumption. First, it ignores the substantial differences in demand elasticity that exist among sole-served shippers. BNSF Reply Nar. at III.H-23 to 25.²⁴ Second, RAM allocates contribution solely on the basis of gross ton-miles. But market-based pricing is not directly linked to distance or ton-miles. Short-haul moves like the Laramie River movement clearly tend to have much higher rates per ton-mile than longer haul moves. Notwithstanding WFA/Basin's efforts to distinguish

²⁴ WFA/Basin claim that the demand elasticity of captive shippers is "reasonably similar," and therefore it is reasonable to assume that the demand elasticity is identical. But the demand elasticity of the shippers in WFA/Basin's so-called captive shipper group is only "similar" to the extent that each shipper in that group probably has less demand elasticity than shippers with multiple railroad options. It has become abundantly clear since *OPPD* and *APL* that demand elasticity among so-called captive shippers varies widely. If WFA/Basin's demand elasticity is higher than that of other shippers in the so-called captive shipper group, then even if the RAM methodology had no other flaws, WFA/Basin would be responsible for a higher, and potentially much higher, allocation of joint and common costs.

the numerous cases addressing ton-mile allocations, the ICC and the Board have repeatedly found that ton-mile allocations of joint and common costs are not consistent with market-based pricing and they should not be used in setting prescribed rates. BNSF Reply Nar. at III.H-22.

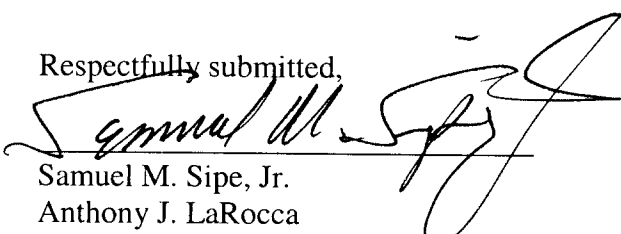
WFA/Basin's fallback approach, the "Reduced Mark-Up Method," is no better. *See* BNSF Reply Nar. at III.H-25 to 28. In contrast to RAM, the Reduced Mark-Up Method correctly assumes that shippers have different demand elasticities, but it incorrectly assumes that the demand elasticities can be calculated. WFA/Basin compound this fundamental problem -- which was recognized in the *Guidelines* and was the reason that the SAC test was developed in the first place -- by calculating demand elasticities for the SARR shippers based on contrived R/VC ratios for movements on the SARR. But among other things, the R/VC ratio for the SARR is entirely dependent upon the SARR's allocation of revenue for cross-over moves and that revenue allocation has no connection to real-world demand considerations. There is no reason to believe that the Reduced Mark-Up method is at all consistent with Ramsey pricing principles.

Finally, WFA/Basin argue that the Board should prescribe a single rate that applies to all mine origins instead of applying any prescription to the current BNSF rate structure which provides different rates for southern, central, and northern mine origins. As BNSF explained, WFA/Basin's proposal for an "average" rate is an obvious ruse. A low "average" rate would be created by assuming, as WFA/Basin do in their SAC model, that a large amount of issue traffic would originate from southern mines, where the mine-specific rates are lowest. But WFA/Basin could then turn around and use the low "average" rate for movements from the much higher rated central and northern PRB origins, where WFA/Basin in fact source most of their coal. BNSF Reply Nar. at III.H-29 to 31. WFA/Basin did not even attempt to rebut these points.

Richard E. Weicher
Michael Roper
BNSF RAILWAY COMPANY
2500 Lou Menk Drive
Fort Worth, TX 76131
(817) 352-2353

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Respectfully submitted,



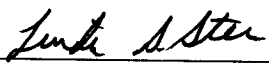
Samuel M. Sipe, Jr.
Anthony J. LaRocca
Linda S. Stein
STEPTOE & JOHNSON, LLP
1330 Connecticut Avenue, N.W.
Washington, D.C. 20036
(202) 429-3000

Attorneys for BNSF Railway Company

CERTIFICATE OF SERVICE

I hereby certify that on December 6, 2005, I caused a copy of the foregoing Defendant's
Final Brief to be served by hand upon the following counsel:

John H. LeSeur
Christopher A. Mills
Robert D. Rosenberg
Andrew B. Kolesar III
Peter A. Pfohl
SLOVER & LOFTUS
1224 Seventeenth Street, N.W.
Washington, D.C. 20036



Linda S. Stein