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## **National Grain and Feed Association**

1250 Eye St., N.W., Suite 1003, Washington, D.C. 20005-3922, Phone: (202) 289-0873, FAX: (202) 289-5388, Web Site: [www.ngfa.org](http://www.ngfa.org)

National Grain and Feed Association

Testimony on Rail Fuel Surcharges

Ex Parte No. 661

before the

Surface Transportation Board

May 11, 2006

Chairman Buttrey and Vice Chairman Mulvey:

I am Dan Mack, Vice President of Transportation for CHS, Inc. in St. Paul, Minnesota. I am here today representing the National Grain and Feed Association. I serve as Chairman of the NGFA's Rail Shipper-Receiver Committee. NGFA's outside transportation counsel, Andrew Goldstein, and president, Kendell Keith, contributed to the preparation of this statement, and they are here with me today to help respond to questions.

NGFA is comprised of some 900 member companies involved in grain storage, grain shipping, commodity and specialty grain merchandising, feed milling, integrated livestock feeding operations, grain processing and exporting. Rail transportation is an integral part of the grain and processed products marketplace. Our industry continues to be highly dependent on rail in many markets, in particular those markets where locations of production and consumption are separated by long distances.

We commend the Surface Transportation Board for conducting this hearing. As you are aware, NGFA, NIT League and several other shipper organizations, since early 2005, have engaged in discussions with most of the Class I carriers regarding concerns that our members have with the implementation of the various fuel surcharge programs. Some carriers have been responsive and made attempts to improve their surcharge programs through modifications in 2005 and 2006. Other carriers have maintained the same surcharge programs that largely have been in place since 2001. While we acknowledge

the progress that some carriers have made, there remain some significant opportunities for changing surcharge programs in ways that permit the legitimate recovery of fuel cost increases, but in ways that would be less objectionable to their customers. Is there an appropriate and helpful role that the STB can play in this process? Yes, we think there is, and we appreciate the opportunity to express how the STB could be helpful to both railroads and rail customers in this regard.

#### I. Major Points of Testimony

1. NGFA's position is that railroads have the right to recover unanticipated increased fuel expenses through tariff surcharges, provided such surcharges are reasonably related to the increase in market fuel expenses that have occurred after the railroads' surcharge rates were published. Railroads, of course, utilize a variety of measures to recoup higher fuel prices, including the Rail Cost Adjustment Factor (a common component often included in rate contracts that reflects increasing fuel costs), higher tariff rates, and higher contract carriage rates, in addition to the publicly announced fuel surcharges.
2. Fuel costs reported by the carriers in company financial reports are influenced by market prices paid for diesel as well as hedging gains and losses from the business activities of the carrier. It is reasonable to expect both gains and losses from hedging activities that, in our view, should accrue to the benefit/cost of the carrier.
3. Fuel costs over time are also influenced by changes in fuel efficiency. Given that surcharge formulas of the carriers were established at a single point in time and therefore reflect fuel usage and base fuel costs for that initial period, carriers should review surcharge formulas on a periodic basis to evaluate the accuracy and equity of the formulas.
4. Most railroads assess a formula-based fuel surcharge as applied to the base rate. Rail rates are not, in general, highly correlated with fuel expense of individual movements. This is a natural outgrowth of differential pricing. We provide several specific examples later in the testimony how this adversely affects individual shippers. When surcharges were less than 5%, the fact that surcharges were applied to freight rates was not a very significant issue. As surcharges have increased to higher levels, the distortions have grown and some shippers are paying what can only be described as punitive assessments. In some cases, surcharges applicable to virtually identical moves, with seemingly identical fuel usage rates, vary by several hundred dollars per car. This issue needs attention from all Class I carriers.
5. By labeling it as a "fuel surcharge," and pegging the surcharge to a fuel cost index, the carriers have essentially characterized fuel surcharges as a "hardship" cost recovery mechanism. However, rail fuel surcharges have caused a great deal of skepticism among rail customers, and a sizeable portion of this skepticism is driven by a lack of transparency by the carriers in reporting information. Most rail customers understand there is a rational business justification for surcharges, but they are skeptical as to whether the surcharges they pay fairly reflect cost increases and whether the surcharges are equitable with the surcharges being assessed to other customers. All railroads concede

that some of their customers do not pay "fuel surcharges," although the carriers do not disclose just how many are excused or precisely why. In our view, it is not justifiable for a carrier to charge a portion of its customers excessive fuel surcharges to compensate for a commercial business decision to not assess surcharges on other customers, particularly when the surcharge has been advertised as a cost recovery hardship measure unrelated to demand elasticity. We believe that some rail customer concerns over surcharges could be mitigated by carriers offering more transparency---making it more straightforward for shippers and receivers to evaluate the reasonableness and equity in the way surcharges are applied. The STB could play a critical role in requiring carriers to provide more information and transparency for their customer base. If railroads expect their customers to compensate them for increased fuel costs, then they should be willing to provide appropriate documentation to demonstrate they are only assessing charges that recover those costs and nothing more.

6. In its announcement of this proceeding, the STB raised the issue of whether rail fuel surcharges are part of the rail rate or could be considered an "unreasonable practice." As explained later, we believe that the case is convincing that the present railroad surcharge regime has aspects that plainly are unreasonable practices. It would be a misuse of the ICCTA to require a shipper with a complaint regarding the structure of fuel surcharges to bring a formal rail rate challenge at a cost that may reach several million dollars per surcharge challenge.
7. There are many factors that influence computed rail fuel surcharges and many of these have changed in substantive ways since the current formulas were put into place (rail rates, relation of diesel and crude oil prices, fuel efficiency, and the overall level of fuel prices which has made the surcharges very high creating highly inequitable surcharges when applied to differential freight rate structures). Because of these changes, we recommend that each of the carriers undertake a serious review of the accuracy and equity of current fuel surcharge formulas, and make needed adjustments. In this review, we also urge that the carriers consider alternative means of assessing surcharges that are truly more related to fuel cost increases of individual shipments, and adopt formulas that do not over-compensate the carriers. If the carriers fail to make voluntary changes and corrections to their programs within a reasonable time frame, NGFA urges the STB to exercise its authority to issue guidelines and parameters to carriers on acceptable methodologies for assessing fuel surcharges. As we have indicated previously, substantial efforts have already been made with Class I carriers, some of which have yielded some improvements. However, some carriers have refused to take any corrective action, and others have made refinements, but in general those refinements have not been adequate to fully correct for the overcompensation.

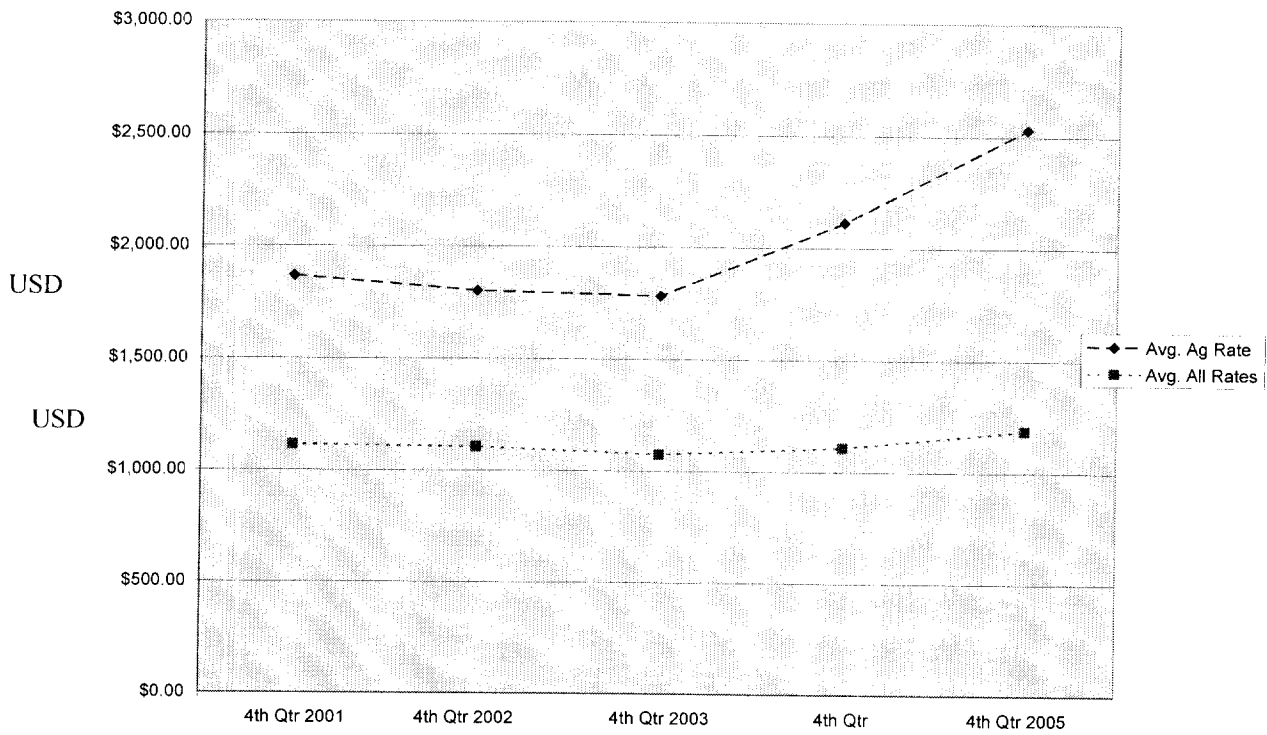
## II. Trends in Rail Fuel Surcharges and Relation to Increased Market Fuel Costs

