



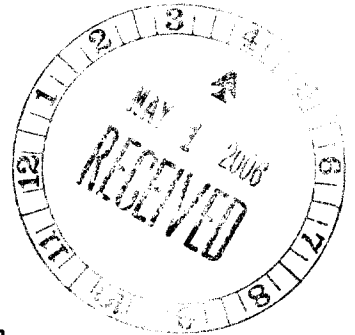
SIDLEY AUSTIN LLP
1501 K STREET, N.W.
WASHINGTON, D.C. 20005
202 736 8000
202 736 8711 FAX

phemmersbaugh@sidley.com
(202) 736-8538

BEIJING	GENEVA	SAN FRANCISCO
BRUSSELS	HONG KONG	SHANGHAI
CHICAGO	LONDON	SINGAPORE
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May 1, 2006



HAND DELIVERY

The Honorable Vernon A. Williams
Secretary
Surface Transportation Board
1925 K Street, N.W.
Washington, D.C. 20423-0001

216462

Re: Ex Parte No. 657 (Sub-No. 1), Major Issues in Rail Rate Cases

Dear Secretary Williams:

Enclosed for filing in the above-referenced proceeding are an original and twenty copies of the Opening Comments of the Association of American Railroads in the above-referenced proceeding. A diskette containing an electronic version of the Comments is also enclosed.

Please acknowledge receipt of the enclosed Opening Comments for filing by date-stamping the enclosed extra copies and returning them via our messenger. If you have any questions, please contact the undersigned counsel.

Sincerely,

G. Paul Moates
Paul A. Hemmersbaugh

*Counsel to The Association of American
Railroads.*

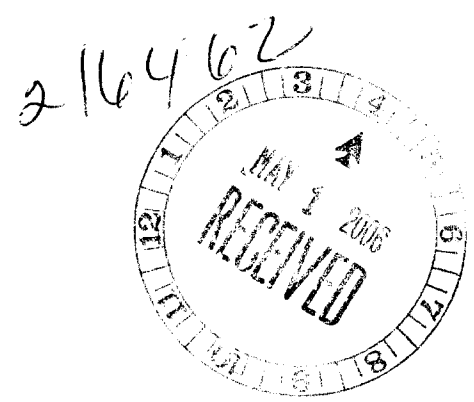
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**UNITED STATES OF AMERICA
SURFACE TRANSPORTATION BOARD**



Ex Parte No. 657 (Sub-No. 1)

MAJOR ISSUES IN RAIL RATE CASES

COMMENTS OF THE ASSOCIATION OF AMERICAN RAILROADS

Richard E. Weicher
Michael E. Roper
BNSF Railway Company

Theodore K. Kalick
Canadian National Railway Company

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J. Michael Hemmer
Louise A. Rinn
Union Pacific Railroad Company

Of Counsel

G. Paul Moates
Paul A. Hemmersbaugh
Donald H. Smith
SIDLEY AUSTIN LLP
1501 K Street, N.W.
Washington, D.C. 20005
(202) 736-8000

Louis P. Warchot
Association of American Railroads
50 F Street, N.W.
Washington, D.C. 20001
(202) 639-2502

Counsel for Association of American Railroads

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Public Record

Dated: May 1, 2006

The Association of American Railroads ("AAR") respectfully submits these Comments as a party of record in accordance with the Board's notice of proposed rulemaking in Ex Parte No. 657 (Sub-No. 1), *et al.*, *Major Issues in Rail Rate Cases* (served Feb. 27, 2006) ("*NPRM*"). The AAR is a North American policy, research and technology organization focusing on the safety and productivity of rail carriers. The AAR's members include, *inter alia*, the major freight railroads of the United States, Canada and Mexico, accounting for more than 96 percent of intercity rail freight service in the United States.

The AAR and its members are vitally interested in the issues raised in the *NPRM*, including the proper application of the stand-alone cost ("SAC") test, differential pricing principles in rail rate reasonableness cases, and the potential effect of any regulatory changes on North American rail carriers' ability to make capital investments necessary to maintain and improve rail system capacity. Proper application of fundamental regulatory and economic principles in rail rate reasonableness cases is essential in order to permit railroads to earn sufficient revenues to continue the massive capital investments (approximately \$8.2 billion in 2006 alone) required to increase the capacity of the nation's privately-owned rail network, and to continue to improve service to rail shippers.

