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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

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Re: Ex Parte No. 657 - Major Rail Rates

Dear Secretary Williams:

Enclosed for filing in the above-referenced proceeding are an original and 20 copies of the Comments of Canadian Pacific Railway Company. A diskette containing an electronic version is also enclosed.

Please acknowledge receipt of the enclosed 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,

Terence M. Hynes

Attorney for Canadian Pacific
Railway Company

TMH:aat
Enclosures
cc: All Parties of Record



**BEFORE THE
SURFACE TRANSPORTATION BOARD**

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

MAJOR ISSUES IN RAIL RATE CASES

COMMENTS OF CANADIAN PACIFIC RAILWAY COMPANY

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Dated: May 1, 2006

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

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

MAJOR ISSUES IN RAIL RATE CASES

COMMENTS OF CANADIAN PACIFIC RAILWAY COMPANY

Pursuant to the Notice of Proposed Rulemaking served in the above-captioned proceeding on February 27, 2006 (the "*NPRM Order*"), Canadian Pacific Railway Company and its subsidiaries, Soo Line Railroad Company and Delaware and Hudson Railway Company, Inc. (collectively "CPR"), submit these initial comments concerning certain proposed changes to the Board's application of the Stand-Alone Cost ("SAC") methodology in railroad rate cases under *Coal Rate Guidelines, Nationwide*, 1 I.C.C. 2d 520 (1985) ("*Coal Rate Guidelines*").

CPR has not been a party to a rate proceeding before the Board in recent years. However, attorneys representing the State of North Dakota have indicated in recent filings with the Board that the State may be preparing to challenge the rates charged by CPR and other carriers for shipments of wheat originating in North Dakota.¹ The SAC-based CMP standards set forth in *Coal Rate Guidelines* are the presumptively applicable standards under which the

¹ See No. WB456-1, Request by Thompson Hine LLP and McCarthy, Sweeney & Harkaway LLP on behalf of the State of North Dakota, dated January 25, 2006 (seeking access pursuant to 49 C.F.R. § 1244.9 to certain information from the STB's Costed Waybill Sample using unmasked revenues); Decision dated March 10, 2006 by Director of the Board's Office of Economics, Environmental Analysis and Administration (denying the State's request).

Board would evaluate such a rate complaint.² Moreover, like all railroads subject to the Board's jurisdiction, CPR has a vital interest in ratemaking standards that do not compromise the opportunity for carriers to earn adequate revenues or to make investments necessary to meet the current and future demand for efficient rail service.

CPR's initial comments will address two of the proposals set forth in the *NPRM Order*: (1) the Board's proposal to take account of productivity gains in indexing a SARR's operating expenses by applying the Rail Cost Adjustment Factor adjusted for productivity ("RCAF-A") in 5 percent increments starting in the second year following the "base year" of the DCF period (*NPRM Order* at 20-21); and (2) the Board's proposal to abandon its "longstanding practice" of permitting parties to propose movement-specific adjustments to the system-average variable costs produced by URCS (*NPRM Order* at 21-23). CPR will review the initial comments filed by other parties with respect to these and the other proposals discussed in the *NPRM Order*, and will respond, as appropriate, in its reply comments to be filed on May 31, 2006.

I. INDEXING OPERATING COSTS

A significant issue in cases under the SAC methodology is how to adjust a Stand-Alone Railroad's ("SARR's") base year operating expenses to account for inflation over the (currently 20-year) DCF period. Complaining shippers have generally asserted that the RCAF-A, which incorporates industry-wide productivity gains, is the appropriate benchmark for indexing a SARR's operating expenses. Carrier defendants have taken the position that such indexing should be based upon the "unadjusted" Rail Cost Adjustment Factor ("RCAF-U") because it is

² In its filings, North Dakota has indicated that its putative complaint may be brought under the simplified procedures established by the Board in Ex Parte No. 347 (Sub-No. 2), *Rate Guidelines – Non-Coal Proceedings*, 1 S.T.B. 1004 (1996) ("*Small Case Guidelines*"). However, the State has not demonstrated that the complaint it envisions would be eligible for handling under the *Small Case Guidelines*.

improper to impute to the SARR, as a newly-constructed, least-cost, most-efficient railroad, the same level of productivity gains as the rail industry generally.

