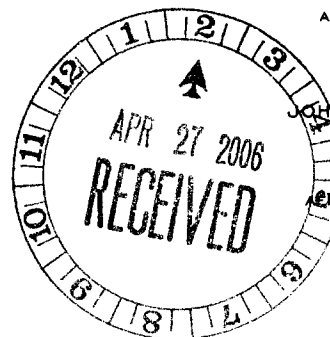


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April 27, 2006

VIA HAND DELIVERY

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

Re: STB Ex Parte No. 661 – Rail Fuel Surcharges

Dear Mr. Williams:

In accordance with the Board's Decision issued March 14, 2006, in the above-referenced proceeding, enclosed is the Testimony of Edison Electric Institute.

Respectfully submitted,

Michael F. McBride

Michael F. McBride

Attorney for Edison Electric Institute

Enclosure

216 384

SURFACE TRANSPORTATION BOARD

Ex Parte No. 661

RAIL FUEL SURCHARGES

TESTIMONY OF
EDISON ELECTRIC INSTITUTE



Pursuant to the Board's Notice served March 14, 2006 ("*Notice*") in the above-referenced proceeding, Edison Electric Institute ("EEI") hereby files its written testimony. EEI also intends to present oral testimony at the hearing on May 11, 2006.

Interest of EEI

EEI is the association of U.S. investor-owned electric utilities and international affiliates and associates worldwide. EEI's U.S. members serve 97 percent of all customers served by the shareholder segment of the U.S. industry and 71 percent of all electricity customers in the United States, and generate almost 60 percent of the electricity produced by U.S. electric generators. EEI frequently represents its U.S. members before state and federal agencies, courts, and legislators in matters of common concern, including before the STB.

EEI members' retail rates are regulated by state utility commissions in virtually every state in the nation, and their wholesale rates are regulated by the Federal Energy Regulatory Commission. Such regulation often includes mechanisms for recovery of fuel costs. As such, EEI members have the same interest as railroads in recovering the costs of fuel. At the same time, EEI members and other electric utilities typically are allowed to recover only the cost of the fuel in their rates.

EEI has no objection to a fair method of adjusting rail rates for the cost of fuel. EEI, however, opposes any effort by the railroads to use fuel costs to increase their profits. If a railroad has agreed by contract to rate-adjustment mechanisms with certain customers (whether EEI members or not), those agreed-upon contractual mechanisms should be followed, and a railroad should be limited to those contractual recovery mechanisms without the ability to apply fuel surcharges on top of the rate levels to which the parties otherwise agreed. At the same time, if a railroad has agreed to rate-adjustment mechanisms that limit their ability to recover all of the fuel used to serve such customers, it is not appropriate to surcharge other customers for more than the total fuel cost for serving those other customers to make up for any shortfall, because the circumstances are those of the railroad's own making.

Legal Argument

1. The STB Clearly Has Authority to Regulate Unreasonable "Rules and Practices." Under 49 U.S.C. § 10702(2), the STB has broad authority over unreasonable "rules and practices" established by railroads, in addition to its more limited authority to regulate rates under 49 U.S.C. § 10701. *Notice* at 2. If a "rate" is involved, clearly the Board must find "market dominance" under 49 U.S.C. § 10707 before it may regulate the rate. 49 U.S.C. § 10707(d)(1); *Union Pacific R.R. v. ICC*, 867 F.2d 646 (D.C. Cir. 1989). However, no such finding of market dominance is required to regulate "rules and practices." *Id.* at 649; *compare* 49 U.S.C. § 10701(1) (reference to Board's authority over "rates, to the extent required by section 10707" and 49 U.S.C. § 10701(d)(1) ("If the Board determines, under section 10707 of this title, that a rail carrier has market dominance over the transportation to which a particular rate applies, the rate

established by such carrier for such transportation must be reasonable.") with 49 U.S.C. § 10702 (2) (no reference to section 10707, the section of Title 49 requiring a finding of market dominance, or else a finding of no market dominance "is determinative.").

