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June 1, 2006

HAND DELIVERY

The Honorable Vernon A. Williams
Secretary
Surface Transportation Board
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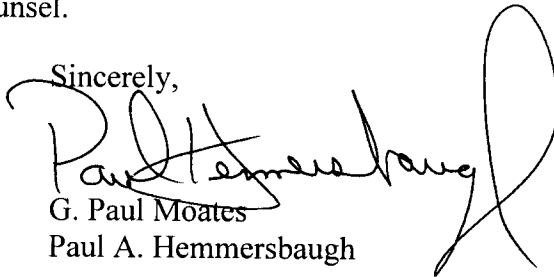
Re: Ex Parte No. 657 (Sub-No. 1), Major Issues in Rail Rate Cases

Dear Secretary Williams:

Enclosed for filing in the above-referenced proceeding are an original and twenty copies of the Joint Reply Comments of Norfolk Southern Railway Company and CSX Transportation, Inc. in the above-referenced proceeding. A diskette containing an electronic version of the Comments is also enclosed. Although we filed an electronic version of these Reply Comments with the Board yesterday, and served copies of that filing on all parties on the service list, we were unable to file paper copies because the Board's office was closed yesterday afternoon. Accordingly, we provide the enclosed courtesy copies this morning for the Board's use.

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.*

Enclosures

**UNITED STATES OF AMERICA
SURFACE TRANSPORTATION BOARD**



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

MAJOR ISSUES IN RAIL RATE CASES

**JOINT REPLY COMMENTS OF NORFOLK SOUTHERN
RAILWAY COMPANY AND CSX TRANSPORTATION, INC.**

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Dated: May 31, 2006

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INTRODUCTION

CSX Transportation, Inc. ("CSXT") and Norfolk Southern Railway Company ("NS") (collectively referred to hereinafter as "CSXT/NS") are pleased to submit their Joint Reply Comments on the Board's proposals regarding issues in rate cases considered under the Stand-Alone Cost ("SAC") constraint of the Constrained Market pricing principles adopted by the *Coal Rate Guidelines*. See Decision in STB Ex Parte 657 (Sub. No. 1), *Major Issues in Rail Rate Cases* (served Feb. 27, 2006) ("*NPRM*").

The *NPRM* sought public comment on six proposals developed by the Board that would make various changes to SAC proceedings. *Id.* at 2. CSXT/NS—along with a wide range of carriers, shippers, and other interested parties—submitted initial comments on these proposals on May 1, 2006. In addition to commenting on the Board's proposals, however, several commenters submitted new proposals of their own, including but not limited to new proposed methodologies for prescribing maximum reasonable rates. Because these new proposals were not raised in the *Notice* and the Board did not seek comment on those new proposals, they are not at issue in this rulemaking. See 5 U.S.C. § 553(b)(3); *Sprint Corp. v. FCC*, 315 F.3d 369, 376 (D.C. Cir. 2003) (holding that agency could not issue final rule adopting proposal that was not included in its notice of proposed rulemaking). Therefore, CSXT/NS will respond to the comments that other parties have made about the Board's proposals, and will not address any of the new proposals raised by commenters. Unless the Board advises commenters to the contrary, CSXT/NS assumes that the Board will not adopt proposals not included in the *NPRM*. Should the Board wish to consider any proposal not raised in the *Notice*, CSXT/NS requests notice and a reasonable opportunity to comment.

This is not to say that CSXT/NS think that some of the new proposals are not worthy of further discussion and consideration by the Board, following appropriate notice and comment. Indeed, CSXT/NS believe there are a number of other SAC issues the Board should consider. For example, in addition to the topics suggested by various commenters, CSXT/NS believe the Board should also consider certain construction, engineering, and road property investment issues. The Board might also consider how Constrained Market Pricing should take into account the current need for extensive capital investment to increase capacity, and whether capping or lowering rates is consistent with the need to invest the capital necessary to accommodate traffic a rail carrier is required to move as a common carrier or other traffic it is in the public interest for the carrier to handle, neither of which may be included in the SARR traffic group. If a SAC result appears inconsistent with capacity investment needs, the Board might consider addressing the problem by adopting an additional CMP test or parameter¹; imposing a common carrier obligation on the SARR; or making other adjustments to CMP to allow rail carriers to earn revenues sufficient to allow them to make investments necessary to meet the demand for increased capacity. In short, CSXT/NS believe the Board should consider – after proper notice and comment – ways to ensure that regulatory theory does not trump railroad reality.