In recent SAC decisions, the Board has consistently concluded that the RCAF-U is the appropriate index to apply because “the potential impact of such [productivity] improvements [for the SARR] is far less than it would be for existing railroads, which make changes incrementally as older-technology assets wear out or become obsolete.” Docket No. 42070, *Duke Energy Corp. v. CSX Transportation, Inc.* (served February 4, 2004) (“*Duke/CSXT*”) at 30. See also Docket No. 42071, *Otter Tail Power Co. v. BNSF Railway Co.* (served Jan. 27, 2006) (“*Otter Tail*”) at 22; Docket No. 42069, *Duke Energy Corp. v. Norfolk Southern Railway Co.* (served Nov. 6, 2003) (“*Duke/NS*”) at 36-37. As the Board stated in the *NPRM Order* (at 20), “[b]ecause the SARR is designed to be an efficient replacement for the railroad, it would not be able to realize the same productivity gains as the rest of the industry, particularly in the early years of the DCF.” Nevertheless, while a SARR is not likely to realize significant productivity benefits in the short term, the Board observed that “as the SARR matures, it could expect some measure of productivity gains in the outward years.” *Otter Tail* at 22 (emphasis added). For that reason, “use of RCAF-U is imperfect, particularly in the more distant years of the DCF analysis.” *NPRM Order* at 20 (emphasis added).

In the *NPRM Order*, the Board suggests a change to its method for indexing operating expenses to “reflect some anticipated productivity improvements for the SARR.” *Id.* Specifically, the Board proposes to use a “hybrid” of the RCAF-U and RCAF-A indices under which the full RCAF-U would be used to project operating expenses in the first year following the base year, but the RCAF-A would be applied, in 5% increments, in each subsequent year of

the DCF period. *NPRM Order* at 21. According to the Board, such a hybrid index represents “a fair compromise between the opposite positions of the railroads and shippers.” *Id.*

The Board’s desire to fine-tune the process used to index SARR operating expenses is a legitimate one. However, the mechanism proposed by the Board to implement that objective – mechanical application of the RCAF-A starting in the very early years of the SARR’s existence – is inconsistent with both the Board’s prior pronouncements and the nature of the technological improvements and operating changes that generate the real-world productivity gains captured in the RCAF-A. As the Board has repeatedly acknowledged, any productivity gains that a SARR might realize are likely to occur (if at all) in the “outward years” of the 20-year DCF period. *NPRM Order* at 20. *See also Otter Tail* at 22; *Duke/CSXT* at 29-30; *Duke/NS* at 37. Given the relatively long lives of most railroad capital assets, it is not realistic to assume that a newly constructed and “most efficient” railroad could garner significant productivity benefits by replacing technology and operating assets during the initial years of its existence.

Indeed, any adjustment to the SARR’s operating expenses to account for productivity during the first five years of the DCF period would appear to be entirely unjustified. The first categories of assets that a newly-constructed SARR would replace would be information technology assets (computers and software) and motor vehicles. SAC analyses generally assume that a SARR would not replace these asset classes until at least five years of operations had elapsed. Moreover, the cost of IT equipment and software is a small fraction of a SARR’s overall investment, so the replacement of IT assets would have minimal impact on the SARR’s overall productivity. Likewise, it doubtful whether acquiring new motor vehicles, even after five years, would generate substantial productivity savings. Under current practice, the SARR’s other capital asset classes would not be due for replacement during the first five years of the

DCF period. Accordingly, there is no rational basis for applying the RCAF-A (even incrementally) in indexing a SARR's operating expenses during the initial five years of SARR operations.³

Shortening the DCF period from 20 years to 10 years (as the Board also proposes to do – see *NPRM Order* at 28-31) would effectively moot the concern that use of the RCAF-U alone deprives a SARR of productivity gains in the later years of the DCF analysis, by eliminating those outward years from the SAC analysis altogether. Thus, if the Board ultimately adopts a 10-year DCF period, it may be unnecessary to make any change in the manner in which the SARR's annual operating expenses are adjusted for inflation.