The charts presented on pages 5-10 indicate how fuel surcharges of the major Class I carriers relate to increased fuel costs as reflected in wholesale diesel prices. The charts compare fourth quarter data for each of the past five years. The wholesale diesel price is U.S. Department of Energy's price series on "wholesale diesel prices paid by large institutional customers." The computed "additional fuel cost per car" assumes that the Class I carriers were paying 75 cents per gallon in the base period of 2001, 4<sup>th</sup> quarter. Actual prices paid in that quarter by carriers range from 77 cents to 82 cents and average 80 cents, so a base price of 75 cents actually provides a conservative estimate of base period costs. (The reason it is a conservative assumption is that the estimated increase in market diesel prices will be generally overstated so that any estimated "overcompensation" caused by fuel surcharge formulas will be understated.) The other justification for using the 75 cent cost as a base price is that the UP and BNSF both use a \$1.25 on-highway diesel price as a basing point for surcharges, and this level is virtually equivalent to the wholesale price of 75 cents, plus average markup from wholesale to retail, plus the average applicable taxes for highway fuel.

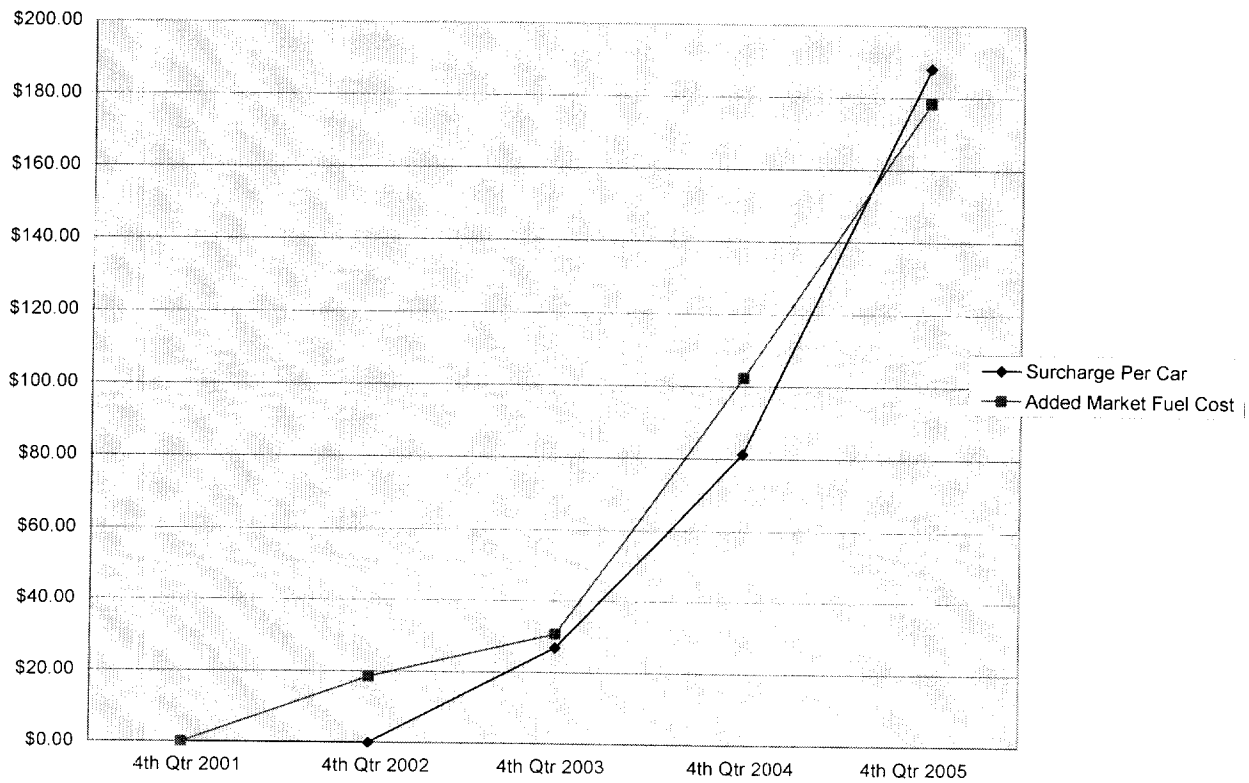
"Average All Rates" shown in the charts is the average carload rail rate for all traffic, and is computed by dividing total rail revenue by carloads originated and dividing that computed per car revenue by:  $(1.0 + \text{fuel surcharge})$ . This has the effect of removing the fuel surcharge from the total rail revenue per car. (It is noteworthy that because intermodal carriage is increasing on all the carriers, and that a single intermodal unit is counted as one "carload", the average rail rate for all traffic computed in this way does not reflect the general increases in freight rates applicable to most movements. Thus, application of the surcharge to the published rail rate is causing more of a "double-dipping" by the carriers for fuel cost compensation than reflected in the charts presented here.) The "average agricultural rate" is simply the quarterly average per car revenue reported by the carrier, without any adjustment for the fuel surcharge (because there are no data available on the average surcharge by type of service), and is presented only for comparison purposes. The "added fuel costs per car" is computed by multiplying actual gallons of fuel used per car by the increase in reported market diesel prices above the 75-cent base fuel cost. The rationale for using this measure to reflect actual fuel cost increases of the carriers (rather than the fuel costs reported by the carriers in their financial reports) is to remove the cost impacts of hedging gains and losses that are internal to the carriers' business. The surcharge per car is computed by multiplying the average rail rate for all carloads by the published surcharge percentage.

The pattern in the BNSF and UP charts of surcharges versus market fuel costs per car are very similar. Changes in the relationship between surcharges and actual changes in fuel costs experienced by carriers are affected by: 1) whether the individual carrier's surcharge formula accurately defines the relationship between cost and revenue; 2) trends in freight rates (because the surcharges are applied to rates); and 3) fuel efficiency gains. Both the BNSF and the UP experienced per car fuel efficiency gains of 3% over these four years, as measured by 4<sup>th</sup> quarter comparisons for 2001 and 2005. The original formula if viewed on a system-wide basis (which is by no means the same as a per shipment basis that we believe to be the correct measure) for both of these carriers appears to reasonably reflect overall fuel cost increases for the average shipment, at least

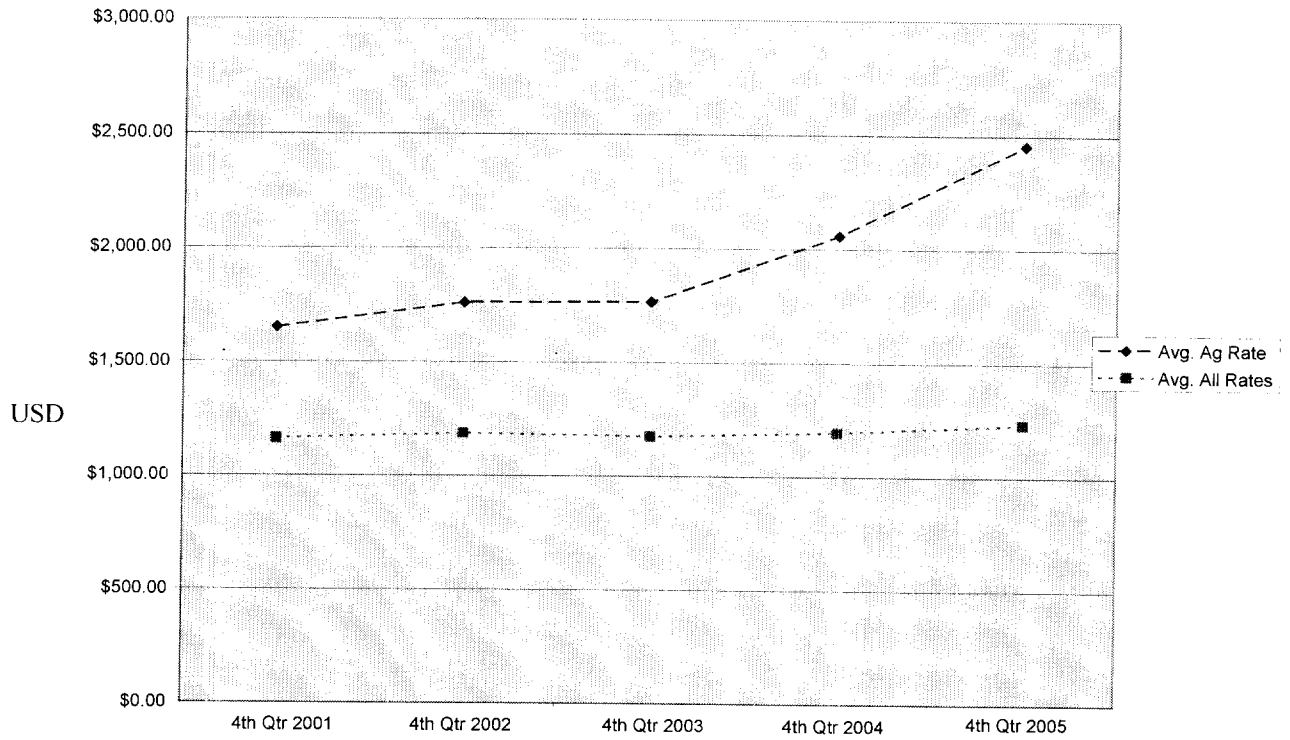
BNSF Rail Rates Per Car, 4th Quarter Data 2001-2005