¹ For example, it may be appropriate to amend the *Guidelines* to include a “capacity constraint” test in addition to the other four existing tests comprising the Constrained Market Pricing system. The *Guidelines* were adopted and implemented at a time of little to no growth (or demand for growth) in the rail industry. Today, the circumstances and challenges facing the rail industry are markedly different. While the stand-alone cost test is an appropriate method for determining the theoretical maximum reasonable rate, the application of such a rate may cause real-world problems in an era like the present, where the rail network requires significant capacity expansion. A “capacity constraint” test could be a mirror image of the phasing constraint. Just as, under certain circumstances, the phasing constraint may prohibit a railroad from charging the full rate that would be allowed by a SAC analysis, a capacity constraint test could, upon a showing of a need to invest in lines replicated in whole or in part by the SARR, allow a railroad to charge a rate that would exceed the level that a SAC analysis would otherwise allow.

I. THE PROPOSED RATE REDUCTION METHODS WOULD UNDERMINE THE CORE POLICIES AND PRINCIPLES OF THE *COAL RATE GUIDELINES*.

“If it ain’t broke, don’t fix it.” Unless and until there are actual demonstrated instances of parties attempting to manipulate the Percentage Reduction Methodology (“PRM”), there is no basis or reason to eliminate that sound approach in favor of *any* new, untested approach, much less in favor of an approach that is inconsistent with Ramsey Pricing principles. Moreover, even if the Board had found that a party in a particular case sought to unfairly manipulate the PRM – which to date it has not – the Board’s two proposed “solutions” would be worse than the hypothetical problem they were designed to address. It is theoretically possible that in some future case it may be necessary for the Board to take some remedial action in response to a finding that a party has attempted to game the system. But that theoretical possibility is no reason for the Board to alter radically the sound approach it has applied for many years. Moreover, the alternative approaches the Board has proposed are fatally flawed and fundamentally irreconcilable with the current rate regulatory system and structure.

Even if the Board were to determine, in some future proceeding, that one or more parties had engaged in conduct designed to “game” the PRM, the Board’s proposed solutions would be inappropriate and inconsistent with existing rate regulatory policy. As CSXT/NS and other commenters demonstrated in their opening comments, both of the Board’s proposed alternative rate reduction methodologies would flout the basic economic principles that form the foundation of Constrained Market Pricing, including use of demand-based differential pricing and allocation of unattributable costs on the basis of customers’ relative elasticity of demand, contestable markets, and avoiding distortions of relative rate relationships embodied in a carrier’s rate structure. *See* CSXT/NS Open. Comments at 4-7; *Comments of BNSF Railway Company*, STB Ex Parte No. 657 (Sub-No. 1) (May 1, 2006) (“BNSF Open.”), at 18-45.

A. No Commenter Has Demonstrated that Any Carrier Has Manipulated the PRM, and Speculation About the Theoretical Potential for Such Manipulation Does Not Justify Replacement of the PRM With MCM or MMM.

During the two decades since the promulgation of the *Coal Rate Guidelines*, there has not been a single case in which a party has been found to have attempted to “game” the Board’s rate reduction methodology. Despite describing hypothetical situations in which it believes either a rail carrier or a shipper could attempt to game the PRM, the *NPRM* cites no case in which the Board determined that any party engaged in such conduct. In the sole case referenced in the *NPRM* in which there was a gaming allegation – *Carolina Power & Light v. Norfolk Southern* – the Board found the challenged rates reasonable, thereby precluding the possibility of “gaming” the PRM (because no rate prescription analysis is undertaken when the SAC analysis determines the challenged rate is not unreasonable). See CSXT/NS Open. Comments at 3-5.