Individual members of the AAR will address the specific proposals set forth in the *NPRM* in more detail in their separately-filed comments. The AAR's Comments are intended primarily to emphasize two critical overarching principles that should be applied and reinforced as the Board considers any proposed modifications to its SAC rules.

First, railroads must be allowed to continue to apply the time-tested and judicially-approved principles of demand-based differential pricing, in order to allow them to make further progress toward recovering their total costs of service. In addressing the issues raised in the *NPRM*, the Board should not adopt any proposal that would impede railroads'

ability to engage in appropriate differential pricing, the fundamental principle of railroad ratemaking and rail rate regulation.

Second, the rail industry urgently needs to expand rail capacity, in order to alleviate existing capacity constraints and to meet projected future demand for rail transportation service. The need for increased rail capacity is one of the most pressing – if not the most pressing – issues facing the rail industry and its customers today. In order to address this vital concern in the course of this rulemaking, the AAR requests that the Board adopt a policy statement finding that the need for rail capacity improvements is of paramount importance to the rail industry and to its customers, and to the continued health and growth of the American economy. The proposed statement should declare as a matter of law and policy that rail carriers must be allowed to earn sufficient revenues to permit them to make the large capital investments necessary to address rail capacity constraints and to meet growing demand.

Any and all proposed changes to the Board's rate reasonableness standards and rate case methods must be measured against the two foregoing bedrock principles, in order to ensure that proposed changes would not undermine rail carriers' ability to engage in differential pricing and thereby generate revenues sufficient to allow essential capital investment. Adherence to these general guiding principles in the Board's consideration of the issues raised in the *NPRM* will help to ensure that any modifications to the Board's rate reasonableness standards and SAC methods and analyses are consistent with the governing statute, and with the compelling public interest in continued improvement in the nation's rail infrastructure.

I. RAILROADS MUST BE ALLOWED TO PRICE THEIR SERVICES DIFFERENTIALLY IN ACCORDANCE WITH DEMAND.

The Board and the ICC have long recognized that railroads must be permitted to apply demand-based differential pricing in order to allow them the possibility of recovering their total costs of service (including the cost of capital). In adopting Constrained Market Pricing

(“CMP”) as the guiding principles governing rail rate regulation, the ICC concluded that “the cost structure of the railroad industry necessitates differential pricing of rail services.” *Coal Rate Guidelines — Nationwide*, 1 I.C.C.2d 520, 526 (1985) (“*Coal Rate Guidelines*”), *aff’d sub nom. Consolidated Rail Corp. v. United States*, 812 F.2d 1444 (3d Cir. 1987). The ICC held that differential pricing is “central” to CMP principles, and stated that “[a]ny means of allocating [unattributable] costs among shippers other than *actual market demand* is arbitrary and may not permit a carrier to cover all of its costs.” *Id.* at 525-526 (emph. added).

Since the adoption of CMP in *Coal Rate Guidelines*, these sound economic principles have been reaffirmed by the ICC and STB, and approved by the courts, in numerous cases.¹ The application of demand-based differential pricing has helped the rail industry earn make tremendous progress toward improving its operating efficiency and financial health, by permitting railroads to make needed investments in physical capacity, in order to accommodate large increases in freight volume, while offering competitive rates and providing improved service to shippers. In considering the issues raised in this proceeding, the AAR respectfully submits that the Board should take care to ensure fidelity to first principles of rail rate regulation, including sound, time-tested and judicially-approved principles of demand-based differential pricing. These principles remain vital to the financial health and continued viability of the rail