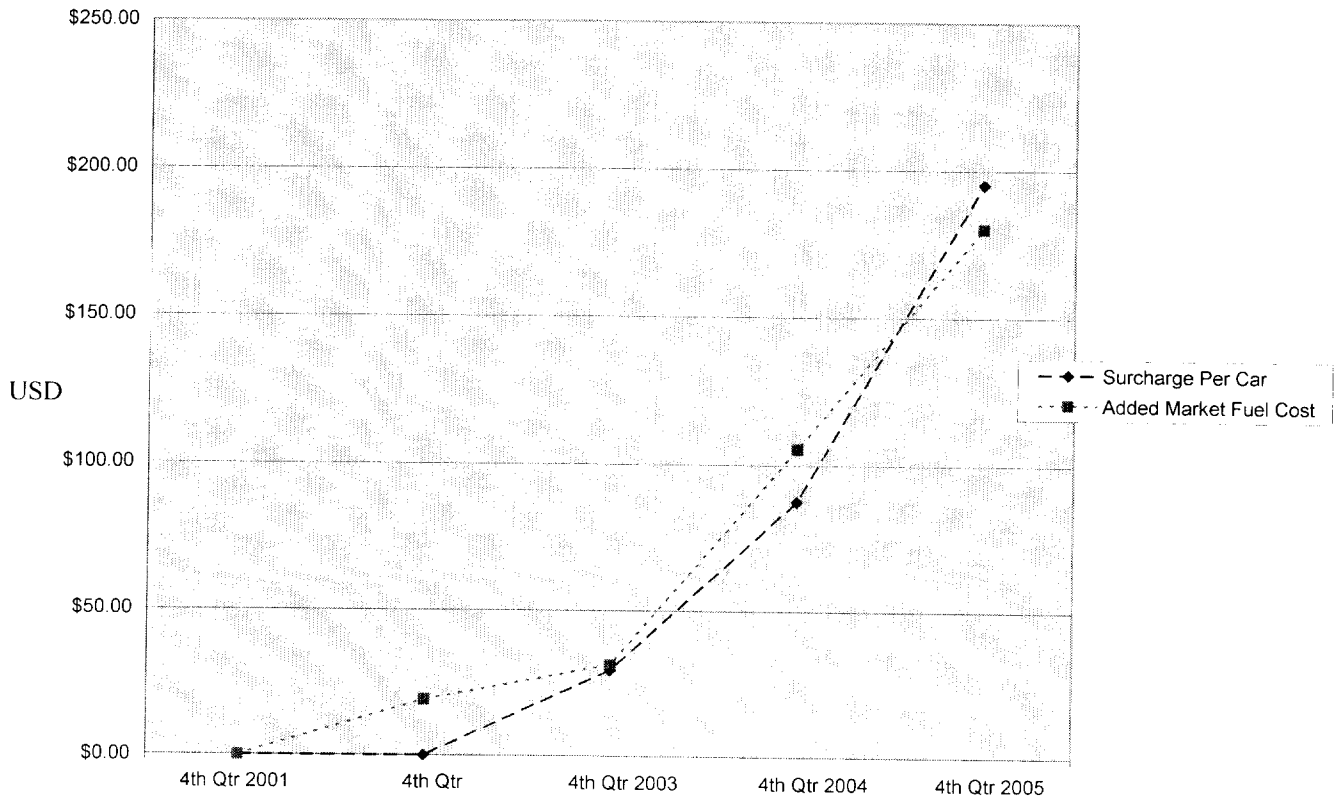
BNSF - Surcharge vs. Increased Market Fuel Cost per Car, 4th Quarter Data 2001-2005



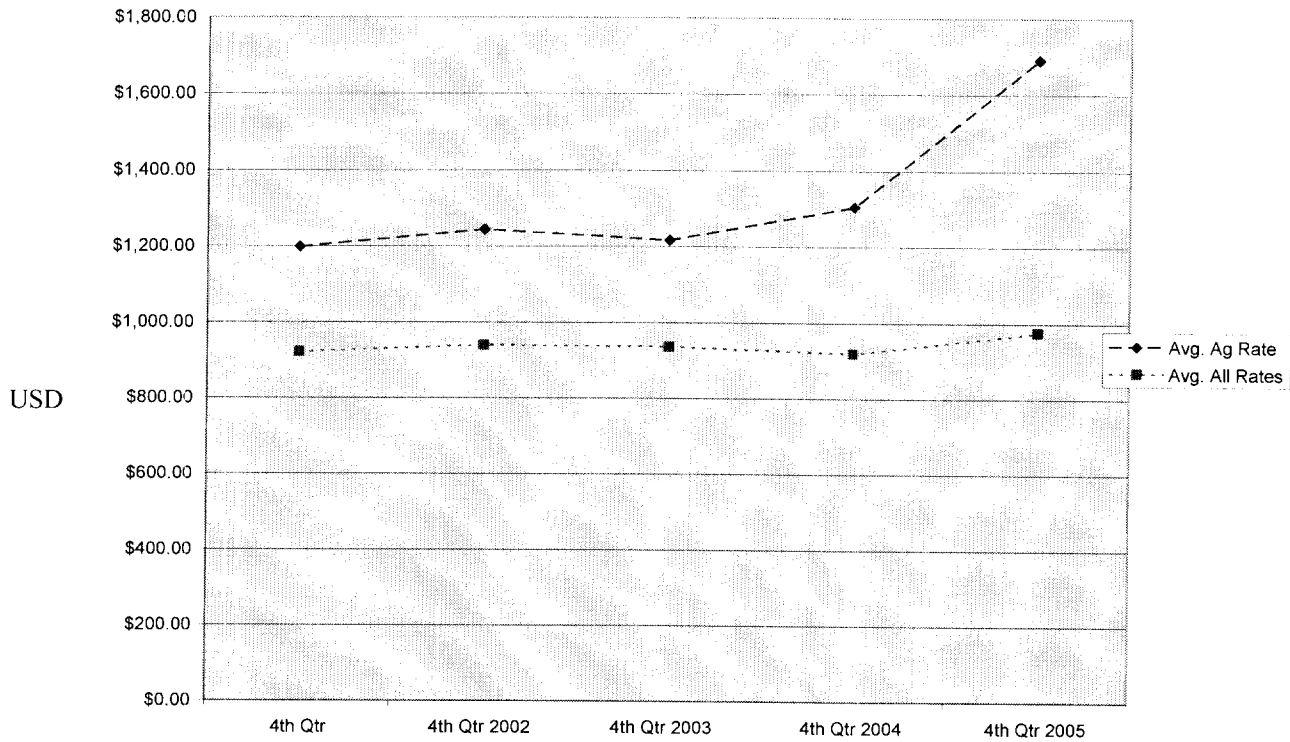
UP - Rail Rates Per Car, 4th Quarter Data 2001-2005



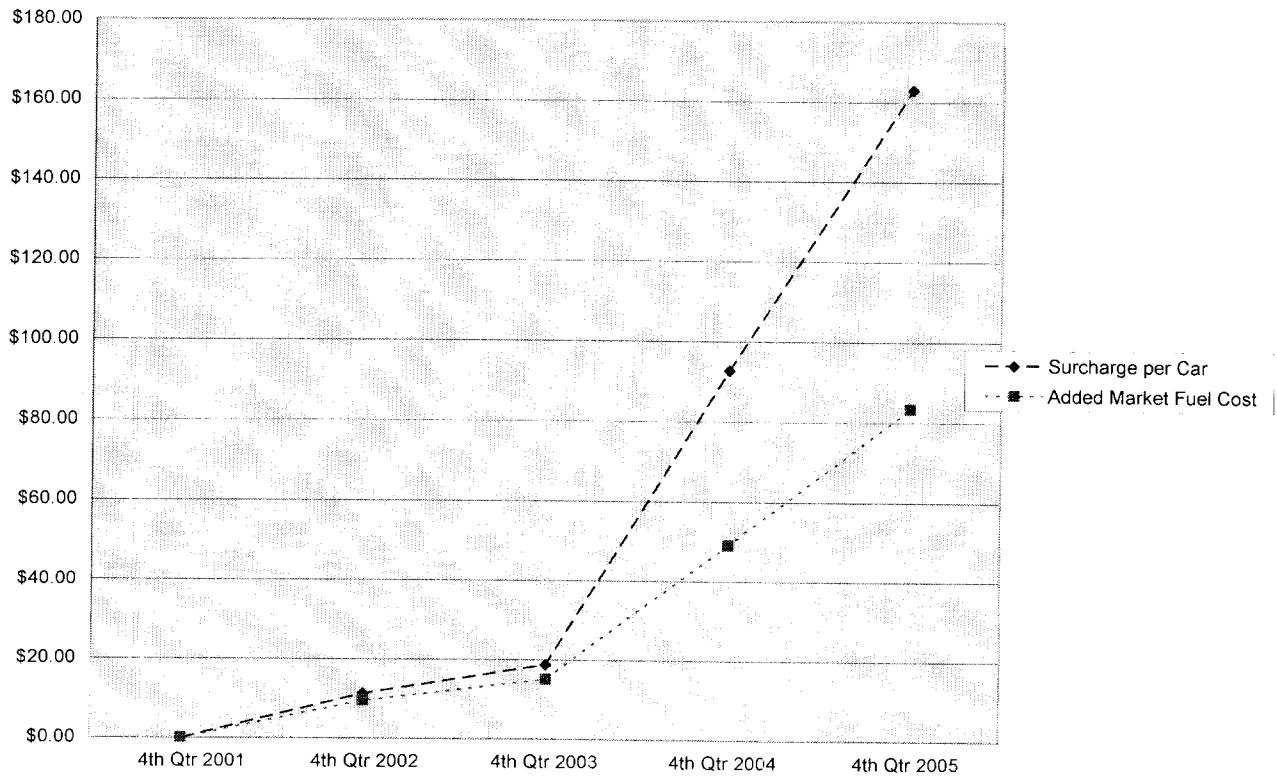
UP - Surcharge vs. Increased Market Fuel Cost Per Car, 4th Quarter Data 2001-2005



