

MAJOR ISSUES IN RAIL RATE CASES) Ex Parte No. 657 (Sub-No. 1)

Introduction

This test has been used for roughly twenty years in a large number of cases challenging the reasonableness of rail rates. In light of the experience gained it is appropriate now to consider how to improve the process, and the United States Department of Transportation (“DOT” or “Department”) welcomes the opportunity to participate.

DOT is not a party in individual rate cases, and thus has no first-hand experience with standards or processes that have been found susceptible of manipulation or

otherwise wanting.¹ The Department therefore has no initial comment on the very detailed proposals put forward by the STB to modify current SAC methodologies. Prior to taking any position on these matters, we intend to review the submissions of other parties and to consider them in light of DOT's strong support for a SAC process that is more accessible and useful to all concerned, and that encourages expanded rail capacity investment.

Streamlining the SAC Process

The Board on various occasions has considered ways to expedite and simplify the rate regulation process in major cases.² Despite these efforts, mounting such a case remains an expensive and time-consuming proposition. Modifications that could reduce the cost of bringing these cases or shorten the time for obtaining a result would benefit all parties and the public interest. Particularly in light of the apparent manipulation of existing processes by one or both sides in SAC cases, however, it is important that the changes under consideration not produce results that favor one group of litigants over the other.

Capital Investment

The single most critical problem facing railroads today, if not the entire freight transportation industry, is providing the capacity to handle growing demand for transportation. Surface carriers in every mode are facing difficulties accommodating the

^{1/} Various cost allocation methods, for example, have apparently proven a fertile ground for problems. The Board has found that one may be exploited by both railroads and shippers, while another simply "does not meet the stated objective." Decision at 7-8 and 18, respectively.

^{2/} See, e.g., Ex Parte No. 638, Procedures to Expedite Resolution of Rail Rate Challenges to be Considered Under the Stand-Alone Cost Methodology, Decision served April 3, 2003, which adopted rules to introduce mediation and facilitate discovery in these cases.

growth in freight traffic arising from a growing economy and increased imports.

Railroads have recognized the problem and have been investing in capacity expansion.

Despite the addition of more crews, locomotives, tracks, and yards, many remain concerned that rail capacity is not being expanded fast enough to keep up with demand. The Department shares this view. In an earlier iteration of this docket, we urged that capacity constraints might require adjustments to the methodology used in rate reasonableness cases. Ex Parte No. 657, Rail Rate Challenges Under the Stand-Alone Cost Methodology, DOT Comments (filed April 20, 2005). Changes should ensure “that carriers have the opportunity to achieve the revenue necessary to make appropriate investments in capacity ... while continuing to ensure the mobility needed by shippers.” Id. at 4. See also DOT Comments in Ex Parte No. 658, The Twenty-Fifth Anniversary of the Staggers Rail Act of 1980: A Review and Look Ahead, (filed April 12, 2005).

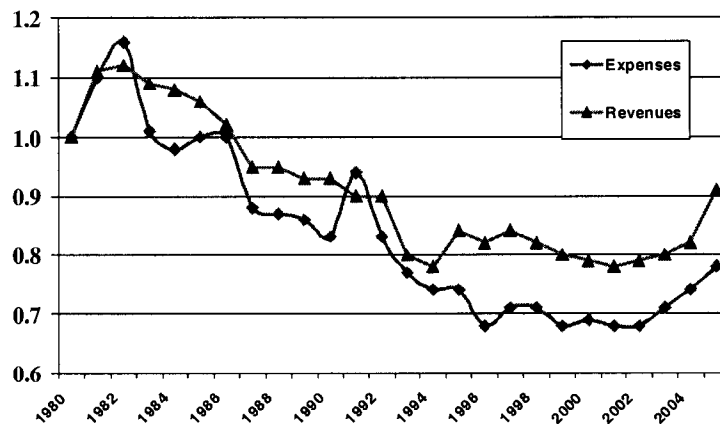
Railroads, like other private sector entities, make investments based upon expected financial returns; capital projects that seem unprofitable will not be made. Moreover, many rail investments (e.g., locomotives, track) are very long-lived, so that carriers still face the cost of amortizing the investment regardless of possible declines in demand in the future. Railroads must continue to have incentives to invest if they are to expand system capacity. A rail network matched in size to the demands placed upon it, both now and in the reasonably foreseeable future, is an important goal under Federal law.³ The task here is to ensure that regulatory proceedings support rather than thwart that goal.

^{3/} As the STB’s predecessor noted when adopting the current regulatory standards, it is Federal policy that rail carriers secure the revenue necessary “to maintain, replace, modernize, and, where appropriate, expand [their] facilities and services.” Coal Rate Guidelines, Nationwide, 1 I.C.C.2d 520, 535 (1985).

Rail Productivity

Rail capital investment should also be encouraged because it has historically meant enhanced industry productivity, and the attendant cost reductions, in turn, have led to lower average rail rates for shippers. Between 1987 and 2003 capital investment by Class I railroads almost doubled (from less than \$3 billion annually to nearly \$6 billion per year).⁴ Over roughly the same period of time (1987 to 1999), railroad productivity grew by 47.9 percent.⁵ Since the Staggers Act, too, most of these productivity gains have been passed through to shippers in the form of lower rates. See Chart below.

