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BEFORE THE
SURFACE TRANSPORTATION BOARD



EX PARTE NO. 657 (SUB-NO. 1)

MAJOR ISSUES IN RAIL RATE CASES

REPLY COMMENTS OF PPL ENERGYPLUS, LLC

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John M. Cutler, Jr.
McCarthy, Sweeney & Harkaway, PC
2175 K Street, N.W., Suite 600
Washington, DC 20037
(202) 775-5560

Attorney for
PPL EnergyPlus, LLC

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PPL EnergyPlus, LLC ("PPL") states that it generally agrees with and supports the Reply Comments being filed in this proceeding by Western Coal Traffic League and Concerned Coal Shippers. In supplementation of those Reply Comments, PPL also states as follows.

If the Board's goal is to render the SAC methodology entirely useless for regulating the rates of market dominant railroads, the opening comments of the railroads in this proceeding should prove helpful inasmuch as even captive shippers that use no grouping whatsoever will have little if any chance of success.

The question that should be asked as the Board considers the railroads' Opening Comments is this: How does rate regulation under the railroads' approach differ from profit maximization by monopoly railroads unconstrained by regulation or competition? The answer is that it doesn't. The railroads' vision of maximum reasonable rate regulation is tantamount to complete deregulation.

The railroads also continue to urge upon the Board controlling principles that have been rejected consistently. See UP's espousal of the Efficient Component Pricing Rule, in the Verified Statement of UP Witness Neels at 14-17. This approach was rejected in Nevada Power Bituminous Coal -- Hiawatha, Utah to Moapa, Nevada, 10 I.C.C. 2d 259 (1994).

See also STB Docket No. 42069, Duke Energy Corp. v. Norfolk Southern Ry. Co., decision served November 6, 2003, slip opinion at 18-20 (and n. 28). The Board there observed that "a debate over how much of the revenues from cross-over traffic the hypothetical carrier could negotiate with the residual defendant has no place in a SAC analysis. "And yet the railroads' opening comments argue extensively for just such an

analysis, in an effort to show that the incumbent would interchange with the SARR only on terms that served the incumbent's goal of profit maximization.

BNSF reiterates its contention, consistently rejected by the Board, that annual RSAM values should be seen as some sort of rule of thumb in SAC cases. BNSF argues that RSAM levels "identify rates that BNSF must charge, on average, to shippers with inelastic demand in order to achieve revenue adequacy." Opening Comments at 2. However, the RSAM benchmark was adopted in Ex Parte No. 347 (Sub-No. 2), Rate Guidelines – Non-Coal Proceedings, 1 S.T.B. 1004 (1996) and is unrelated to the SAC test as adopted in Ex Parte No. 347 (Sub-No. 1), Coal Rate Guidelines, Nationwide, 1 I.C.C. 2d 512 (1985).

In Coal Rate Guidelines Nationwide, the ICC did adopt a revenue adequacy constraint as a "top down" alternative to the "bottom up" SAC methodology. However, the ICC and STB have set such a high standard for revenue adequacy (and therefore for RSAM) as to render the revenue adequacy constraint irrelevant to rail rate regulation in the last 20 years.

When the Board takes up the revenue adequacy constraint (something PPL urged the Board to do sooner rather than later in its opening comments in this proceeding), the Board should reject the approach urged by BNSF in its opening comments. BNSF argues that demand-based pricing should not be subject to new constraints at a time when railroads must make substantial new investments in rail infrastructure. Opening comments at 6-8. See also the opening comments of the AAR.

The argument is made in support of maintaining recent changes in the SAC constraint that have worked very well for BNSF and other market dominant railroads. How-

ever, the argument is broad enough to undermine the revenue adequacy constraint by encouraging the Board to continue approving virtually unconstrained differential pricing of rail service as long as railroads are engaged in capital investments to expand capacity.

PPL certainly does not oppose railroad efforts to add capacity through double or triple tracking, positive train control and other capital investments. However, these improvements benefit all shippers, not just captive shippers (let alone captive coal shippers).

Moreover, the revenue adequacy constraint contemplates reduced differential pricing once revenue adequacy is achieved not because of any assumption that revenue adequate railroads will have no need for capital investments. Rather, revenue adequate railroads will not need to rely so heavily on differential pricing to fund their investments. Their revenues will be such that they will be able to attract capital without further differential pricing. As the ICC explained in Coal Rate Guidelines, "captive shippers should not be required to continue to pay differentially higher rates than other shippers when some or all of that differential is no longer necessary to ensure a financially sound carrier capable of meeting its current and future service needs." 1 I.C.C. 2d at 535-36.

PPL believes and the evidence demonstrates that most Class I railroads have been able to do this for many years. The recent dramatic increase in rail rates and revenues from shippers other than coal shippers, and shippers paying rates below the threshold of STB jurisdiction, simply reinforces the point. The Board should no longer credit the refrain that any effective limit on differential pricing of captive traffic jeopardizes the railroads' ability to meet increasing demand.

Another argument that must be rejected out of hand is the contention that "commercially viable" rates necessarily reflect Ramsey pricing and should therefore be seen as reasonable, negating any implication of "gaming."

When the railroads' conception of commercial viability is fleshed out, it becomes clear that the railroads are calling for new approaches to SAC that would eliminate whatever value the SAC constraint still has. For example, BNSF Witness Kalt suggests that every rate that has not been challenged by a captive shipper within one year of publication should be deemed "commercially viable." V.S. at 32. But rates may go unchallenged for many reasons other than that they are benign.