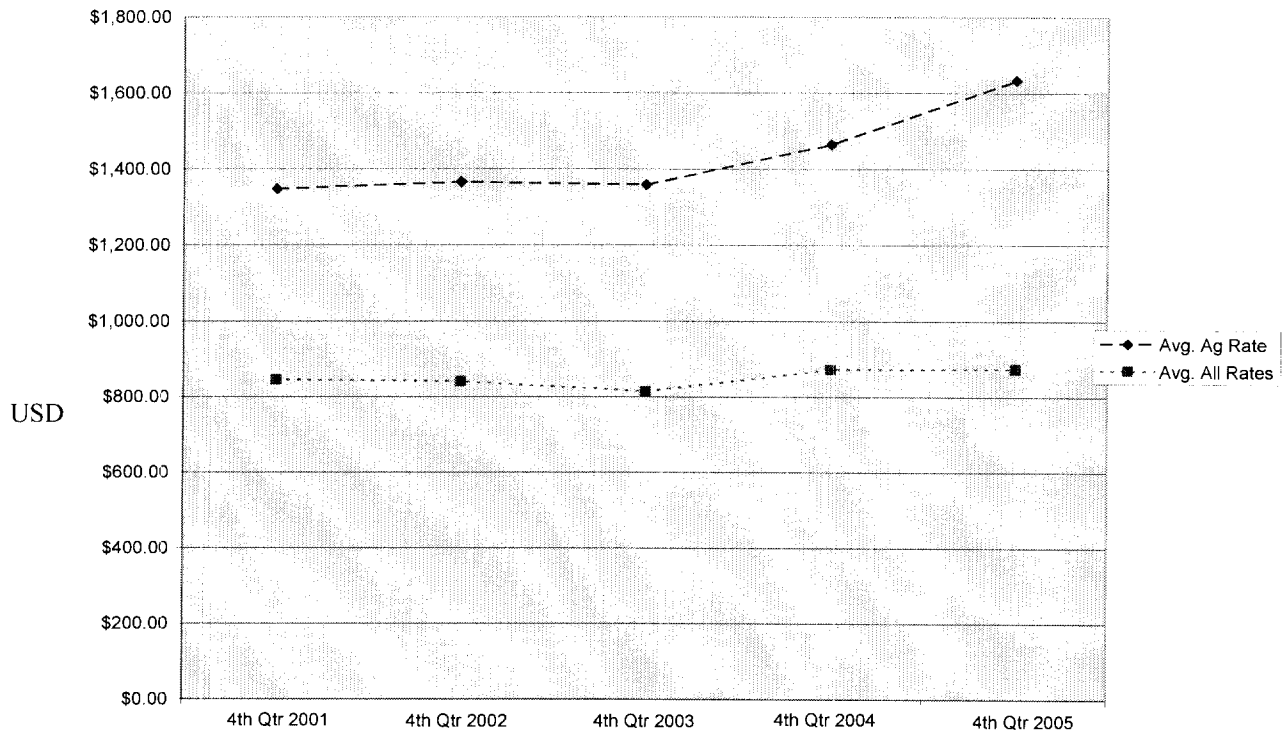
NS Rail Rates Per Car, 4th Quarter Data 2001-2005



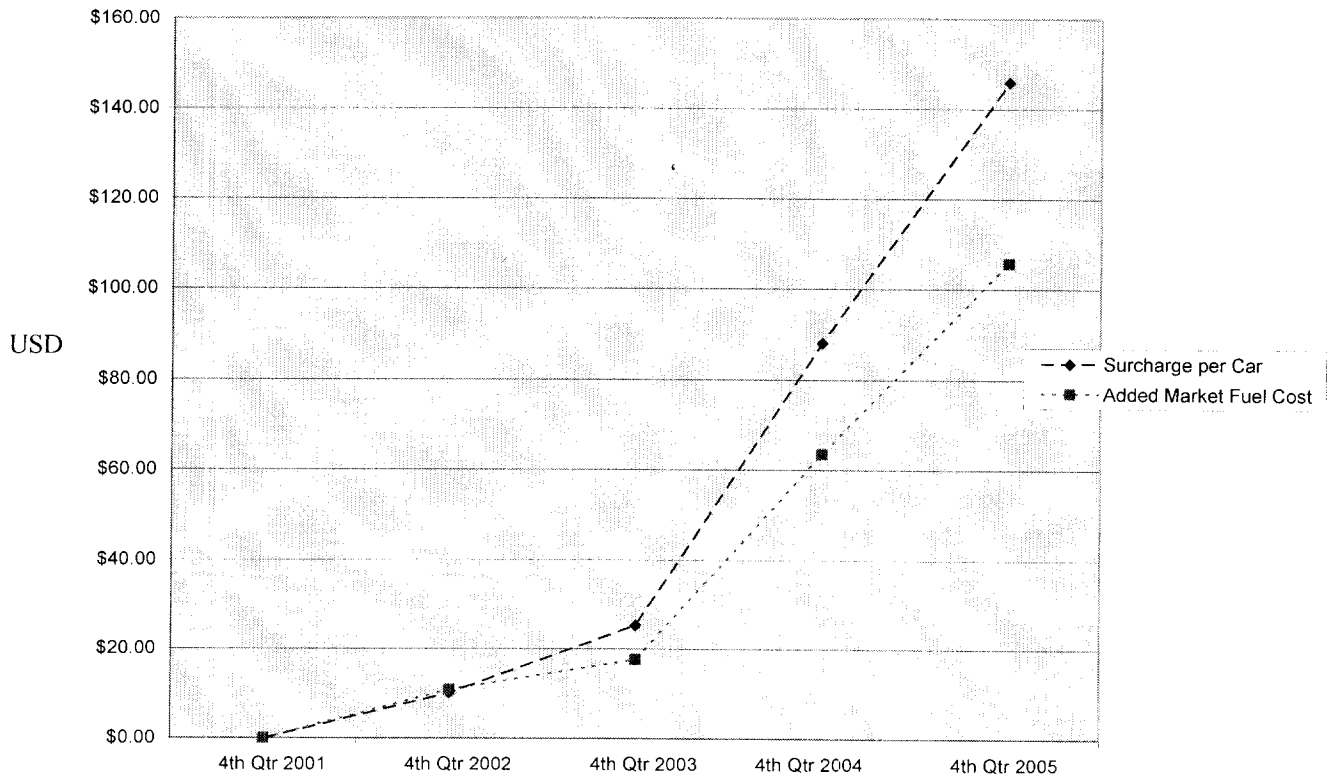
NS - Surcharge vs. Increased Market Fuel Cost per Car, 4th Quarter Data 2001-2005