No commenter has offered any argument or evidence to support the notion that gaming is a real – as opposed to theoretical – problem in SAC cases, or that any party to a SAC case has actually attempted to “game” the PRM rate reduction methodology. Instead, those shippers’ comments that address the issue simply assume the existence of the predicate “problem” and then comment on the Board’s proposed measures to address that non-existent problem. See, e.g., *Joint Opening Comments of Western Coal Traffic League et al*, STB Ex Parte 657 (Sub-No. 1), at 15, 17-25 (May 1, 2006) (hereinafter “Joint Shipper Comments” or “J.S. Comments”). Thus, despite multiple expressions of concern that the PRM might, theoretically, be subject to manipulation, neither the Board nor any commenter has come forward with any evidence whatsoever that such manipulation has ever occurred. At least until the Board determines, based on real evidence, that a party has actually engaged in such manipulation, there is no justification

for “remedial” action. Without more, speculation about a hypothetical potential problem is insufficient to justify wholesale changes in the Board’s fundamentally sound PRM methodology.

B. The Proposed Alternative Approaches Would Violate Core Principles of the Guidelines, and Their Adoption Would Create an Incoherent Rate Regulatory Regime.

Contrary to the *NPRM* and the unsupported assertions of some commenters, both of the rate reduction approaches on which the Board seeks comment are inconsistent with – indeed would directly contravene – the economic and regulatory principles that lie at the heart of the *Guidelines*. See, e.g., CSXT/NS Open. at 6-7; BNSF Open. at 18-45. One of these core principles is that rail carriers must be allowed to engage in differential pricing in order to cover their costs. See *Coal Rate Guidelines, Nationwide*, 1 I.C.C.2d 520, 526 (1985). MCM and MMM would flout differential pricing principles by imposing uniform average rates (measured by ton-mile or revenue-to-variable cost ratio) on all higher-rated traffic. See *NPRM* at 9-16. The ICC expressly rejected similar proposals when it adopted the *Guidelines*, because imposing the same rates on all “captive” higher rated traffic

ignores the varying degrees of elasticity (or inelasticity) among “captive” shippers . . . The objective of Ramsey pricing is to permit recovery of unattributable costs in accordance with variations in demand. Setting all captive rates in the same proportion to marginal costs would be contrary to the principle of differential pricing, and could prevent a railroad from covering its total costs.

Coal Rate Guidelines, 1 I.C.C.2d at 533 (emphasis added); see *id.* at 559 (rejecting maximum reasonable rate proposal requiring uniform mark-up for higher rated traffic as arbitrary). The Board, and the ICC before it, have repeatedly affirmed that demand-based differential pricing is at the core of the rate regime established by the *Guidelines*, and that those *Guidelines* – and the Ramsey pricing principles they implement – preclude any approach that would allocate SAC

costs on any basis other than rail shippers' relative demand elasticities (reflected in railroads' real-world rates and relative rate structures).² See, e.g., *CP&L v. NS*, STB Dkt. No. 42072, slip op at 33 (served Dec. 23, 2003) (rejecting proposed allocation of unattributable costs on a uniform ton-mile basis as inconsistent with the *Guidelines*' requirement that railroads be allowed to engage in demand-based differential pricing); *Xcel v. BNSF*, STB Doc. No. 42057, slip op at 37-38 (rejecting, as inconsistent with demand-based differential pricing principles of *Guidelines*, complainant's proposal to impose uniform R/VC percentage on higher rated traffic).

By imposing a uniform average rate on all higher rated traffic, however, the approaches proposed in the *NPRM* would effectively assume that all such traffic necessarily has the *same* elasticity of demand, thereby abandoning demand-based differential pricing for all such traffic. Such approaches are flatly inconsistent with twenty years of ICC/STB decisions under the *Guidelines*, and would directly contravene the Ramsey pricing principles that animate the *Guidelines*. See, e.g., *Rate Guidelines – Non-Coal Proceedings*, 1 S.T.B. 1004, 1030 (1996) (“*Simplified Guidelines*”) (rejecting proposal to set rates based on uniform mark-up over RSAM as “premised on the general notion that a railroad can and should charge a single, uniform markup to all of its captive shippers. Such an approach is fundamentally inconsistent with demand-based differential pricing principles.”).³ No commenter has offered any basis for the

² Stated differently, so long as the Board continues to use the *Guidelines* and the differential principles they embody as the basis for evaluating maximum rate reasonableness challenges, logic and consistency compel rejection of any approach that requires uniform allocation of unattributable costs to all shippers, or even to a subset of SARR shippers.

