

Ex Parte No. 661 – Rail Fuel Surcharges**Before the Surface Transportation Board
May 11, 2006****Comments of North Dakota Grain Dealers Association**

I am Steve Strege, Executive Vice President of the North Dakota Grain Dealers Association. NDGDA is a 95 year-old voluntary membership trade association of over 90% of the licensed and bonded grain elevators in North Dakota. These elevators are the first point of sale and delivery for hundreds of millions of bushels of grain produced by our state's farmers annually. NDGDA's Board of Directors is ten grain elevator managers. Almost all of them deal with railroads and fuel surcharges on a daily basis.

Hearing Focus Appropriate

Thank you Chairman Buttrey and Vice Chairman Mulvey for holding this hearing. In your March 14 announcement you zeroed-in on precisely the right question: "whether railroad fuel surcharges are being set in such a manner as to insure that they are used only to recover the increased cost of fuel for the particular movements to which the surcharge is applied..." We believe there is substantial evidence that rail fuel surcharges exceed increased cost of fuel. We also believe this is an unreasonable practice.

BNSF Railway and CP Railway operate in our state. BNSF is by far the bigger of the two. Both these railroads assessed their fuel surcharges as a percentage of the rate up through the end of 2005. At that point the BNSF converted to a mileage-based fuel surcharge. As we have done several times in the past, I will state here again for the record our compliments to BNSF for making this change. Other railroads would be wise to also incorporate a distance component in their fuel surcharges. Driving the family car or a railroad locomotive 1,000 miles obviously consumes more fuel than

driving either one 500 miles. What we seek is a true cost-based system. Mileage is a necessary component, but using it doesn't necessarily produce cost-based results. The per-car-mile charge is the second major component in the calculation. A reasonable fuel surcharge should be truly reflective of increased fuel cost. When BNSF went to mileage-based it said the change would be revenue-neutral for BNSF. This brought about shifting of surcharges instead of moving to a true cost-based system. Some shipments rightfully benefited, such as high priced movements of northern plains wheat. Some others, that may have been overcharged to a lesser degree by the previous system, have experienced increased surcharges.

Fuel Surcharges Excessive and Skewed

To illustrate how skewed fuel surcharges can get I've included with my testimony a spreadsheet labeled BNSF FUEL SURCHARGES. (Sheet 2 is a summary of the two-page Sheet 1.) This was prepared in March 2005 as our North Dakota Legislature was debating a bill that would have limited fuel surcharges to actual increased cost of fuel. The spreadsheet uses BNSF's numbers such as cost of fuel and fuel efficiency measured in gross ton-miles (GTM) per gallon. One ton of equipment or product moved one mile is one gross ton-mile. If you know the weight of shipment, freight cars and locomotives, the distance, and the fuel efficiency, you can calculate the gallons of fuel used.

Line 19 of the spreadsheet is a 110-car shuttle train of wheat moving 1288 miles from Berthold, ND to Portland, OR. It is a poster child of what is wrong with this kind of fuel surcharge calculation. Let's walk across the pages of Sheet 1.

- Columns A through K are self-explanatory.
- Column L is the weight of 110 empty cars and M the weight of the three locomotives used. The trip to destination and back again, creates 10,329,760 GTM for equipment in column N.

- Column O is the tons of grain in column I multiplied by the miles in column E to yield 15,868,160 GTM for grain. Total GTM in Column P is the sum of N and O.
- Column P is then divided by the BNSF's fuel efficiency at that time of 761 GTM per gallon to get the gallons of fuel used in column Q. A possible variable here is that the fuel efficiency in GTM per gallon might vary between shipments.
- Fuel prices in columns R and T are from BNSF financial reports. The mid-2002 fuel price of 74 cents is significant because that is the last time BNSF had zero fuel surcharge. Thus, one would think, fuel surcharges should cover only the fuel costs above that level.
- Fuel costs in columns S and U are fuel prices multiplied by the gallons used.
- Column Y, the actual surcharge, is the product of column W base freight cost times column X, the surcharge percentage.
- The column Z overcharge is the surcharge in column Y minus the fuel cost increase in column V.
- Column AA is Z divided by V. Column AB is Z divided by the bushels in column J.

Now let's make some comparisons. Cell 19S shows a fuel cost in the fourth quarter of 2004 of \$39,245. Cell 19V shows that only \$13,770 of the \$39,245 is actual fuel cost increase since BNSF began a fuel surcharge program in 2002. But yet the surcharge in Cell 19Y is \$41,323. That is three times the fuel cost increase and more than the total fuel cost. Column AA shows that with one exception this fuel surcharge to fuel cost increase ratio runs from 1.5 to over 7 for various grains from origins throughout the northern and central plains to different destinations. This is a broad-based problem.