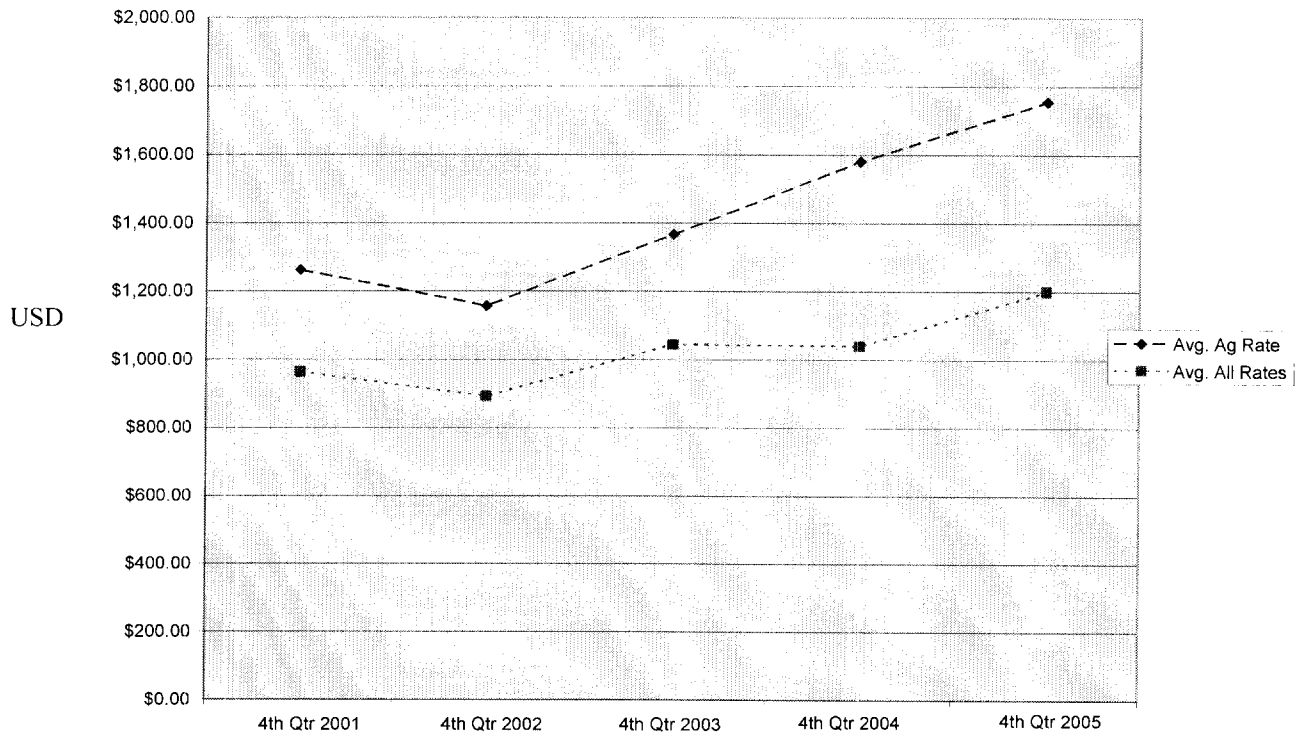
CSX - Rail Rates per Car, 4th Quarter Data 2001-2005



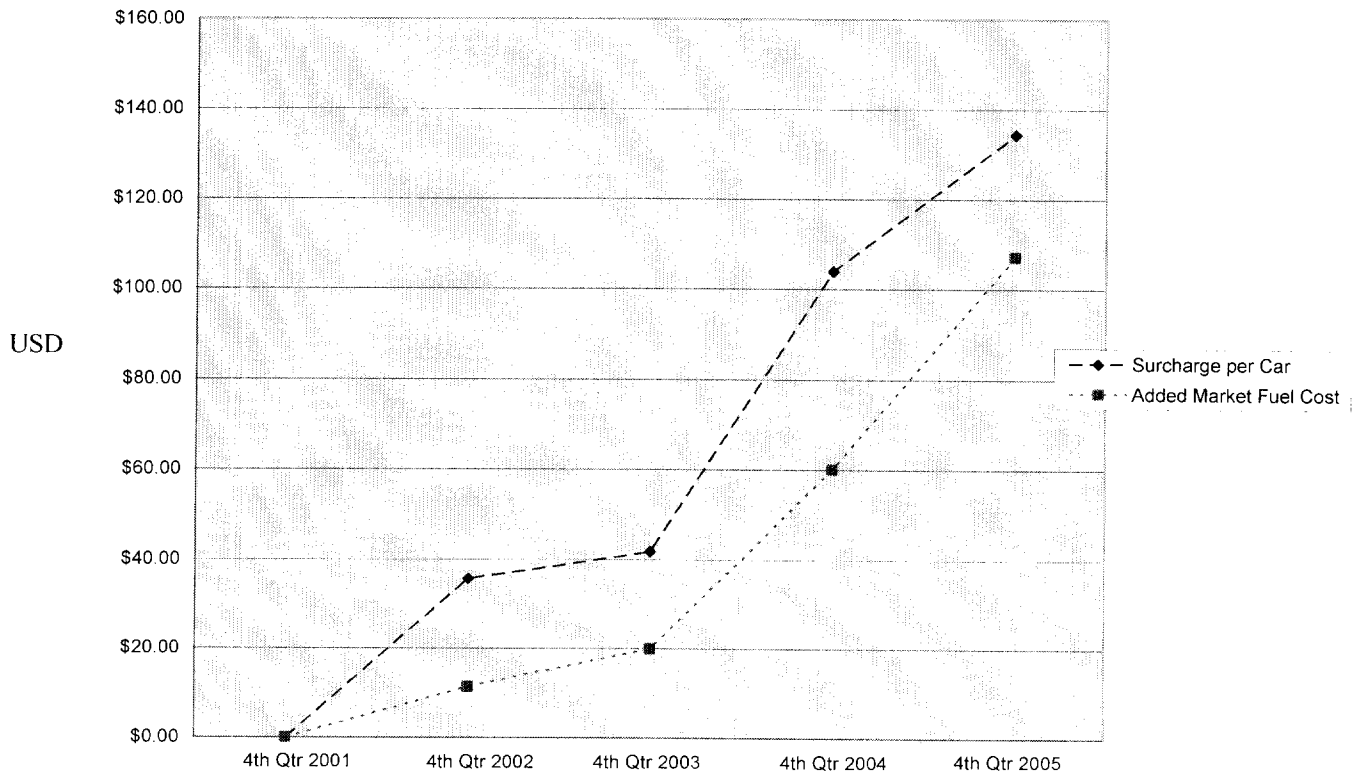
CSX - Surcharge vs. Increased Market Cost per Car, 4th Quarter Data 2001-2005



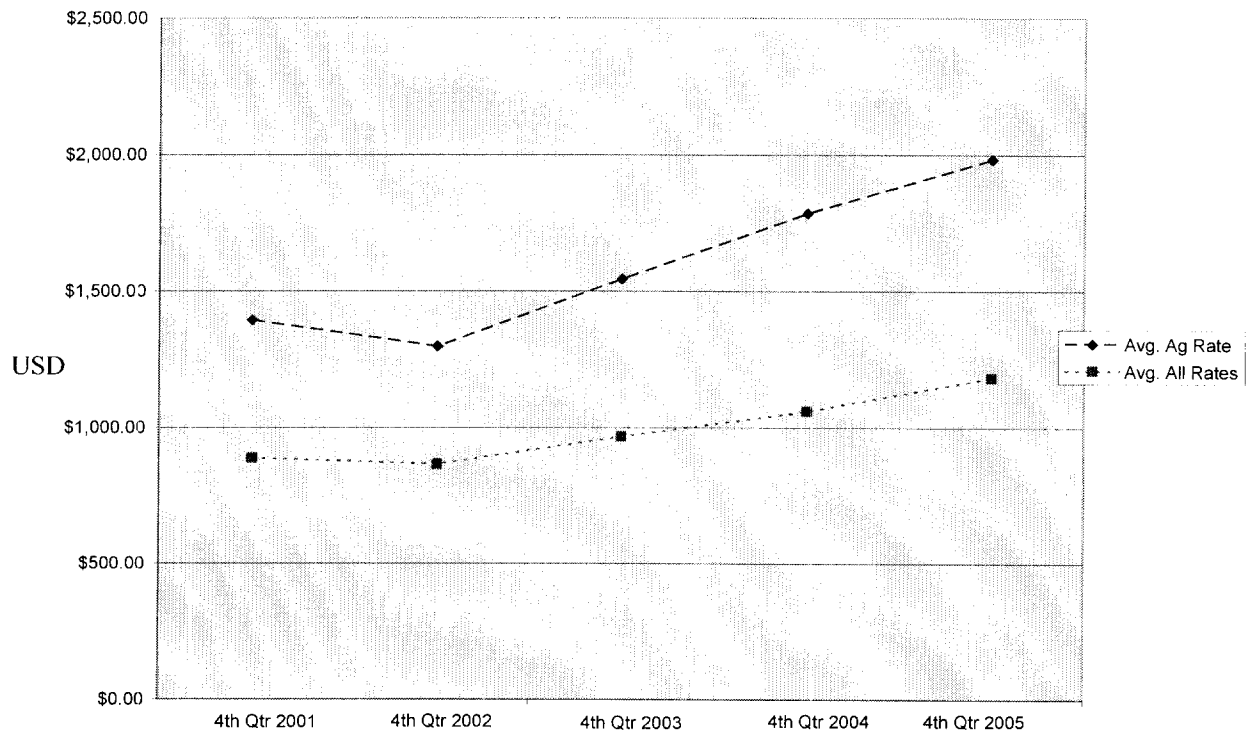
CN Rail Rates Per Car, 4th Quarter Data 2001-2005