³ The Board's proposals would render the current rail rate regulatory regime arbitrary and incoherent. The rate regulatory regime adopted in the *Guidelines*, and affirmed by the courts, is premised on the precept that railroads must engage in demand-based differential pricing in order to recover their joint and common costs. See, e.g., *Guidelines*, 1 I.C.C.2d at 526-28. The *Guidelines* further establish that such demand-based differential pricing (*i.e.*, the setting of prices in inverse relation to shippers' relative elasticity of demand) is necessary to allow an efficient

Board to abandon its longstanding reliance on sound economic theory, including differential pricing principles.

Contrary to the Board's suggestion, the fact that MCM and MMM would allow carriers to charge demand-based differential prices on certain lower-rated, "competitive" traffic does not cure this fundamental flaw. In order to satisfy the *Guidelines*' requirements of demand-based differential pricing, a carrier must be allowed to differentially price all of its traffic (including all traffic selected by a complainant for inclusion in its SARR traffic group), not just a segment of its traffic that is more competitive or lower-rated. See, e.g., *Xcel v. BNSF*, STB Doc. No. 42057, slip op at 37-38; *Simplified Guidelines*, 1 STB at 1030.

Thus, use of MMM or MCM in SAC cases brought under the *Guidelines* would result in a rate regulatory process founded on two opposite and irreconcilable propositions: that rail carriers *must* engage in demand-based differential pricing and that rail carriers *may not* engage in full differential pricing. Such an internally contradictory system would be fundamentally unsound and irrational. Far from resolving the (theoretical) problem of potential "gaming," the Board's proposals would create an incoherent and arbitrary system that would undermine the long-term best interests of rail carriers, shippers, and the public.

The existing PRM approach, in contrast, is consistent with Ramsey pricing principles, and the fundamental theories of differential pricing and contestable markets that undergird the CMP system established by the *Guidelines*. The PRM allocates excess SAC costs in a manner that preserves the proportionate relationships among a carrier's existing rates, which are

carrier to earn adequate revenues, as mandated by the Interstate Commerce Act. See 49 U.S.C. §§ 10101, 10704(a)(2). MMM and MCM, in contrast, would discard differential pricing in favor of a uniform allocation of costs among all traffic having rates that exceed either their variable costs or a ton-mile-based distribution of SAC costs. See, e.g., *NPRM* at 11 (MCM allows differential pricing "only to the extent needed to cover SAC costs that could not be covered by a uniform allocation among all the traffic in the traffic group.")

presumed to reflect the observed demand elasticities of the SARR traffic group. *See, e.g., Coal Trading Corp. v. Balt. & Ohio R.R.*, 6 I.C.C.2d 361, 380 (1990); *NPRM* at 7. Although, like CMP, the PRM is an imperfect approximation of pure Ramsey pricing principles, it is nonetheless far superior to the alternative approaches the Board has proposed. The Board should reject the fundamentally flawed MCM and MMM approaches and retain the PRM.

C. The Joint Shippers' Comments Further Demonstrate that Neither MCM Nor MMM is an Appropriate Replacement for the PRM.

Comments supporting the Board's proposed alternative rate reduction methods fail to reconcile those proposals with the fundamental principles and policies underpinning the Board's rail rate regulation regime. The Joint Shipper Comments, for example, assert that because MCM uses price as a measure of demand elasticity, it is "no more true to the core principle of Ramsey pricing than is percent reduction" (which they claim "distorts Ramsey results."). *J.S. Comments* at 16, 19. They further attack the Board's MCM proposal because it "does not take into account differences in variable costs" between different types of SARR traffic. *Id.* at 20.

The Joint Shippers also doubt that MCM would "solve" the hypothetical gaming problem, because it uses rates set by the carrier as an indicator of demand elasticity. *See id.* at 18-19. Finally, the Joint Shippers correctly note that, contrary to the Board's suggestion, MCM will not provide significant additional incentives for negotiation. *Id.* at 19. Thus, with respect to MCM, the leading shippers' group asserts that it would not solve the (hypothetical) problem it is designed to address, and it is not consistent with core Ramsey Pricing principles. If a proposed solution would not remedy the purported problem and is inconsistent with core regulatory principles and requirements, it plainly should not be adopted.