Comparing lines 16 and 19 reveals that surcharges can actually have an inverse relationship with distance. That's pretty unreasonable – assessing more fuel surcharge

for pulling the same weight less distance. A soybean train moving 1748 miles from Clarkfield, MN to Portland, OR has a surcharge of \$32,670 (cell 16Y) as compared to the \$41,323 for Berthold wheat moving only 1288 miles. The soybean and wheat trains weigh the same and the cars and locomotives used are interchangeable. Most of the routing is likely over the same track. The wheat surcharge is 70% more per car mile than for the soybeans. And that starts with a soybean surcharge that is already inflated to 1.75 times what it needs to be according to cell 16AA.

Another absurd outcome with this kind of surcharge is that different commodities moving from the same origin to the same destination can have vastly different surcharges. Lines 19 and 20 compare wheat and barley moving from Berthold, ND to Portland, OR. Barley weighs less per bushel than wheat so gross ton-miles for wheat are 4% more than with barley. But the wheat fuel surcharge (cell 19Y) is nearly 50% more than for barley (cell 20Y).

A smaller volume moving fewer miles is the 26-car train of wheat from Reynolds, ND to Minneapolis, MN, line 8 on the spreadsheet. Surcharge is \$4,528 (Cell 8Y). Increased cost of fuel was only \$744 (Cell 8V). The surcharge was over six times the cost increase and more than double the entire cost of fuel at \$2,122 (Cell 8S).

This spreadsheet was based on the 9% fuel surcharge of BNSF in December 2004 and January 2005. That percentage got as high as 18.5% on ag products in December 2005. Of course fuel had gone up too. Grain and coal now move on BNSF at a mileage basis fuel surcharge. The change to mileage basis has mitigated some of these distortions. Nevertheless, this data shows how its revenue-based surcharge was excessive. This method is still being used by other railroads.

This spreadsheet has been widely circulated since prepared in March 2005. The BNSF has it. Never have they challenged its accuracy with me and I have not heard of them challenging it with anyone else.

Canadian Pacific Lags BNSF

In late 2004 and throughout 2005, Canadian Pacific fuel surcharges have been 3.5% less than BNSF's. Thus the overcharge is that much less. Just lately the CP has changed its surcharge calculations down to the hundredth of a percent, such as the 9.46% for May 2006. This is now 4.04% under BNSF's revenue-based surcharge.

Impact Of Surcharges On Shippers and Farmers

One impact of fuel surcharges is the actual cost. Another is the unpredictability. Destination market price minus transportation cost and gross operating margin equal the grain elevator's bid to the farmer for his grain. When fuel surcharges increase transportation cost, the price for the farmer is reduced. If the surcharge is more than necessary, the price to the farmer is reduced even more, and unjustifiably. Grain elevators contract with farmers for some of their harvest delivery before the seed is even planted. The price may be tied to some market index at the time of delivery. Escalating fuel surcharges make total transportation cost unpredictable. In early 2005, when some of these contracts would have been written for the 2005 harvest, BNSF fuel surcharges were in the 7.5-8% range. By the fall heavy shipping season those had jumped to 13% in October, 16% in November and 18.5% in December. An increase of 10% on a carload of corn paying a base rate of \$3,200 adds an unanticipated \$320 or 8 cents per bushel to transportation cost. This is half or more of a typical elevator's gross margin.

Why Use On-Highway Diesel As An Index

BNSF, CP and some other railroads compute their fuel surcharges off the Retail On Highway Diesel (HDF) prices as published weekly by the Energy Information Administration. One major question we have is why railroads would use the price of on-highway diesel. I'm told there is an industrial diesel fuel index that would be more realistic.

Ultra Low Sulfur On-Highway Fuel

A requirement for ultra low sulfur diesel fuel burned on-highway starts taking effect in June 2006. This fuel will cost more than fuel with higher sulfur content. To the extent that railroads burn the cheaper higher sulfur fuel, but link their surcharge to a higher-priced on-highway low sulfur fuel, there will be an unjustified further increase in fuel surcharges. This must be dealt with before it becomes a factor in fuel surcharge calculation.