In fact, railroads establish what they refer to as "rates" and then apply surcharges to many of them, so, by the railroads' admission, surcharges, including fuel surcharges, are not "rates," but instead are part of the overall transportation charges imposed by railroads.¹

2. Fuel Surcharges Are Not "Rates." Therefore, STB has authority to regulate surcharges (or any other "rule" or "practice" a railroad may impose), over and above the "rate" for the transportation at issue, as unreasonable, without a shipper having to prove market dominance and without having to proceed with a full-blown "rate" case, because such surcharges, "rules," or "practices" are not (by definition) "rates."

3. Calling Surcharges "Rates" Should Not Delimit the Board's Broad Authority over Them If They Are, in Fact, "Rules" or "Practices." Assuming *arguendo* that fuel surcharges are deemed to be "rates" in addition to the rate(s) that the shipper is already, by definition, paying, the STB could regulate without all that is required in a challenge to the "rate" as discussed above, because *Union Pacific R.R. v. ICC, supra*, cited in the *Notice* (at 2) should not be considered a bar to doing so, for two reasons.

¹ The Board stated in its *Notice* (at 2) that "The Board only has jurisdiction over a railroad's common carriage rates, not rates governed by a rail transportation contract negotiated by the shipper and railroad. 49 U.S.C. § 10709." The Board's statement is true as far as it goes, because 49 U.S.C. § 10709(c)(2) provides that "The exclusive remedy for any alleged breach of contract entered into under this section shall be an action in an appropriate State court or United States district court, unless the parties otherwise agree." However, if a fuel surcharge is not provided for in such a contract, and if the fuel surcharge is imposed separately (whether in a "tariff" or other document is immaterial), the separate fuel surcharge is, by definition, not the "rates governed by a rail transportation contract negotiated by the shipper and the railroad" and is, therefore, extra-contractual. The Board may act with respect to such a tariff or other document, whether or not it is referenced in, or incorporated in, a contract.

First, *Union Pacific R.R. v. ICC* involved classic rate complaints filed with the ICC, alleging that railroads possessed market dominance and that the rail rates at issue were unreasonably high. The ICC decided the merits of those challenges without finding market dominance. 867 F.2d at 648. The Court of Appeals concluded that such an action was prohibited by the statute's limitations on regulating rail rates unless a railroad possessed "market dominance." *Id.* at 649. In contrast, as the STB stated, shippers have "expressed concerns that recent fuel surcharges collected by railroads are designed to recover amounts over and above increased fuel costs." *Notice* (at 1). Those concerns are not addressed to the *rates* shippers are being charged, but rather at the fuel surcharges being charged *over and above* the rates themselves.²

Moreover, when *Union Pacific R.R. v. ICC, supra*, was decided, the statute forbade STB from using its rate jurisdiction to regulate railroad practices, but that statute (49 U.S.C. § 10707a(h)³) was repealed in the ICC Termination Act of 1995. By implication, therefore, Congress has removed the bar to regulating unreasonable "rules" and "practices," even *assuming arguendo* that they are treated as part of a "rate." It would be appropriate to conclude that the STB has such authority over unreasonable fuel surcharges by treating them as a "rule" or "practice," because any separate challenge to the underlying rate still would be limited as Congress provided in 49 U.S.C. §§ 10701(d)(1), 10702(1), and 10707(b)-(c), *i.e.*, a showing of market dominance and

² The Board's statement in its *Notice* that "A surcharge is a separately identified component of the total rate that is charged for the transportation involved" is not technically correct. In fact, railroads charge rates, and charge fuel surcharges or other charges *separately* from the rates themselves, even if shown on the same invoice. Rather, the Board's statement would more accurately have said "A surcharge is a separately identified component of the total charges for the transportation involved" instead of referring to the "total rate that is charged for the transportation involved."

³ Former section 10707a(h) stated: "The authority of the Commission to determine and prescribe rules, classifications and practices may not be used, directly or indirectly, to limit the rates which carriers are otherwise authorized to establish under this subtitle."

satisfaction of the STB's rate guidelines would be required. Accordingly, it would be inappropriate to limit challenges to "rules" and "practices," in addition to the statutory limits on "rates" that concededly would apply, simply because of the label applied to them by the railroad (or the STB). Substance should control over form. *Union Pacific R.R. v. ICC*, 867 F.2d at 649. Congress did not limit the Board's jurisdiction over unreasonable "rules" and "practices" in that way.