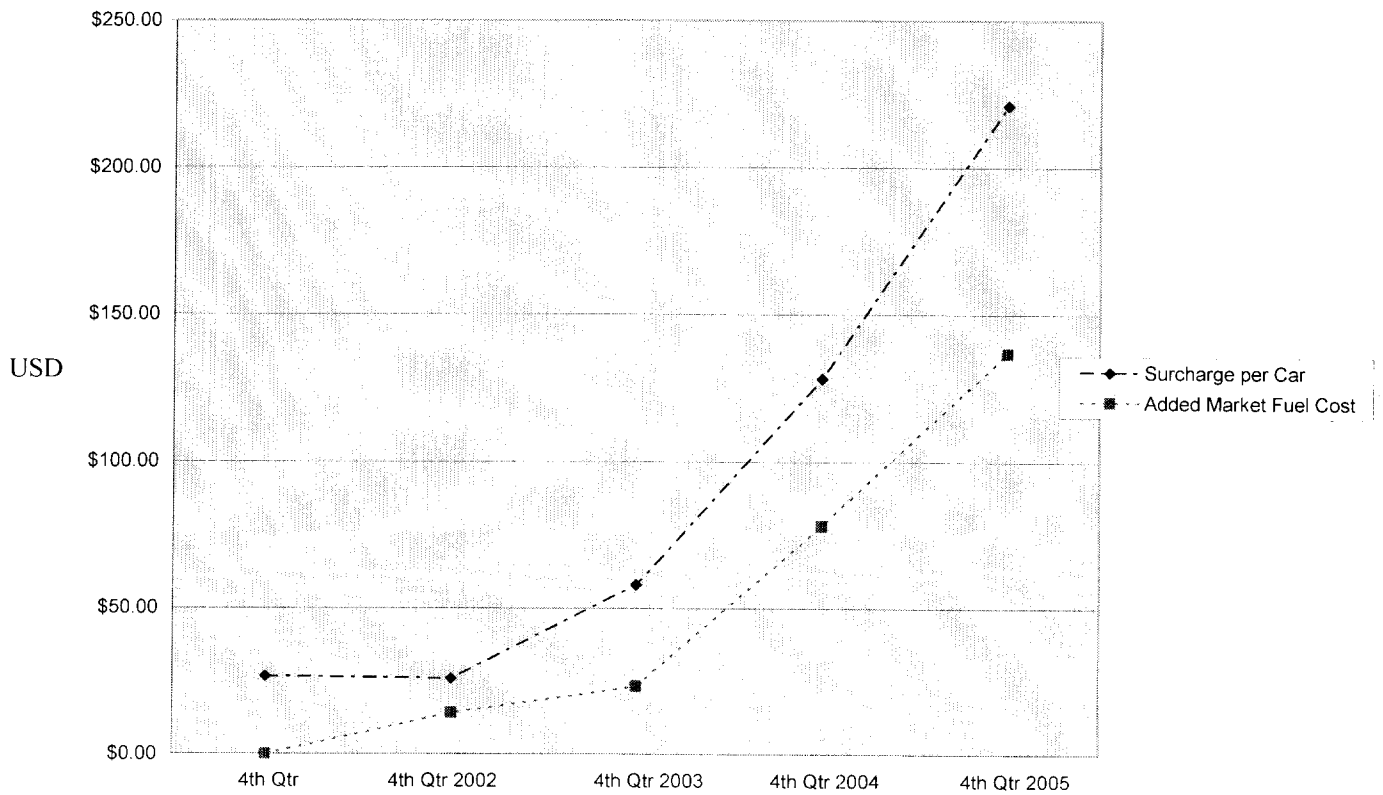
CN - Surcharge vs. Increased Market Fuel Cost per Car, 4th Quarter Data 2001-2005



CP Rail Rates Per Car, 4th Quarter Data 2001-2005



CP - Surcharge vs. Increased Market Fuel Cost per Car, 4th Quarter Data 2001-2005



in the first 3 years. (Note, however, that from 2002-2004, these BNSF and UP charts indicate that surcharges may not have quite covered the increased fuel cost. A more likely explanation is that the conservative assumptions used in this analysis are causing the spread between the two lines depicting cost and recovery through the surcharge; rather than reflecting an actual under-recovery of fuel cost increases.) In 2005, though, it appears that because freight rates have begun to increase, the surcharge formula being applied to rates is now starting to overcompensate both the BNSF and UP in the most recent quarter. The computed overcompensation for BNSF is \$10 per car and \$15 per car for the UP.

Thus, even across the entire system, rather than on a per shipment basis, it is now becoming clearer than ever that higher freight rates and higher fuel costs are producing a double surcharge whammy for shippers.

The pattern of surcharges versus market fuel costs per car are more troubling for the Eastern carriers, CSX and NS. Given the consistent pattern of surcharge revenues exceeding market price impacts on fuel costs, one would have to conclude there is a systematic bias in the NS and CSX formulas that needs to be corrected. Both of these carriers have surcharge formulas based upon West Texas Intermediate Crude oil prices. While crude oil prices are statistically correlated with diesel prices paid by the carriers, this is not the only pertinent consideration in establishing a fair and accurate surcharge formula. The reason for this is that while crude oil and diesel prices do move in the same general direction, in a rising crude oil market, diesel prices will not increase at the same rate as crude oil, because refining and marketing costs remain a significant part of the spread between ready-to-use fuel and crude oil.

A worrisome trend is that the over-compensation bias in the surcharge formula used by the Eastern carriers is increasing over time. The computations shown in the chart indicate that the NS surcharge now exceeds the additional market cost for fuel by \$79 per car. For the CSX, the surcharge formula is overcompensating the carrier by \$40 per car. (Again, because of the conservative assumptions used here, these estimates of overcompensation are likely an understatement of the actual level of overcompensation.) Comparing the 4<sup>th</sup> quarters of 2001 and 2005 for the NS, of the total excess compensation for fuel cost increases, 11% comes from the increase in base freight rates, 22% comes from gains in fuel efficiency, and 67% comes from the fundamental bias in the surcharge formula. In the case of the CSX, excess compensation for fuel cost increases is arising from higher rail rates (12%) and the bias in the surcharge formula (88%). Like the BNSF and UP analyses, these are system-wide observations. Over-compensation under fuel surcharge formulas can be much greater for individual shipments.

What is most troubling about the Eastern carriers is the "funnel"-shaped pattern that is emerging in the charts comparing actual fuel cost increases and per-car surcharges. That "funnel" pattern reflects the fact that as crude oil prices continue to rise, the bias in the surcharge formula is forcing the average shipper that pays the full surcharge to pay increasingly punitive assessments. Also, the very high percentage surcharges create other

distortions among individual shippers who may be paying vast differences in base rates that have no relationship with the price of fuel for a shipment. As we have already suggested to both the NS and CSX in private discussions, those companies need to revisit their fundamental surcharge formula to make it more reasonably related to costs. There are other ways to enhance revenue than through excessive fuel surcharge formulas.

The results for the Canadian Pacific Railway and the Canadian National Railway are more complex to interpret because all of the data have been converted into U.S. dollars for consistency. Both of these Canada-based carriers have benefited in the last 5 years by the general appreciation of the Canadian dollar relative to the U.S. dollar, such that U.S. dollar-based rates have increased 33% in the case of the CP and 25% for the CN across the five years. For the CN, the surcharge per car has consistently exceeded the added market fuel cost per car, but the 2005 downward adjustments to the CN surcharge formula corrected at least some of the growing bias in the CN computations. The surcharge formula reported here for the CP is the formula for general merchandise traffic transported in Canada (not the agricultural surcharge formula which is lower). In 2004 and 2005 CP surcharges were also beginning to increase at an increasing rate and needed to be adjusted to reduce the systematic bias of the formula and the impact of higher rail rates. The CP did make a reduction in its formula, beginning in the first quarter of 2006.

In some cases carriers are attempting to portray any situation in which they are not recovering the full cost of fuel to the railroad through the surcharge assessment as "under recovery." This is a misguided statement on at least two accords: 1) rail fuel surcharges have only been stated by the railroads to be intended for recovery of those fuel cost increases above a "base level"; thus fuel surcharge revenue should never reach the absolute level of total market prices of fuel (after adjusting for hedging gains and losses); and 2) railroads can through the rail cost adjustment factor have another means of fuel cost recovery. In addition, freight rates established in more recent years, such as 2005 contemplate current fuel costs. The Uniform Rail Cost System accounting uses current fuel costs, which railroads rely upon when defending challenges to their rate levels.

### III. The Need for Transparency: What the Public Marketplace Doesn't Know

The data we have presented provide a reasonably accurate assessment of how the average rail customer that is paying the published fuel surcharge is being affected by the applied surcharges relative to the market changes in diesel fuel prices. However, that does not tell the individual rail customer that may be shipping grain, coal, lumber or any other type of freight how his costs compare to the increased fuel costs for shipments and how his surcharges compare with those applied to other types of rail traffic and competitors that may be shipping like commodities. That kind of detail is simply not fully available because of gaps in uniform data reported by carriers. As we noted earlier, the lack of transparency for assessing the reasonableness of fuel surcharges breeds skepticism among rail customers, a situation that needs to be corrected promptly.

What information is lacking?