¹ See, e.g., *Consolidated Rail Corp. v. United States*, 812 F.2d at 1448-49; *Potomac Electric Power Co. v. ICC*, 744 F.2d 185, 193 (D.C. Cir. 1984) (in enacting the Staggers Act, Congress understood the “necessity of such differential pricing”); see *id.* at 194 (the “concept of differential pricing ... necessarily contemplates that the carrier will maximize its profits on traffic for which it has no competition so as to offset its lower earnings on competitive traffic”); *MidAmerican Energy Co. v. STB*, 169 F.3d 1099, 1106 (8th Cir. 1999) (affirming application of differential pricing to so-called “bottleneck” shippers; noting that the “Board has recognized that an important part of achieving revenue adequacy is differential pricing”); STB Docket No. 42072, *Carolina Power & Light Co. v. Norfolk Southern Ry. Co.*, slip op. at 33 (served Dec. 23, 2003) (“[d]emand-based differential pricing is essential in the railroad industry because railroads serve a mix of captive and competitive traffic”; non-demand-based cost apportionment methods do not necessarily permit carriers to recover costs) (reconsideration granted on other grounds in STB Decision served October 20, 2004).

industry, and the essential service it provides to its customers. The Board should not adopt any proposals to modify SAC or CMP principles in ways that would interfere with the rail industry's ability to price its services differentially in accordance with demand.

II. CAPACITY-CONSTRAINED RAIL CARRIERS WILL REQUIRE SUBSTANTIAL ADDITIONAL REVENUE TO ALLOW THEM TO INCREASE CAPACITY AND MAKE OTHER CAPITAL INVESTMENTS NECESSARY TO MEET PROJECTED GROWTH IN DEMAND FOR RAIL TRANSPORTATION SERVICES.

As the Board is well aware, railroads and their customers are presently facing a significant capacity shortage. *See, e.g., "Traffic Jam on the Tracks," The Wall Street Journal at A18 (April 4, 2006).* Demand for rail transportation services has exceeded railroads' capacity to deliver those services for some types of freight along certain routes, resulting in transit time increases and delays for some shipments. For the foreseeable future, overall demand for rail freight transportation is projected to continue to grow rapidly. *See, e.g., Shipping Digest at WP (April 17, 2006) (rail traffic volume increased by 50%, to 1.6 trillion ton-miles per year, from 1990 to 2003, and the federal Energy Information Agency estimates that annual volume will increase to 2.4 trillion ton-miles by 2030).* The U.S. Department of Transportation has estimated that demand for rail freight transportation will increase 55 percent by 2020, and the American Association of State Highway and Transportation Officials has projected that freight tonnage will grow by almost 57 percent between 2000 and 2020. Indeed, for some commodities, demand growth may accelerate further. Together, existing capacity constraints, and projected increases in demand for rail transportation service, make rail capacity improvement one of the most significant issues facing the railroad industry and its customers today.

AAR members have made substantial capital investments in recent years in order to address capacity challenges created by the continuing growth in demand for rail services. Most Class I railroads are engaged in significant capacity expansion and improvement projects

designed to allow them to serve this demand growth. *See, e.g., "Rails Say Capital on Track," Traffic World* at 31 (March 27, 2006) ("The nation's biggest rail carriers will expand their capital spending 21 percent [in 2006], investing \$8 billion on rail cars, track and facilities to keep up record volume growth and improve service."). The following is just a sampling of the diverse capacity-enhancing investments that individual railroads have recently made:

- BNSF Railway double-tracked 76 miles of main line between Chicago and Los Angeles in 2005, and another 56 miles will be double- or triple-tracked this year. Within a couple of years, the entire 2,200-mile route will be double-tracked. In 2005, BNSF also took delivery of some 400 centerbeam cars (for hauling lumber); 3,700 high-capacity covered hoppers for carrying grain and other commodities; 1,300 rapid-discharge coal cars; and 650 intermodal flatcars with capacity to carry 6,500 intermodal double-stack containers. BNSF also took delivery of 288 new locomotives in 2005 and will add more than 300 more in 2006.
- In 2006, Canadian National will spend approximately \$1.5 billion on capital programs in the United States and Canada. Included are the reconfiguration of the key Johnston Yard in Memphis, a gateway for CN's rail operations in the Gulf of Mexico region; siding extensions in Western Canada; and investments in CN's Prince Rupert, British Columbia, corridor to capitalize on the Port of Prince Rupert's potential as an important traffic gateway between Asia and the North American heartland.
- In 2005, Canadian Pacific finished its biggest capacity enhancement project in more than 20 years by expanding its network from the Prairie region to the Port of Vancouver. The project increased the capacity of CP's western network by 12 percent and improved the route structure from Canada's Pacific coast to the United States. Like other carriers, CP has added new sidings on congested corridors; taken delivery of dozens of new locomotives and newer, higher-capacity freight cars; and hired and trained hundreds of new employees, many of whom will be in the United States.
- CSX recently announced plans to spend \$1.3 billion to \$1.4 billion per year on capital expenditures in 2006 and 2007, up from approximately \$1 billion over the previous few years. In addition to improvements elsewhere, installation of sidings, signals, and other infrastructure on lines between Chicago and Florida and between New York City and Albany will expand capacity and improve service reliability. CSX will also add several hundred new locomotives over the next few years.
- Kansas City Southern is busy integrating its Kansas City Southern de Mexico subsidiary fully into the railroad's other operations. KCS plans to spend some \$120 million in the United States and another \$96 million in Mexico in 2006. Particular attention will be given to the construction of new tracks and other improvements at the railroad's Shreveport, Louisiana hub; improvements on the "Meridian Speedway" between Shreveport and Meridian, Mississippi to augment the new rails, new sidings, and new drainage system installed in 2005; and the expansion of rail yards, track upgrades, and new sidings on its "Tex-Mex" subsidiary.