4. Railroads May Be Over-recovering for Their Fuel Costs. The Board indicated it did not want to adjudicate at this stage of the proceeding the level of fuel surcharges railroads may be imposing. Accordingly, EEI would simply proffer some evidence, without attempting to "prove" anything at this stage of the proceeding, that some railroads are overcharging for their fuel costs. EEI certainly does not begrudge the railroads recovery of their fuel costs (except where by contract a railroad and a shipper have agreed to another means of adjusting rates for fuel and other costs), but EEI respectfully suggests it is patently unreasonable to surcharge a rate for more than a carrier's fuel costs, yet claim the surcharge is for fuel.⁴ Nevertheless, Citigroup Smith Barney authored a report, in early January 2005 (copy attached as Exhibit A), that several of the largest railroads (especially Norfolk Southern Railway Company, but also BNSF Railway Company and CSX Transportation, Inc.) had recovered more than the costs of fuel in their fuel surcharges. (Union Pacific did not over-recover in 2004 in *toto*, according to the same report, because it did not hedge to the same extent as the others.)

⁴ Among the reasons that such would be unreasonable is that, if a railroad wanted to increase a rate to improve the profitability of the traffic, its position clearly would take on an entirely different cast (whether the underlying rate was a contract rate or a common carrier rate) at the STB or before a court than if it were merely purporting to adjust the rate to recover its fuel costs.

Therefore, without asking the Board to make any definitive finding in the matter at this stage, Exhibit A is *prima facie* evidence that at least some railroads' fuel surcharges are "unreasonable" within the meaning of 49 U.S.C. § 10702(2).

Moreover, the undersigned can attest that some EEI members and other shippers have been sent invoices for rail transportation that included fuel surcharges where the rail transportation contract applicable to the movement(s) at issue contains a different methodology for adjusting rates for fuel and other costs. In many such instances, the contract will provide for the "Rail Cost Adjustment Factor" published by the STB to be the mechanism for adjusting rates. The RCAF is weighted appropriately by the Board for fuel and other costs, and is re-weighted periodically to ensure that the "weights" are still appropriate. In such a contract, the railroad and the shipper have agreed that a mechanism *other than a fuel surcharge* is to be used to recover changes in fuel costs. By implication, therefore, were such a matter to come before the Board or a court, EEI is confident that either would have no difficulty concluding that a fuel surcharge in addition to an RCAF increase is inappropriate and *ultra vires*.

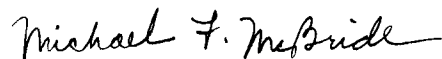
Conclusion

The Board should conclude that its broad authority to regulate "rules and practices" of railroads, without a requirement that it find that there is market dominance, is more than sufficient to regulate unreasonable fuel surcharges to rates. By definition, a fuel surcharge is not the "rate," because the fuel surcharge is imposed *in addition to* the underlying rate being charged.

Nothing in *Union Pacific R.R. v. ICC*, 867 F.2d 649 (D.C. Cir. 1989), should lead the Board to conclude otherwise, because that was a case in which a challenge to rail

rates was filed, alleging market dominance, but the ICC decided the rate challenge without a finding of market dominance. Moreover, the statute then contained a prohibition on the ICC's use of its authority over "rules" and "practices" to regulate rates, but that provision was repealed in 1995. Any challenge to fuel surcharges would not constitute a challenge to the underlying rate, and thus is not barred by that case or by the statute.