Based upon the foregoing, CPR urges the Board not to adopt its current proposal, under which the RCAF-A would be applied incrementally beginning in the second year following the SARR's base year. If the Board adopts the proposal to shorten the DCF period from 20 years to 10 years, there would appear to be little justification for applying the RCAF-A at all in indexing the SARR's operating expenses. At a minimum, use of the RCAF-A should be deferred until the sixth year of the DCF analysis, when the SARR would begin to replace limited classes of its original assets.

II. MOVEMENT-SPECIFIC ADJUSTMENTS TO URCS

The *NPRM Order* proposes to abandon the Board's "longstanding practice" of permitting the parties to a SAC case to propose movement-specific adjustments to the system-average variable costs produced by URCS for purposes of determining whether the defendant rail carrier has market dominance over the issue traffic, and in determining the "jurisdictional floor" for any

³ Interestingly, the complaining shipper in *Otter Tail* proposed on brief that the Board transition from the RCAF-U to the RCAF-A only after five years of operations had elapsed. See *Otter Tail* at 22.

rate prescription (*NPRM Order* at 21-23).⁴ CPR opposes this proposal. An outright prohibition of movement-specific adjustments to URCS-generated costs would undermine the primary objective of a SAC analysis – *i.e.*, to determine as accurately as possible the rate that a hypothetical least-cost, most-efficient railroad would need to charge to handle the issue traffic. The reasons for this proposed change cited in the *NPRM Order* are insufficient to justify discarding evidence that may, in a particular case, be critical to producing an accurate result.

“CMP provides the only economically precise measure of rate reasonableness and therefore must be used wherever possible.” *Small Case Guidelines*, 1 S.T.B. 1004, 1021 (1996). In promulgating simplified rate procedures for small cases in which a full blown SAC analysis would not be practicable, the Board lamented the fact that those procedures would sacrifice precision for the sake of achieving simplicity. *Id.* For that reason, the Board declared that “[b]ecause of their roughness . . . the simplified procedures must be used as sparingly as possible, reserved for only those cases where CMP is not a realistic option.” *Id.*

Moreover, “[t]he Commission normally finds individual cost study data to reflect more accurately actual costs than regional or aggregated data.” Docket No. 39912, *Pozzolan Int’l v. Union Pacific R.R.*, 1989 WL 246868, at *4 (Nov. 7, 1989). Movement-specific adjustments are favored whenever they “would better reflect the variable costs of serving the particular traffic at issue than the URCS system-average figure.” Docket No. 42056, *Texas Municipal Power Agency v. BNSF Ry. Co.*, (served Sept. 24, 2004) (“*TMPA*”) at 10-11. “Such adjustments—to reflect the actual cars used, actual lading weights, and actual train equipment, crew, and operations involved—are possible and appropriate where such information is known and differs

⁴ In a Decision served on April 17, 2006, the Board rejected a proposal by BP/Amoco that its ruling on the issue of movement-specific adjustments to URCS in this proceeding be extended as well in applying the variable cost-based substantive benchmarks under the Board’s *Small Case Guidelines*.

from the carrier's system average data." *Small Case Guidelines*, 1 S.T.B. 1004, 1037 n. 104 (1996). For these reasons, presentation of movement-specific variable cost evidence is a well-established practice in SAC cases. *NPRM Order* at 23.

Indeed, it may be critical in particular cases to adjust URCS-generated costs in order to obtain an accurate (and fair) measure of a defendant railroad's variable costs of serving specific movements. "Because a carrier's system-wide average costs are not necessarily representative of the costs of providing a particular service" Docket No. 42072, *Carolina Power & Light Co. v. Norfolk Southern Railway Co.* (served Dec. 23, 2003) at 114. *Accord* Docket No. 42057, *Public Service Co. of Colo. d/b/a XCel Energy v. BNSF Ry. Co.* (served June 7, 2004) at 77; *TMPA* at *43; Docket No. 42051, *Wisconsin Power & Light Co. v. Union Pacific R.R. Co.*, 2001 WL 1075821, at *18 (Sept. 13, 2001). Because movement-specific adjustments produce more precise variable cost evidence, and such accuracy is a primary objective of a SAC analysis, the Board has consistently permitted – indeed, it has encouraged – parties to present movement-specific data wherever possible. *Id.*