• Norfolk Southern (NS) will purchase more than 220 new locomotives from late 2005 through mid-2006 to augment the hundreds purchased over the past few years. NS is also in the midst of its largest-ever locomotive rehabilitation program — in 2005, 491 locomotives were overhauled and 29 were rebuilt; another 420 will be overhauled and 52 rebuilt in 2006. NS is also beginning its “Heartland Corridor” project, which, among other things, will entail raising clearances at 28 tunnels in Virginia, West Virginia, and Kentucky to allow double-stack intermodal service over the entire route from the Port of Norfolk to Columbus, Ohio and Chicago.

• Since 2004, Union Pacific has purchased 713 new locomotives and will purchase an additional 200 in 2006. Major capacity projects are underway on the central corridor to support coal. These include: completing the Marysville Bypass, extending the third mainline on the SPRB Joint Line, constructing a third runthrough mainline to speed coal trains through North Platte, and improving its Kansas City to St. Louis main line, which is a primary coal corridor. Another UP main capacity expansion programs for 2006 is its 760-mile Sunset Route between Los Angeles and El Paso. Today, more than 42 percent of the Sunset Route is double tracked, including 69 miles that were completed in 2005 at a cost of some \$100 million. UP plans to double-track another 50 miles this year. In addition, UP will also be adding siding capacity improvements along its corridor from Los Angeles to Salt Lake City to facilitate bi-directional running and provide further surge capacity for the Sunset Route.

In addition to these and other ongoing efforts, it is clear that American rail carriers will need to make even more large capital investments and expenditures to meet projected rail transportation demand in the coming years. *See, e.g.*, “Move from Roads to Railroads,” *The Washington Post* at B8 (Oct. 23, 2005) (citing estimates that rail infrastructure needs will cost more than \$200 billion over the next 20 years).

Such infrastructure investments, and the economic growth they promote and facilitate, will be possible only if rail carriers can earn sufficient revenues and return on investment to justify such investment. Improved revenues and returns in recent years have been the primary factors that have enabled American rail carriers to make much-needed investments aimed at improving and maintaining capacity. Continued rail revenue growth will be essential to allow railroads to make the additional investments necessary to meet continuing increases in demand. It is therefore critical that the Board, when considering changes to SAC proceedings or other aspects of rate regulation, firmly bear in mind rail carriers’ need for revenues sufficient to allow the additional investment required to improve capacity. Any proposed changes to Board

rules, standards, or regulations must be assessed for their potential effect on rail carrier revenues and the concomitant ability of carriers to earn sufficient return to permit needed investment in rail infrastructure and other capital improvements.