Respectfully submitted,



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April 27, 2006

EXHIBIT A

Airfreight & Surface Transportation

Fuel Hedge & Surcharge Impacts: Not all Rails Created Equally

January 5, 2005

SUMMARY

- Historically rail EPS has been negatively correlated to oil price movements, but this relationship is changing given varying hedge and surcharge policies.
- Given greater relative fuel intensity for TL modal alternatives, some rails have tactically used fuel surcharges as a way of enhancing pricing above simple fuel cost recovery levels, especially the Eastern rails, thereby enhancing EPS in '04.
- We est. that 20-30% of NSC '04 EPS growth driven by fuel surcharge revenues above fuel expense increases; most other carriers benefited to the tune of 2-6% of '04 EPS growth. UNP had 18% EPS drag with unhedged fuel position.
- Using scenarios for '05, we see greatest EPS headwind (6-8% range) to BNI and NSC if oil prices stay in base case \$40 range. A 9-12% EPS drag for these two & CSX (with its greater '05 hedge) if oil falls to ~\$30. CSX & NSC gain most if oil were to rise further to \$60 with +10-20% help to EPS. UNP EPS gains most if oil falls to \$30 [+12%], hurt most if it rises more to \$60 (-28%).

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OPINION

Fuel and oil prices were a factor impacting the rail group during 2004. We note that given differing hedge positions as well as different approaches and aggressiveness related to fuel surcharge mechanisms, the impact of oil prices varied among the rail stocks rather widely. We note that at the extremes of the continuum in the group, Union Pacific (UNP; 2M - \$65.80) clearly had a significant headwind to its 2004 earnings while perhaps counter-intuitively Norfolk Southern (NSC; 2M - \$35.24) experienced a substantive boost or tailwind to last year's results through a combination of its extremely effective fuel hedge combined with a very robust approach to fuel surcharge usage. **Illustrating our point, we estimate that roughly 20-30% of 2004's earnings growth at Norfolk Southern has been driven by fuel surcharge revenues above fuel expense variances at the operations; we also note that this is in addition to the opportunity benefit impact of favorable fuel hedges on 2004 earnings for NSC.** We estimate that the relationship of fuel surcharge revenue to fuel price variances during 2004 for most of the other carriers in the group accounted for 2-6% of EPS growth last year; in the case of UNP, we note that the company's surcharges did not nearly come close to offsetting its fuel price variance, thus fuel was nearly a \$0.50 drag to the company's EPS during last year, or approximately 18%. We again note that these estimates do not include the impact of fuel hedging which would be incremental to these estimates. Hedges were most beneficial during 2004 for Norfolk Southern, Burlington Northern Santa Fe (BNI; 1L - \$45.13), and Canadian National (CNI; 1M - \$59.19), in order of the relative impact on earnings, respectively. Finally, we also note that in many cases fuel surcharge adjustments may lag by one to two months, thus complicating an understanding of the longer-term impact of a move in fuel prices when looking at individual rail equities.

United States

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Using our understanding of the fuel hedge positions at each of the major North American railroads coupled with our estimates of the fuel surcharge revenue being generated by each of the rails, we have performed a scenario analysis to determine the potential earnings impact of changes in crude oil prices. We feel this analysis is particularly worthwhile at the present time for several reasons. First, as has been the case in recent months, crude oil prices have the potential for a great deal of volatility to both the upside and downside. Second, with varying hedge positions and aggressive fuel surcharge mechanisms, we feel that some railroads may be more than 100% insulated from recent high fuel prices. In other words, rising fuel surcharges have supplemented earnings in some instances. **Given that truckload (TL) trucking is more fuel intensive than rails, fuel's sharp increase through the first 10 months of 2004 provided the rails an opportunity to use rising fuel surcharges at TL carriers as a price umbrella for comparable rail fuel surcharge increases. And this is despite the lesser fuel intensity of rail as a transport mode. Furthermore, many intermodal moves actually saw limited fuel cost increases as such units were filling-in existing available capacity on existing train starts.** Thus, fuel surcharges had been used as a means to increase pricing for certain rail carriers, thereby becoming a way to enhance base rates in the name of "offsetting" rising fuel costs. **In particular, we have found that fuel surcharges are supplemental to profitability (i.e., more than offsetting fuel cost increases) primarily at the Eastern rail carriers, where such surcharges become incremental to base pricing increases. This impact is in addition to the benefits of fuel hedges in certain instances.**