Indices of Operating Expenses & Freight Revenue
to Revenue Ton-Miles
Indexed to 1980



Source: Assn. of American Railroads, "Railroad Facts."
2005 data are from AAR, "Railroad Revenues, Expenses and Income, U.S. Class I Railroads, Fourth Quarter 2005."

⁴/ Association of American Railroads, Railroad Facts, page 44, various years.

⁵/ U.S. Bureau of Labor Statistics ("BLS"), Railroad Industry Multifactor Productivity Data. This information is available via the following link, under Standard Industrial Classification 4011: <ftp://ftp.bls.gov/pub/special.requests/opt/dipts/indmfp.txt> By comparison, productivity in the U.S. manufacturing sector as a whole increased by only 16.1 percent during this period. Id.

Thus, it is clear that continued, and even expanded, rail capital investment is in the public interest.⁶

Rate Regulation and Investment

A central goal in this proceeding, accordingly, is to adopt SAC modifications that serve the public interest in the above respects. A simple example illustrates how rate regulation can influence decisions on potential investments. Consider the potential impact of a productivity-enhancing investment on the threshold for litigating a rate case. Railroad investments that enhance productivity influence variable costs, and hence may change revenue /variable cost (“R/VC”) ratios. R/VC ratios, of course, are the standard by which the Board assumes authority over rate complaints and by which rail rates are adjudged reasonable.⁷

Assume a railroad’s variable cost for a shipment is \$1,000 and the revenue from that shipment is \$1,700, for an R/VC ratio of 170 percent. That is below the STB jurisdictional threshold and the hypothetical shipper therefore could not pursue a rate case. But further assume that the relevant railroad is considering a particular capital investment -- for example, a more efficient locomotive or an improved signaling system that allows the railroad to operate more trains over a line -- that would reduce its costs for the same shipment by 10 percent, to \$900. If the share of the investment attributable to

⁶/ Railroads continue to consider investments in several areas with the potential for large payoffs in productivity, such as various forms of train control and new braking systems.

⁷/ A railroad without effective competition for traffic (*i.e.*, with “market dominance”) must levy only reasonable rates, and federal law precludes the STB from finding market dominance if the revenues produced by a challenged rate are less than 180 percent of the carrier’s variable costs of providing the service. 49 U.S.C. §§ 10701(d)(1), 10701(d)(1)(A), 10702.

this shipment is a “fixed cost” of \$500, but it reduces the variable cost of moving the shipment by \$100 a year, the rate of return on the investment is an attractive 20 percent. This would then seem to be a good investment for the carrier to undertake.

But the regulatory structure allows for a different result. Under the above scenario if the railroad still charges \$1,700 for the move, the variable cost would now be \$900. This produces a new R/VC ratio (189 percent) that is above the STB statutory threshold. The hypothetical shipper would now be free to bring a case, even though the reasonableness of the same rate was beyond legal challenge before the investment. If it is further assumed that as a result of the case the rate was reduced to the 180 percent level, the rate would be lowered to \$1,622. The railroad in this case would find that it only retained \$22 of the projected \$100 in savings while the shipper received a benefit of \$78 from the investment. A return of \$22 on a \$500 investment is only 4.4 percent, making it far more likely that the railroad would decline to make the investment.

Railroad Productivity, Investment, and Rate Regulation

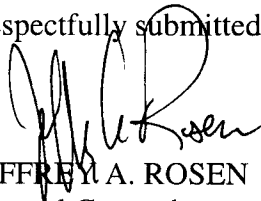
The same Chart (page 4, supra) that illustrates the pass-through to shippers of most of the productivity gains in the railroad industry also shows that rail costs have declined generally faster than revenues per ton-mile. This indicates that the R/VC ratio for a rate held steady since 1982 would have increased about one-third. For example, a rate with an R/VC ratio of 150 percent in 1982 would now have an R/VC ratio of approximately 200 percent. It is likely that, if rates had not declined so much, many would have come within the Board’s regulatory jurisdiction -- not because of railroad rate increases based on heightened market power, but because of railroad productivity increases and their effect on R/VC ratios. Even with the decline in rates, the general

trend of R/VC ratios would be up because expenses have declined more quickly than rates.

Conclusion

The Department generally supports modifications to the SAC process that would streamline regulatory hurdles and, especially, facilitate capital investment. This would both improve access and enhance capacity, productivity growth, and (likely) lower rates. All would redound to the benefit of railroads and shippers and the public interest. As it considers modifying the SAC process, the STB should be particularly mindful of the impact of any changes on railroad investment decisions. DOT expects to refine its views on the Board's proposals upon consideration of comments from parties with experience in litigating rate cases.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "J. A. Rosen", is written over the printed name.

JEFFREY A. ROSEN
General Counsel

May 1, 2006