Converting Fuel Cost to Surcharge

Another major question from rail customers is how the fuel price is translated into the actual fuel surcharge. Railroads seem to have a black box into which the price of crude oil or on-highway diesel is fed on one end. Out the other end pops the fuel surcharge. What goes on inside that black box? The March 2006 HDF average price of \$2.559 per gallon goes in BNSF's black box. Out the other end comes a 33¢ per car-mile fuel surcharge on grain and a 22¢ per car-mile charge on coal. Why does the same fuel price generate one fuel surcharge that is 50% more than the other? The weight of these loaded cars are not that much different. (This is not to suggest that the charge on coal should be increased.) Shippers want to see what's going on. We need transparency in this process.

Some Pay Surcharge; Some Don't

Both BNSF Railway and CP Railway told our Legislature in early 2005 that they were not recouping fuel cost increases with their fuel surcharges. Even if that were true on a system-wide basis, it is no excuse for gouging some shippers to pay the increased fuel cost for others. In the attached February 14, 2005 letter to North Dakota Public Service Commission Chairman Tony Clark, BNSF Ag Products Vice President Kevin Kaufman said BNSF was not collecting enough fuel surcharge to cover its incremental fuel expense. But he also revealed that BNSF collected fuel surcharge on only about half of its revenue base. Neither of these situations is the fault of those who pay. Those who pay should not be forced to pay more because the railroad isn't

collecting from everyone. That is not the fault of those who pay. This gets to the heart of the matter of this hearing about whether fuel surcharges on particular movements cover only the increased fuel cost on that particular movement. Let's not rob shipper Peter to cover the expenses generated by shipper Paul.

Fuel Surcharges as Profit Center

Fuel surcharges should not be an additional profit center for railroads. But an early 2005 industry analysis from Smith Barney says "...some rails have tactically used the fuel surcharges as a way on enhancing pricing above simple fuel cost recovery levels, especially the Eastern rails, thereby enhancing EPS (earnings per share) in '04." For 2005 the analysis predicted an EPS headwind or drag for certain railroads if oil prices fell and a gain if the price of oil were to rise further. (January 5, 2005 Airfreight & Surface Transportation Industry Note of CitiGroup Smith Barney).

Short lines and Regional Railroads

Another matter that should be of interest to the STB is whether any of this fuel surcharge is going back to the short lines and regional railroads. They gather much of the freight for Class I mainline movements. We have three short line/regional railroads operating in North Dakota. These people did not come to me; I asked them what portion of fuel surcharges they were getting out of their Class I connections. They told me they were getting nothing. Perhaps the STB should ask the Class I's about this matter. The start and stop short trips associated with gathering traffic might use more fuel than equivalent mileage on a long haul.

What is to be done?

Railroad fuel surcharges are a big deal by anyone's measure. According to its own financial reports over 57% of the BNSF Railway's total fuel cost in 2005 was covered by fuel surcharge. The changeover to mileage-based was to be revenue-neutral, so that kind of proportion will hold steady or increase. With the recent run-up in crude oil prices, fuel surcharges on all railroads will become even more of an issue.

This hearing and its focus on whether fuel surcharges accurately reflect the actual increased cost of the movement to which they are applied is a good start, but only a start. STB should strongly encourage and if necessary enforce some basic principles on railroad fuel surcharge programs. Those include:

1. Assessing fuel surcharges is justified only if the railroad is not recovering its increased fuel cost through other mechanisms such as rate increases or the Rail Cost Adjustment Factor.
2. Fuel surcharges are justifiable only to the point where they recover the actual increased fuel cost on the movement to which they are applied. In other words they must be truly cost-based.
3. It is unreasonable for a railroad to assess a fuel surcharge in excess of what is necessary, to make up for increased fuel cost on other shipments where it is unable to assess a fuel surcharge.
4. There must be transparency in the fuel surcharge calculation process so that rail customers can be assured they are being treated equitably. Railroads should open the black box by providing the evidence in a simple reproducible format.
5. Short lines and regional railroads should get their fair share of fuel surcharges.

Thank you for the opportunity to present our views and suggestions on this matter.

Steven D. Strege, Executive Vice President
North Dakota Grain Dealers Association
118 Broadway, Suite 606 Black Bldg
Fargo, ND 58102
Ph: 701-235-4184 Fax: 701-235-1026
Email: sstrege@ndgda.org

SUMMARY

Locations selected by ND Grain Dealers Association. Mileages from BNSF website. Fuel prices from past BNSF financial reports. Used 761 GTM (gross ton mile) per gallon of fuel, BNSF's 2004 average. Calculations include equipment round trip. Used BNSF's Dec '04 - Jan '05 surcharge of 9%. 110-car shuttles are 286,000 lb gross cars, others 268,000. Cars estimated at 31 tons empty weight and locos at 200 tons.