Against this backdrop, we feel the conventional wisdom that declining fuel prices should lead to improving earnings performance at the rails may prove incorrect, in certain instances, this time around. Rather, given the hedge positions at the rails, fuel surcharge revenue may decline more rapidly than underlying fuel expense, thereby leading to headwind to earnings performance that may be counter-intuitive to the equity market expectations. While this analysis does not consider the more intangible impact that high fuel prices can have in restraining the economy and, hence, volumes we feel it is clearly an important consideration for rail equity investors seeking to ascertain the realistic earnings potential of the group in various fuel scenarios. In performing our analysis, we have attempted to be forward looking, generating various scenarios for crude oil and diesel prices in 2005 to better assess the impact of fuel prices on earnings.

BACKGROUND

Rising crude oil and diesel fuel prices were a consistent theme throughout 2004. Spot WTI crude oil prices peaked at over \$56/bbl in late-October, while national average on-highway diesel prices peaked at over \$2.21 per gallon at roughly the same time. More recently, WTI has been testing the low \$40's with relatively mild winter temperatures. This represents an approximate 25% drop in oil prices in less than three months. Rising fuel prices have resulted in increased fuel surcharges across freight transportation modes. It has generally been understood that the trucking carriers have historically done a better job than the rails in offsetting the negative impacts of rising fuel expenses. Specifically, while truckload carriers recover roughly 70-80% of higher fuel costs, less-than-truckload carriers cover closer to, if not greater than, 100% of increased fuel expense.

Against this backdrop, we note that the railroads have historically been more deficient in recouping rising fuel prices through fuel surcharges. Rather, a reliance on the Rail Cost Adjustment Factor (RCAF) calculated by the Association of American Railroads (AAR) and, only recently greater use of fuel hedging mechanisms, have been more prevalent ways the rails have sought to over the years. That said, we view RCAF as being woefully inadequate in that it adjusts but once a quarter and is thus inherently lagged. Furthermore, RCAF takes

seven separate cost line items into account. Hence, fuel is not isolated, thereby calling into question the degree to which rising fuel prices can be adequately recovered. Frankly, during the mid to late 1990s, in a period of relatively lower and more stable oil prices, the rails were content to rely on RCAF and base rate increases to cover cost inflation, including that related to oil or fuel expense.

Over the past two to three years, given greater volatility and increasing fuel costs, however, the rails have been making a more concerted effort to implement more effective and timely fuel surcharges across larger swaths of their book of business. The greatest success has been achieved in domestic intermodal traffic, we suspect due to these shippers' greater comfort level with fuel surcharges given their familiarity with and use of TL trucking carriers, where fuel surcharges have been the norm for some time. The key opportunity, in our view, is in broadening the use of fuel surcharges to the carload merchandise and bulk coal businesses. RCAF is predominantly used on coal and remains the standard cost adjustment mechanism for many rail transport contracts. Yet we note that some of the rail carriers have been working with their utility coal customers to allow the continued use of RCAF as an escalator. These carriers are, however, insisting that it be RCAF excluding the fuel component, which is then supplemented by a carrier derived specific fuel surcharge for such cost increases.

SCENARIO SUMMARY

Our proprietary analysis suggests that the degree to which crude oil prices increase or decline (presuming they do, as we have noted they already have over the past 10 weeks) will be a primary determinant of the earnings impact of fuel surcharges and hedges. Of course, given differing comparisons, hedge positions for 2005, and coverage and amounts of fuel surcharges, the impacts will be unique to each rail carrier earnings. While forecasting crude oil prices over the past year has proven to be a fool's game and we can conceivably dream up innumerable scenarios for the next few years, we have settled on three fairly simple scenarios giving a framework of the varying expected impacts that fuel prices can have on the different carriers given our estimates of hedges as well as fuel surcharge coverage and mechanisms. A summary of our analysis can be seen in the table below. Our stable price case scenario is based on oil prices roughly staying the same on average for 2005 as they were in 2004. The optimistic case assumes a more rapid fall off in oil, while the pessimistic scenario assumes further increases in the coming year. The following represents changes in EPS from our existing baseline earnings estimates for 2005 given different WTI oil pricing assumptions:

Figure 1. Earnings Impacts Under Varying Fuel Price Scenarios '05E

	<u>Optimistic Case</u>	<u>Stable Price Case</u>	<u>Pessimistic Case</u>
Average Crude Oil Price	\$30.00	\$40.00	\$60.00
	<u>2005E</u>	<u>2005E</u>	<u>2005E</u>
CSX	(\$0.20)	\$0.07	\$0.60
NSC	(\$0.28)	(\$0.12)	\$0.21
BNI	(\$0.26)	(\$0.25)	(\$0.27)
UNP	\$0.46	\$0.08	(\$0.94)
CNI	(\$0.08)	\$0.09	(\$0.13)
CP	(\$0.08)	\$0.10	\$0.37

Source: Smith Barney analysis and estimates.

The following represents our key takeaways from our analyses:

Stable Oil Price Case Scenario: Under our stable case scenario, which assumes an average \$40/bbl price for crude oil in 2005, both NSC and BNI would likely experience pressure on earnings. This impact is the result of a reduced hedge position at both railroads year-over-year comparing 2005 to 2004. Hence, there is less "cost avoidance" than was the case in 2004, and hence this will create an incremental drag on 2005 earnings. More importantly, however, we feel that fuel surcharge revenue will increase at a slower rate than fuel expense; the opposite has been the case through 2004. **This would represent a 6-8% drag on EPS growth for NSC and BNI, respectively, in 2005. The impact on the remaining carriers is negligible from a percentage standpoint, but is a modest EPS positive as fuel costs on average are roughly comparable, and fuel surcharge levels and coverage will be higher for most of the remaining rails.**

Optimistic Oil Price Case Scenario: Were fuel prices to decline more rapidly, averaging \$30 in 2005, in line with our optimistic case, the disparity between declining fuel surcharge revenue and declining fuel expense would substantively impact a larger number of railroads, in our estimation, particularly the Eastern rails (CSX & NSC) and BNI. We also note that the lesser hedge positions comparatively for BNI and NSC would continue to provide some level of earnings drag even at these lower oil prices than our stable price case. For each of these three carriers, we estimate the drag to our current 2005 EPS to be in the range of 9-12%. While we view the negative impact of hedges at higher price levels to be of minimal consequence under this scenario, the falloff in fuel surcharge revenue would more than offset declining fuel expenses, thus would represent a drag on earnings growth vs. market expectations on a lagged basis. **Specifically, we expect each of the rails would be faced with an earnings headwind to overcome, with the exception of UNP, which is unhedged in 2005, and thus would have the most to gain of any of the rails from a notable decline in fuel prices.** This would represent a 12% tailwind to UNP earnings. The impact to CNI and CP would be relatively minor in scope.

Pessimistic Oil Price Case Scenario: Under our pessimistic case, we assume crude oil prices average \$60 in 2005. While this would seem like a stretch given the sharp decline in crude oil prices toward \$40 in recent weeks, we would have made the same argument a year ago if told crude oil prices would peak at over \$56 in 2004. Hence, it has become quite clear that anything can happen in the volatile crude oil supply and demand situation. **Under this scenario, UNP stands to have earnings come under the greatest pressure, given its unhedged position with an EPS drag of over \$0.90 per share, or roughly 28% of our current EPS outlook.** BNI and CNI on the other hand would experience earnings headwinds of \$0.27 and \$0.13, respectively, as we expect fuel expense would rise more rapidly than surcharge revenue. By our estimation, the fuel surcharge programs in place at the eastern rails and CP would more than adequately cover the increased expense. **Given its substantially increased hedge position, CSX would benefit notably, with NSC still a significant beneficiary with its aggressive approach to surcharge revenues and its strong but lesser year-over-year hedge position. These carriers would see EPS benefits in the 10-20% range.**

ANALYST CERTIFICATION

APPENDIX A-1

I, Scott Flower, hereby certify that all of the views expressed in this research report accurately reflect my personal views about any and all of the subject issuer(s) or securities. I also certify that no part of my compensation was, is, or will be directly or indirectly related to the specific recommendation(s) or view(s) in this report.

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