With respect to the MMM, commenters concede that it would be more complicated to apply (therefore, it would also likely be more costly and time-consuming), but assert that it

would be preferable to MCM because MMM would be “somewhat truer to Ramsey principles.” J.S. Comments at 20. They support MMM because it relies on each movement’s variable costs (rather than its rates), and uses a (uniform) mark-up over those costs to determine the SAC price ceiling for higher rated traffic. *See id.*⁴

As the Board recognizes, consistency and analytical rigor require that, if parties are allowed to continue to seek movement-specific adjustments to URCS system average variable costs for purposes of determining the jurisdictional threshold and the floor on rate prescriptions for issue traffic, adjustments to URCS variable costs for all other traffic must also be allowed for purposes of the MMM rate reduction process. *See NPRM* at 16; *but compare* J.S. Comments at 20-21 (opposing movement specific adjustments to variable costs for rate reduction purposes) *with id.* at 89-101 (arguing in favor of movement-specific adjustments to variable costs). Allowing movement-specific adjustments for issue traffic but prohibiting them for other SARR traffic would destroy the internal logic and coherence of the proposed MMM approach. *See, e.g., NPRM* at 16.

As a practical matter, making movement-specific adjustments to URCS costs for every SARR movement would add substantial cost and complexity to a SAC proceeding. *See NPRM* at 16 (If such an approach were implemented, “[t]he cost of bringing a full SAC case would increase exponentially.”).⁵ Thus, even putting aside MMM’s fundamental inconsistency with

⁴ Only weeks after the Western Fuels Association submitted two sets of comments in this proceeding advocating the more expensive and time-consuming MMM approach, its members testified before Congress that SAC cases were already unduly time-consuming and costly. *See, e.g., “Statement of Tri-State Generation and Transmission Association,” Hearing on Coal-Based Generation Reliability*, before the U.S. Senate Committee on Energy and Natural Resources (May 25, 2006) (Tri-State is a member of Western Fuels Association).

⁵ *Cf. “Statement of Tri-State Generation and Transmission Association,” supra* n. 4 (testifying before Senate committee that SAC cases are too expensive and time-consuming).

differential pricing and other core CMP principles, the costs of implementing that approach using movement-specific variable costs would be prohibitive. As the Board correctly concluded in its Notice, it is “inadvisable to apply [the MMM] approach if we continue to permit movement-specific adjustments to URCS for the issue traffic.” *NPRM* at 16. Because the Joint Shippers (and virtually all of the other commenting shippers), like CSXT/NS, advocate continued use of such movement-specific adjustments, MMM simply would not be practical or cost-effective, and should be rejected.

At the end of their comments on this first issue, the Joint Shippers advocate adoption of an open-ended approach that would allow parties to advocate any rate reduction methodology (except the PRM) they choose in any given case. J.S. Comments at 25. In effect, the shippers are asking that the Board prohibit use of the PRM, but otherwise allow shippers free rein to advocate any other rate reduction methodology they may choose in individual adjudications. Such an indeterminate “rule” would undermine the very goals the Board seeks to promote in this proceeding, including predictability and stability in SAC results, promotion of negotiated settlements, and reduction of the ability of parties to manipulate SAC rate reduction methodology. See *NPRM* at 8, 11-13; cf. *Procedures to Expedite Resolution of Rail Rate Challenges to be Considered under the Stand-Alone Cost Methodology*, STB Ex Parte 638 (served April 3, 2003).

Moreover, it would be fundamentally unfair to allow shippers to cherry-pick the rate reduction methodology approach they wish to use in each case, a selection that would inevitably be based upon an assessment of which approach would yield the greatest rate reduction in a given case. The purpose of this rulemaking proceeding should be to establish (or refine) rules of general applicability that will apply equally to all future SAC cases, not to eliminate such rules in

favor of increased uncertainty and greater potential for result-oriented manipulation of the SAC process. The approach advocated by the Joint Shippers would also introduce additional complexity, cost, and delay to SAC proceedings – again the polar opposite of the Board’s aim – by effectively requiring an additional round of argument and evidence regarding rate reduction methodologies in any case in which the Board determines, after three rounds of SAC evidence, that the SARR’s revenues would exceed its costs.