- We don't generally know how much increased fuel cost is being recovered in RCAF formulas, contract rates and general tariff increases. Anecdotal reports suggest that some or all of these approaches are being used by carriers to recover fuel cost increases, in addition to the fuel costs recovered through the application of published fuel surcharges. Railroads will enter into contracts with some customers that contain negotiated rate escalation clauses either to the exclusion of the fuel surcharge tariff or in a way that modifies their fuel surcharge tariff. It is probable that the carriers then claim that these are customers from which they cannot collect "fuel surcharges," creating a need on their part to seek compensating fuel surcharge revenues from the remainder of their customer base. The Board should require a definite statement from carriers as to whether they recover increased fuel costs through contract or other provisions that are not included in their tally of "fuel surcharge" revenues.
- There are no generally available data from the carriers as to what proportion of their customer base is being assessed the surcharge. To our knowledge, only the Union Pacific has been forthcoming in annual reports about the percentage of customers being assessed the surcharge. The BNSF in its 2005 annual report announced annual fuel surcharge revenues for 2004 and 2005.
- Because the railroads do not report rail ton miles and fuel utilization for various product sectors, it is impossible to compare how average shippers in various rail business categories are being treated with respect to surcharge program application.
- Individual railroads' incremental fuel costs net of hedging. Plus, definition of the base fuel cost used to calculate the incremental fuel cost, including justification for the base.
- Data as necessary to measure the per shipment cost of fuel for each published or quoted common carrier rate in the same units as the carrier may select for a fuel surcharge (e.g., \$ per mile if the surcharge is calculated by mileage or \$ per car-mile if the surcharge is on a per car basis).

We suspect that the carriers have such information readily available. The STB could compel carriers to begin reporting this information so that rail customers could more accurately assess the reasonableness of rapidly escalating fuel surcharges as applied to their business. We offer the observation that most railroads utilize either rates based on a specific weight unit or rates applicable to different gross weight cars and that per shipment mileages readily are available in carrier computer systems, so that rates per distance unit would not be impossible to calculate or to correlate with fuel surcharge revenues on the same basis.

#### IV. Distortions in Surcharges Applied to Individual Shippers

The following table illustrates how a carrier's fuel surcharge methodology when applied to the underlying rate, imposes disproportionate and unfair fuel surcharge burdens on traffic paying the highest rates.

Per Car Comparison of Fuel Surcharge Revenue on Shipments of the Same Size Moving  
from Enderlin, North Dakota to Pacific Northwest Ports on the Canadian Pacific  
Railroad, May Shipment, 2006

| <u>Commodity</u> | <u>May 2006 Surcharge</u> | <u>Freight Rate/Car</u> | <u>Fuel Surcharge/Car</u> |
|------------------|---------------------------|-------------------------|---------------------------|
| Corn             | 9.46%                     | \$3,184                 | \$301                     |
| Soybeans         | 9.46%                     | \$3,300                 | \$312                     |
| Wheat            | 9.46%                     | \$3,894                 | \$368                     |

There plainly is no greater cost for moving identical quantities of corn, wheat or soybeans over identical routes for identical distances. Yet, because the freight rate on wheat is higher than the freight rate on corn between the same two points, and for no other reason, the wheat shipper is forced to make a greater fuel surcharge contribution than the corn shipper, as illustrated in the table.

Because railroads engage in differential pricing, there are many other examples that could be provided of the inequities and distortions that arise by applying fuel surcharge formulas to the freight rate. Another example provided by one of our members served by an Eastern railroad is that a freight rate between two points is \$2,900 if loaded in a railroad car, but only \$2,450 if loaded in an identical private car. At a 17.2% fuel surcharge rate, there is a \$77 difference in the fuel surcharge. There plainly is no difference between the railroad car and the privately owned car other than who owns it. It looks the same, weighs the same, has the same cost of movement, and from the standpoint of fuel usage is identical.

These are the kinds of examples of surcharge inequities that raise suspicions and skepticism among rail customers.

#### V. Hedging Fuel Costs

All the major carriers engage in certain hedging activities related to fuel purchases. In the last four years, because fuel prices have generally been trending upward, many of the carriers have managed to successfully reduce their fuel costs. The table below compares the 4<sup>th</sup> quarter 2005 reported per gallon fuel costs of the major carriers with the wholesale price of diesel reported by the Department of Energy, which is roughly what the carriers would have had to pay if, rather than hedging and buying fuel in advance, each of the railroads paid the cash market price for wholesale diesel as it was being consumed.

| 4 <sup>th</sup> Quarter, 2005 Wholesale Diesel Price vs. Diesel Cost Reported by Railroads<br>(\$US/Gal) |             |             |             |             |             |             |
|----------------------------------------------------------------------------------------------------------|-------------|-------------|-------------|-------------|-------------|-------------|
| <u>Market</u>                                                                                            | <u>UP</u>   | <u>BNSF</u> | <u>NS</u>   | <u>CSX</u>  | <u>CP</u>   | <u>CN</u>   |
| <u>Diesel Price</u>                                                                                      | <u>Cost</u> | <u>Cost</u> | <u>Cost</u> | <u>Cost</u> | <u>Cost</u> | <u>Cost</u> |
| \$2.03                                                                                                   | \$2.08      | \$1.69      | \$1.76      | \$1.60      | \$1.82      | \$1.68      |

In our view hedging is an internal business choice that can assist in stabilizing the predictability of corporate net revenue, and hedging performance is dependent on business decisions made by the railroad. The chart reflects the differentials that can occur because carriers employ different hedging strategies. Therefore, we think that hedging gains should accrue to the railroad. Conversely, if there are hedging losses, the railroad should absorb those losses.

Some have suggested that rail customers' concerns with fuel surcharges could largely be solved through some hedging programs employed by rail customers. While we agree that hedging could be used by rail customers to manage variability in freight costs, such hedging does not solve the more fundamental problems confronting shippers that are paying surcharges that far exceed the market cost of fuel used in the shipment. Excessive costs that have a consistent upward bias are not resolvable through hedging.

#### VI. Fixing the Problems with Fuel Surcharges

From all available evidence, rail fuel surcharge programs do not result in fuel surcharges on individual shipments that are closely related to applicable fuel cost increases. And the observed inequities are becoming substantial economic factors as crude oil prices, diesel prices and freight rates all continue to climb. In addition to providing more transparency through the reporting of additional data for rail customers to be able to evaluate whether surcharges they pay are reasonably related to cost increases, all of the Class I railroads need to periodically review and revise their surcharge programs as market, economic and operational changes occur over time, all of which can affect the relationship of surcharges and actual fuel cost increases.

The analyses presented in this paper indicate that the following factors not related to market fuel costs have had significant impacts on the surcharge revenue assessed of the average rail customer paying the published surcharge rate:

- Freight rate increases, which have affected all the carriers
- Higher percentage increase in the price of crude oil relative to the market price of diesel (for those carriers using crude oil indices for surcharges)
- Fuel efficiency changes

Looking into the future, we can expect these factors that affect applicable fuel surcharges to continue to change, plus there will be others that may or may not be predictable. For example, as the market adjusts to new regulations regarding the use of ultra-low sulfur diesel, the price relationship between "on-highway diesel" price series used by some carriers as a fuel cost index and the actual diesel price confronted by rail carriers could change in substantive ways.

As we noted previously, some of the carriers are already making periodic assessments of their surcharge programs for these and possibly other reasons. The Canadian National Railway and the Canadian Pacific Railway have both made downward revisions in their fuel surcharge formulas to more accurately reflect overall fuel costs. However, both of these carriers still apply the calculated surcharge to the freight rate so inequities still occur across individual industry shipments caused by differential pricing of rates.

The BNSF has adopted a mileage-based system for both coal and grain. A mileage-based system has the potential to be more closely related to cost than a surcharge applied to rates. We commend the BNSF for attempting to respond to its customer base on the matter of surcharges, but the implementation of the mileage-based system has proven to be more challenging for the BNSF and its customers than I believe most of us had expected. The mileage system has not proven to be the complete or perfect answer regarding surcharge assessments, as some shippers continue to believe that the surcharges they confront exceed the cost of fuel for individual shipments. (It should be noted that NGFA and other organizations approached BNSF and other carriers in 2005 requesting that fuel surcharges be more closely related to cost. We did not make a specific recommendation as to what type of cost-based surcharge would be most appropriate, most equitable, or easiest to implement. As an example, we provided a case study demonstrating a mileage-based approach could be one way to approach the issue. The example we provided each of the carriers is different than the surcharge formula eventually adopted by the BNSF.) Thus, additional transparency that would permit easier fuel cost calculations for individual shipments would help. As grain shippers, we also would like to understand the reasons why the mileage rate for coal is 22 cents while the mileage rate for grain is 33 cents. Again, this matter might be put to rest with some additional transparency from the carrier. At the same time, it should be noted that in general, the BNSF has been forthcoming with information on surcharges when our industry has requested it in the past.

Across the rail industry, fuel costs expressed as a percentage of rail rates cover a wide range, as depicted in the chart below. So in the simplest of analyses, if surcharges continue to be applied to rates by the railroads, and if surcharges are computed through formulas that fairly recoup only the fuel cost increases and no more, the surcharge formulas of the carriers should not result in like surcharge levels. However, that does not mean that fuel surcharges should not all be judged by the same standards of reasonableness as related to the increased fuel costs for individual movements.