The shipper may have multiple origins, multiple destinations and shifting markets, making a SAC challenge prohibitively expensive. The shipper may not be shipping exclusively over high density main lines (making SAC useless under PPL Montana and Otter Tail). The shipper may have concluded, based on Duke Energy and Carolina Power & Light, that the Board is unlikely to find any rail rates unreasonably high until revenue adequacy is achieved (if then). Or the shipper may not be in a position to spend \$3-5 million on rate litigation in the face of obstacles like those summarized above.

Professor Kalt goes on to say that raising rail rates up to, but not beyond, the point that the delivered coal price "makes a power plant's operation uncompetitive in the marketplace" is consistent with Ramsey pricing. V.S. at 27. How does this limit differ from the highest rail rates likely to be set by an unregulated but profit maximizing monopolist?

Professor Kalt's failure to differentiate between maximum reasonable rail rates under regulation and maximum reasonable pricing by deregulated monopolists leads to a bizarre redefinition of gaming, under which railroads could only be found to have gamed

the system when they have charged higher rates on captive traffic than they wanted to, i.e., higher rates than a profit maximizing monopolist would charge. V.S. at 25. As Professor Kalt puts it, the railroad needs to be "sorry it set that rate if, in fact, it is not successfully challenged."

But if this the thinking on which rail rate regulation is to be based, gaming is the least of captive shippers' concerns. Instead of protecting captive shippers from the abuse of railroad market power, the Board's main function would become protecting monopoly railroads from their own short-sightedness in setting rates above what the market will bear.

Also missing from the railroads' analysis is any recognition of the fact that, when railroads are free to publish extremely high tariff rate increases exceeding 50% or 100%, and threatening the transfer of hundreds of millions of dollars, they hold all the cards in contract negotiations. Where market dominance exists but rate regulation is ineffective, "private sector solution" simply means that the railroad wins.

BNSF Witness Gaskins acknowledges that even captive shippers need to retain some of the profits generated by their enterprises. V.S. at 8. However, the railroads' position still boils down to the proposition that, so long they do not seize all available rents, their rates are commercially viable, Ramsey-optimal, and cannot be seen as influenced by railroad gaming.

Moreover, Witness Gaskins' approach would force the STB, which has its hands full with rail issues, to expand its inquiries dramatically. Shifting the focus of rail rate regulation to how much the traffic can bear would force the Board to try to analyze profit margins and market pressures in the coal, electricity and other industries, in an effort to

gauge each captive shipper's breaking point. Even if there were good reason to adopt this test (and there isn't, since it is tantamount to deregulation), the Board is ill-equipped to implement it.

When the focus turns to the issue of revenue allocation for cross-over traffic, the railroads continue to promote "regulation" that condones monopoly pricing. Thus, we are told that under contestable market theory, a SARR built by a captive shipper should be presumed to act like a profit-maximizing monopolist because that is how incumbent market dominant railroads act. Accordingly, the SARR's greater efficiency vis-à-vis the incumbent would produce minimal benefit for the captive shipper or captive shipper group because the SARR would allegedly price its services no lower than just below the lowest price the incumbent could charge and survive. See *Kalt V.S.* at 39-40, citing the incumbent's avoided cost "less one cent." See also *UP Witness Neels V.S.* at 16-17.

No attempt is made to reconcile this position with the definition in Coal Rate Guidelines of SAC as "the least cost at which an efficient competitor could provide the service." 1 I.C.C. 2d at 542, emphasis in original.

It is argued by BNSF Witness Willig that Ramsey pricing as understood by the railroads is not equivalent to charging what the traffic would bear. *V.S.* at 16. But the difference is evidently miniscule and legally insignificant (e.g., Witness Kalt's one penny differential). Witness Willig does, however, make one interesting observation, saying (*id.*) that "Ramsey prices are lower, overall, than those that the traffic would bear, provided that the rail carrier could, if unconstrained by regulation, earn a rate of return on its capital in excess of its cost of capital."

Of course, nothing in Coal Rate Guidelines or in current STB rate regulation prevents railroads from enjoying returns on capital exceeding their cost of capital. In fact, because the revenue adequacy constraint will not apply until "long term" revenue adequacy is achieved, it is likely that all railroads will experience several years in which their returns exceed their cost of capital, and there is nothing to prevent returns that are far higher than the cost of capital. As Professor Willig recognizes, rates in excess of Ramsey optimal levels are therefore likely. Unfortunately, neither Professor Willig nor any other railroad witness regards this as problematic or supports effective remedial action.

Here again, PPL does not oppose railroad revenue adequacy. However, allowing unconstrained monopoly pricing until long-term revenue adequacy is achieved would be inconsistent with the Act and case law. As the ICC observed in Coal Rate Guidelines, "a rate may be unreasonable even if the carrier is far short of revenue adequacy." 1 I.C.C. 2d at 536.

In its opening comments, PPL stated that railroads support the status quo because ineffective rate regulation is in their economic interest. A review of the railroads' opening comments leads to the conclusion that the railroads' interest is not limited to defending the status quo. They seek to make the SAC methodology even less effective, essentially promoting unregulated monopoly pricing as the model the Board should accept.

The Board should reject the railroads' arguments and adopted the positions on SAC issues detailed by Western Coal Traffic League and other captive shippers and shipper groups.

Respectfully submitted,



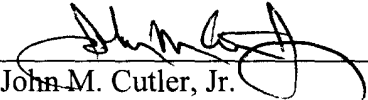
John M. Cutler, Jr.
McCarthy, Sweeney & Harkaway, PC
2175 K Street, N.W., Suite 600
Washington, DC 20037
(202) 775-5560

Attorney for
PPL EnergyPlus, LLC

Dated: May 31, 2006

CERTIFICATE OF SERVICE

I hereby certify that I have this 31st day of May, 2006, caused copies of the foregoing comments to be served by first class mail, postage prepaid on all parties of record.


John M. Cutler, Jr.

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