The Board's proposal now to prohibit all movement-specific adjustments to URCS variable costs in SAC cases would sacrifice the very precision that the Board has sought to achieve in evaluating railroad rates under the SAC test. A wholesale prohibition on adjustments to cost data generated by URCS could also have inequitable consequences. Movement-specific adjustments, both individually and collectively, can have a significant impact on the accuracy and results of a variable costs analysis, and on the calculation of R/VC ratios. The costs incurred by a carrier in providing heavy-haul rail services in mountainous terrain are likely to be substantially higher than its "system average" costs (which may be based in substantial part on very different operations, such as intermodal services provided between major metropolitan

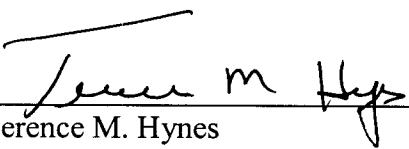
areas). URCS may likewise fail to take into account expenses incurred by the defendant carrier for various functions that are essential to providing rail service to particular shippers (*e.g.*, haulage fees paid to a shortline that physically serves the origin, or loading charges paid to a third party). The exclusion of such expenses, which may be substantial in relation to the overall variable cost of handling particular movements, would obviously affect the accuracy of variable cost calculations (and resulting R/VC ratios) for such shipments. CPR opposes any rule that would categorically foreclose the ability of a carrier to present credible evidence relating to these and similar real-world costs.

The reasons cited in the *NPRM Order* are not sufficient to support such a marked departure from the Board's established precedents permitting parties to submit evidence relating to movement-specific adjustments to variable costs. The suggestion that wholesale abandonment of movement-specific adjustments is warranted by "the need to expedite cases" (*NPRM Order* at 23) is misplaced. Banning movement-specific adjustments to URCS would not, by itself, obviate the need for parties to submit variable cost evidence – it would simply result in the submission of less accurate evidence, thereby undermining a key objective of the SAC analysis. Variable cost evidence would be unnecessary only in those cases in which the defendant carrier conceded that it had market dominance over the issue traffic, and the Board ultimately concluded that the challenged rates were reasonable. Thus, the Board's proposal would have little impact on the procedural schedule in most future SAC cases. Nor is the proposed change justified on the grounds that the presentation and consideration of such adjustments is "complex, expensive and time-consuming" (*NPRM Order* at 26). SAC cases are by their very nature both complicated and expensive to litigate. Analysis of the defendant carrier's variable costs is but one of many issues (including traffic selection, revenue allocation, construction costs, and SARR operating plan)

that the parties – and the Board – must address in every SAC case. The Board’s prior decisions provide substantial guidance regarding the types of movement-specific adjustments likely to be accepted by the Board in future SAC cases. Continued case-by-case consideration of proposed adjustments, and adherence to precedents once established, will further reduce the areas of legitimate dispute with respect to permissible adjustments to URCS-based costs.

In declaring that the SAC standard must be applied in rate proceedings “wherever possible” (*Small Case Guidelines* at 1021), the Board (correctly) concluded that precision should not be sacrificed for the sake of expediency except in those limited instances in which a SAC analysis is not “a realistic option” at all. Sacrificing accuracy for simplicity, *a fortiori*, is not appropriate in a case in which SAC is the governing standard. By continuing to resolve issues relating to movement-specific adjustments to URCS on a case-by-case basis – rather than discarding such adjustments altogether – the Board can both promote the vital goal of making accurate SAC determinations and reduce the evidentiary burden placed on the parties (and the Board’s staff) in future SAC proceedings.

Respectfully submitted,



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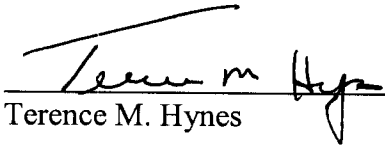
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Dated: May 1, 2006

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.


Terence M. Hynes