Fuel Costs as Percentage of Rail Rates for Class I Carriers, 4<sup>th</sup> Qtr, 2005

|             |           |           |            |           |           |
|-------------|-----------|-----------|------------|-----------|-----------|
| <u>BNSF</u> | <u>UP</u> | <u>NS</u> | <u>CSX</u> | <u>CP</u> | <u>CN</u> |
| 17%         | 22%       | 10%       | 13%        | 15%       | 11%       |

In re-evaluating and changing fuel surcharges to be more accurately reflect the additional cost of fuel for individual shipments, we would recommend that carriers:

- Seriously consider surcharge systems that are not applied to the freight rate, because of the equity issues caused by differential pricing and because rate escalation over time causes the formula to over-compensate for actual fuel cost increases. Possibly per car charges with some adjustment for mileage ranges on individual movements should be considered as a mechanism for recouping increased fuel cost.
- To assess fuel surcharges on a per shipment basis only to the approximate extent necessary to allow carriers to recover fuel cost increases unknown at the time the freight rate to which the surcharge is applied was published.
- If surcharge formulas continue to be applied to rates, undertake more frequent review and adjustment to the formula to avoid the "double-dipping" of multiplying a higher fuel surcharge to a higher rate that causes surcharges to increase at a geometric rate.
- If surcharge formulas continue to be applied to rates, raise the base fuel price at which surcharges begin, so as to lower the surcharge percentage. This will tend to reduce the inequities of applying the surcharge percentage to differential rate structures.

If the carriers continue to ignore calls for correcting fuel surcharge formulas that are clearly excessive and fail to address equity issues across classes of shippers, we urge the STB to take action to direct the carriers to make needed changes to make the surcharges reasonably related to the costs of individual movements.

VII. Fuel Surcharges as Unreasonable Practices

The Board's March 14, 2006 Notice in this proceeding suggests that the Board may harbor some uncertainty regarding its jurisdiction to correct or respond to complaints regarding fuel surcharges. The March 14 Notice indicates no uncertainty whatsoever on the Board's part regarding its ability to require carriers to furnish data regarding their revenues, expenses, fuel costs, or fuel surcharge calculations.

As the Notice states, the Board can review the level of a railroad's rate only if the railroad has "market dominance" over the service to which the rate applies, within the meaning of 49 U.S.C. 10707(a) and 10707(d)(1)(A).

On the other hand, the Board has jurisdiction over the reasonableness of a railroad's practices pursuant to 49 U.S.C. 10702(2). The Board, citing *Union Pacific R.R. v. ICC*, 867 F.2d 646 (D.C. Cir. 1989), stated in the Notice that it "cannot use its authority over the reasonableness of a carrier's practices to regulate the level of a carrier's rates." *Ibid.*<sup>1</sup> In *Union Pacific*, the court held that where a challenge to a railroad publication as an unreasonable practice is "manifested *exclusively* in the level of rates that customers are charged," the challenge really is a rate challenge subject to the Board's limited jurisdiction to regulate railroad rates. *Union Pacific*, 867 F.2d at 649. To support its point, the court observed that each of the complaints that had been before the ICC "alleges that the defendant railroads are market dominant and that the rates they charge for the movement of radioactive materials are unreasonable ... in violation of Section 10701a(b)(1). None alleges that the carriers are engaged in an unreasonable practice. Both the ALJ and the Review Board treated these disputes as challenges to the reasonableness of the railroads' rates." *Ibid.*

By contrast, the Board's Notice in this proceeding expressly disclaims any intent "to address the level of surcharges," slip op. at 2, and displays no intent to address the level of any railroad rate whatsoever. The focus of this proceeding is, instead, to determine whether the assessment of "fuel surcharges" that are not "directly and closely correlated to increases in the cost of fuel for the particular movement to which the surcharges applied" are unreasonable practices. Notice, slip op. at 2.

Insofar as NGFA is concerned, the Board's jurisdiction over "unreasonable practices" is amply broad to encompass an examination and, if necessary, correction of the railroads' fuel surcharge programs. Railroads have touted their fuel surcharges as necessary to recover unanticipated increases in fuel costs, impliedly for the individual shipments to which the surcharges are applied. If fuel surcharges are being used for some other purpose, the railroads have been misleading their customers. A "fuel surcharge" has never been necessary, and would not be necessary today, except to recover fuel costs that are not ordinary and usual, i.e., that are not anticipated at the time the freight rate is established and that are not recovered through freight rates. To the extent a railroad uses fuel surcharges for some other purpose, it is an unreasonable practice.

Some railroads argue that a fuel surcharge is merely another form of freight rate and cannot be assailed in any respect except as provided in Sections 10701 and 10707. This argument, if accepted, would place the use of the railroad's "hardship" cost recovery apparatus effectively beyond challenge in almost every instance. The Board is well aware of the extreme cost associated with any challenge to a railroad rate based upon the so-called Stand-Alone-Cost methodology prescribed in *Coal Rate Guidelines*,

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<sup>1</sup> It is noteworthy that, when the *Union Pacific* case was decided, the Interstate Commerce Act contained a specific prohibition against the use of the Interstate Commerce Commission's jurisdiction over unreasonable practices to regulate the level of railroad rates. See former 49 U.S.C. 10707a(h) ("The authority of the Commission to determine and prescribe reasonable rules, classifications and practices may not be used, directly or indirectly to limit the rates which rail carriers are otherwise authorized to establish under this title."). Although *Union Pacific* does not mention Section 10707a(h), it is difficult to imagine that the court was unaware of that provision, which subsequently was repealed when the ICCTA was enacted.

*Nationwide*, 1 I.C.C 2d 520 (1985). And the Board is equally aware of the daunting problems that have stood in the way of any other type of challenge to a railroad rate.

Under the ICCTA, railroads can increase their rates with no regulatory suspension or examination except after-the-fact. If fuel surcharges were mere and usual rate increases, they could be published as such and the railroads would be protected by all of the statutory provisions applicable to challenges against railroad rates. For some reason totally unexplained by the railroads individually or as an industry, fuel surcharges have been advanced as a manner of "cost recovery" rather than rate increases. The ICCTA encourages railroads to rely fundamentally on market forces to guide their rate structures, and provides that rail rates may be challenged as unreasonably high only under limited circumstances, including the absence of effective competition. Fuel surcharges, at least when posited, as they have been, to be hardship measures designed to recover unanticipated costs, rather than reflective of market pricing opportunities, do not fit into the mold of the type of railroad rate intended to be subjected to only the limited regulatory oversight applicable to market-oriented rates.

Surcharges have been recognized by the Board to be distinguishable from other rates. The Interstate Commerce Act, prior to the ICCTA, contained various types of surcharge authorizations that were recognized as having limited functions. In *Parrish & Heimbecker, Inc. – Petition for Declaratory Order*, Docket No. 42031 (decided May 24, 2001), the Board had occasion to review the lawfulness of certain railroad surcharges under an unreasonable practice standard. Although the specific grounds for unreasonableness involved in *Parrish & Heimbecker* were unrelated to fuel costs, the Board's decision provides a relevant statement indicating that rate surcharges were not conceived for broad application, but only to rectify a limited range of problems. "There is nothing in the statute or the legislative history of former 49 U.S.C. 10705(a) [a surcharge provision] to suggest that the surcharge remedy was meant to go beyond affording carriers a limited relief from the failures of then-existing common carriage tariff rate structure. The surcharge provisions of former 49 U.S.C. 10705(a) grew out of events relating to the unilateral publication by Consolidated Rail Corporation (Conrail) of surcharges for its own account. The ICC initially granted Conrail permission to publish a surcharge on pulp board as 'an innovative approach to meet a chronic problem of non-compensatory rates.'" *Parrish & Heimbecker, supra*, slip op. at 5. We are unaware that any railroad currently is claiming the need to publish fuel surcharges in order to correct an imbalance in the inter-carrier distribution of revenue. Nor are we that the Class I railroads who champion fuel surcharges do so in order to overcome a "chronic problem of non-compensatory rates." A public justification given by some railroads for fuel surcharges that produce excessive compensation for individual shipments is that their ability to assess fuel surcharges against their entire customer base is hampered by "legacy" contracts. We are forced to regard this as an odd defense, particularly for the Board to accept, inasmuch as contracts foregoing the collection of fuel surcharge revenue were purely voluntary on the part of the railroad industry, and are beyond the Board's jurisdiction. The Board has ruled on numerous occasions that it will not be bound by the ramifications of any contract over which the Board lacks jurisdiction, and there appears

to be no sound reason why the Board should make an exception to that rule simply to accommodate the railroad's desire for more money.

NGFA believes that the Board not only has jurisdiction under its unreasonable practice jurisdiction to require carriers to report all data necessary to bring transparency to their fuel surcharge practices, but also to regulate the manner in which fuel surcharges are calculated or assessed at all, at least so long as railroads elect to hold out fuel surcharges as necessary to avert hardship to them resulting from unanticipated spikes in the cost of fuel.

We appreciate the opportunity to present our views on this issue, and will be pleased to respond to questions.