It is important to note that the fundamental principles of rail rate regulation continue to apply regardless of capacity constraints. As the ICC noted in adopting CMP, “economies of scope, scale and density need not be present for CMP to yield efficient and reasonable maximum rates.” *Coal Rate Guidelines*, 1 I.C.C.2d at 532. As the ICC stated, “[u]nder CMP, the presence and extent of production economies can be tested in each case through a stand-alone cost calculation.” *Id.* If additional traffic would not lower the cost to the stand-alone group of shippers, the ICC stated, “the most efficient plant size has been demonstrated.” *Id.* Thus, CMP principles allow a captive shipper to “identify and take full advantage of any economies of scope, scale and density,” to the extent they exist, by adjusting both the SAC configuration and the traffic base. *Id.*

Allowing railroads the opportunity to earn revenues sufficient to support critical infrastructure investment is not only in the national economic interest, it is fully consistent with the goals of the National Rail Transportation Policy (“RTP”), including the Board’s statutory mandate to maintain regulatory policies designed to promote long term revenue adequacy for rail carriers. *See generally* 49 U.S.C. §§ 10101; 10704(a)(2). For example, the Board’s governing statute expressly mandates that it maintain standards and procedures necessary to allow rail carriers to earn revenues sufficient to “attract and retain capital in amounts adequate to provide a sound transportation system in the United States.” 49 U.S.C. § 10704(a)(2)(B). Similarly, the RTP requires that rail regulation seek to “allow, to the maximum extent possible, competition and the demand for services to establish reasonable rates for transportation by rail”; “to minimize the need for Federal regulatory control over the rail transportation system”; “to promote a safe

and efficient rail transportation system by allowing rail carriers to earn adequate revenues”; and “to foster sound economic conditions in transportation and to ensure effective competition and coordination between rail carriers and other modes.” 49 U.S.C. § 1010(1)-(3), (5) (emphasis added).

The objectives and requirements of the RTP and other governing statutes, including those highlighted above, provide the overriding principles that must guide rail rate regulation and any changes to such regulation. Any rule or regulation that does not advance these statutory requirements should be rejected as inconsistent with the Board’s statutory mandates. Because essential capital investment is an indispensable requirement for achieving the goals of the national Rail Transportation Policy and to facilitate continued long-term growth of the American economy, and because the need for significant additional rail capacity is presently the most pressing issue for rail carriers and shippers, the AAR proposes that the Board issue a statement of policy emphasizing the importance of rail transportation capacity improvements.

More specifically, AAR requests that, in this rulemaking proceeding, the Board adopt a policy statement making clear that it is of paramount importance to the industry (including both railroads and their customers) – and to the continued health and growth of the American economy – that American rail carriers be allowed to earn revenues sufficient to permit them to make the large capital investments necessary to address rail capacity challenges. Because of the overriding importance of ensuring adequate rail transportation capacity, the statement of policy should establish that any rules or regulatory changes the Board may adopt in this proceeding will be implemented in a manner that will not unduly impede the ability of rail carriers to raise capital needed for infrastructure improvement and other investments necessary to improve and enhance rail capacity and service.

CONCLUSION

For the foregoing reasons, the Board should continue to apply the sound economic principles of CMP, and should reject any proposals to depart from these fundamental principles of rail rate regulation. Critically, the Board should not adopt any proposed changes to its rules that would interfere with the railroads' continued ability to engage in demand-based differential pricing. In addition, the Board should adopt a policy statement finding an important need for rail capacity improvements, and declaring that rail carriers must be allowed to earn sufficient revenues to permit them to make necessary capital investments.

Respectfully submitted,

Richard E. Weicher
Michael E. Roper
BNSF Railway Company

Theodore K. Kalick
Canadian National Railway Company

Paul A. Guthrie
Canadian Pacific Railway Limited

Peter J. Shudtz
Paul R. Hitchcock
CSX Transportation, Inc.

Robert B. Terry
The Kansas City Southern Railway Company

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Louise A. Rinn
Union Pacific Railroad Company

Of Counsel


G. Paul Moates
Paul A. Hemmersbaugh
Donald H. Smith
SIDLEY AUSTIN LLP
1501 K Street, N.W.
Washington, D.C. 20005
(202) 736-8000

Louis P. Warchot
Association of American Railroads
50 F Street, N.W.
Washington, D.C. 20001
(202) 639-2502

Counsel for Association of American Railroads

Dated: May 1, 2006

CERTIFICATE OF SERVICE

I hereby certify this 1st day of May, 2006 that I have served all parties of record in this proceeding by first class mail, postage prepaid.

Cathleen Greah

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