Kevin D. Kaufman
Group Vice President
Agricultural Products

BNSF Railway Company
P.O. Box 961051
Fort Worth, TX 76161-0051
2650 Lou Menk Drive, 2nd Floor
Fort Worth, TX 76131-2830
817-867-6700 Office
817-352-7932 Fax
Kevin.Kaufman@bnsf.com

February 14, 2005

Honorable Tony Clark, President
North Dakota Public Service Commission
600 E. Boulevard Ave. Dept 408
Bismarck, North Dakota 58505-0480

Re: Fuel Surcharge

Dear Mr. Clark:

In response to your original letter, dated January 20, 2005, I told you that following John Lanigan's meeting with the National Industrial Transportation League ("NITL") I would report back to you.

On Thursday, January 27, John Lanigan met with John Ficker, NITL, Kendall Keith, NGFA, and David Church, Forest Products Association of Canada for ninety minutes in Washington. During this positive meeting, John expressed our willingness to continue to explore options to our current revenue percentage system to determine if we can construct a proxy or modifier for distance to adjust the impact on higher (and lower) revenue per shipment customers. He further conveyed to the meeting participants that while BNSF Railway has no disagreement with the principle and general concept of a mileage-based program, it is important that NITL review their study and make corrections where the study is inaccurate so that misunderstanding does not impede the success of further dialogue. Permit me to point out just four of the most obvious inaccuracies.

1) Fuel price increases have been and continue to negatively impact earnings. BNSF does not collect more in fuel surcharge ("FSC") than what it incurs in incremental fuel expense. The fact is that BNSF recovers only about 50 percent of its incremental fuel expense, based on a \$1.25 per gallon, using EIA's On-Highway Diesel Fuel price as the floor as suggested in the NITL study. The cost of fuel increased dramatically throughout 2004. This dynamic has caused BNSF to insist that FSC provisions be included in all price authorities for all commodities shipped on the railroad.

2) Most railroads do not have 100% of their revenue base participating in FSC programs. For example, BNSF's fuel coverage from surcharges is approximately 50% of our fuel expense at the strike price of \$1.25 HDF. This coverage is currently coming from only about 50% of our revenue base. This indicates that contrary to the NITL study, our fuel surcharge revenue does not exceed the cost of fuel and thus FSC programs have not become a method for enhancing revenue.

3) Fuel hedge results are included in the NITL calculations despite their conclusion that, "hedging is an internal business choice that assists in stabilizing the predictability of corporate revenue....and that hedging gains should accrue to the railroad". This inconsistency results in a significant understatement of the calculated fuel costs per carload because they offset the actual costs with the hedge affect. BNSF agrees with the authors of the study that hedging is an internal choice and that an equitable FSC formula should not take into account hedging gains and losses.

4) The program uses specific miles per gallon ("MPG") consumed by each of our major train types to determine fuel intensity. The NITL study determines fuel intensity on a fuel expense per car basis. It then determines an average surcharge per loaded car mile by dividing fuel surcharge per car by loaded car miles. However, in

estimating the applicable surcharge per shipment, it uses the total actual miles, thus effectively charging for the empties twice.

I hope that the foregoing is helpful for your continued, unbiased review of the fuel surcharge issue. I think that you will agree that it is in our mutual interest to reduce misunderstanding by making sure that our discussions are based upon the facts and not distorted by misleading statements such as those made in a recent trade organization fax to its members. Their implication was that BNSF made 5 percent off of fuel surcharge in our recently reported fourth quarter. But revenues are not earnings and proper analysis requires that revenues be offset by their applicable expenses.

Thank you for the opportunity to report to you on our meeting. We continue to explore options to our current program that would correctly address the true, underlying economics of fuel surcharge and are practical to implement. I will keep you informed of our progress.

Sincerely,

Kevin Kaufman
Group Vice President, Ag Products

cc: Roger Nober
NDGDA Members
Kendall Keith
John Ficker
David Church

SUMMARY

Locations selected by ND Grain Dealers Association. Mileages from BNSF website. Fuel prices from past BNSF financial reports. Used 761 GTM (gross ton mile) per gallon of fuel, BNSF's 2004 average. Calculations include equipment round trip. Used BNSF's Dec '04 - Jan '05 surcharge of 9%. 110-car shuttles are 286,000 lb gross cars, others 268,000. Cars estimated at 31 tons empty weight and locos at 200 tons.