D. The Notion of a “Revenue Adequate” SARR Has No Relevance to the Board’s Rate Reduction Methodology

Comments submitted on behalf of a group of shippers also suggest that the PRM is somehow inconsistent with the revenue adequacy constraint, because the SARR should be presumed to be revenue adequate. *See* J.S. Comments at 16-17. This confused assertion is difficult to comprehend, let alone accord any credibility. The concept of “revenue adequacy” applies to real world rail carriers, not to hypothetical stand-alone railroads. Neither the *Guidelines* nor any other STB regulation or decision provides that the Board should consider the hypothetical revenue adequacy (however that might be determined) of a hypothetical SARR in determining the appropriate rate reduction for issue traffic. Stated differently, the purported revenue adequacy of a SARR has no relation to a real world carrier’s need to engage in differential pricing, or to the proper application of differential pricing principles in the determination of an appropriate rate prescription in a SAC proceeding.

II. REVENUE ALLOCATION FOR CROSSOVER TRAFFIC – THE ATC METHOD WOULD BE AN IMPROVEMENT OVER THE EXISTING APPROACH.

The overwhelming majority of SARR traffic in every recent SAC case has been cross-over traffic. Existing methods of allocating revenue between the SARR and the residual incumbent have distorted SARR revenue projections and resulted in the residual incumbent subsidizing the operations of the SARR. If the Board continues to allow crossover traffic, it is

essential that it apply a new revenue allocation method that eliminates the cross-subsidies and the resulting distortion of SAC analysis and results. As CSXT/NS discussed in their opening comments, the ATC represents an improvement over the Board's existing method for allocating cross-over traffic revenues. *See* CSXT/NS Open. at 8. Certain comments submitted in opposition to the proposal are confused and misleading, and CSXT/NS briefly responds to those comments here.

First, it is simply not correct to suggest that the ATC approach or other "cost-based" approaches to allocating cross-over traffic revenue would require the SARR to "replicate all service provided by the incumbent," or "provide origin-to-destination service for all members of [the SARR's] traffic group." J.S. Comments at 31, 36, 39. Rather, ATC uses the average total cost of the SARR and the average total cost of the residual incumbent to estimate the appropriate allocation of cross-over traffic revenues. *See NPRM* at 19-20. Nothing in the Board's proposal remotely suggests that it is proposing to require the SARR to provide origin-to-destination service for all SARR traffic, which would essentially eliminate the use of cross-over traffic. To the contrary, the *NPRM* makes clear its revenue allocation methods are intended as a simplifying device to *approximate* a full SAC analysis of origin-to-destination service, without requiring the complainant to develop and present a full origin-to-destination SAC analysis. *Id.* at 17.⁶

Second, and related, the shippers are incorrect when they assert that the ATC would impose an impermissible barrier to entry. *See* J.S. Comments at 39-40. This claim depends entirely on the assertion that such "cost-based" divisions methods require the SARR to "replicate the incumbent's origin-to-destination service for all members of the SARR traffic group." *Id.* at

⁶ If shippers contend that it is not necessary to approximate a full SAC analysis for crossover traffic, they are simply wrong – that is the very premise that allows the use of hypothetical crossover traffic in a SAC case.

39.⁷ But ATC imposes no such requirement. Indeed, the Board has allowed cross-over traffic as an expedient device to allow complainants to avoid the complexity and expense of developing a full origin-to-destination SAC presentation. MMP, MSP, and ATC are simply alternative approaches to allocating revenues from cross-over traffic between the SARR and the residual incumbent. If the SARR were required to replicate full origin-to-destination service, there would be no need for such revenue allocation, because the SARR would be entitled to the full revenue generated by the traffic.

Third, the shippers' comments ignore the fact that MMP and MSP provide incentives for gaming. Indeed, the Board appears to have moved away from MMP precisely because of such gaming in the *Duke v. CSXT* rate case, in which the complaining shipper designed a SARR to obtain an extra mileage block, and in doing so sited a rail yard at the bottom of an 800-foot gorge on the Gauley River. Although MSP is less susceptible to such shipper gaming, the shipper can still design a SARR to take advantage of the MSP approach in a manner that distorts the SAC analysis.

⁷ The Joint Shippers' Comments devote many pages to a confused and misleading argument that, in *Duke v. NS*, the Board discarded its previous "market-based" crossover traffic revenue allocation approach in favor of a "cost-based" approach. See J.S. at 33-48. To the extent this argument can even be understood, it appears to be based on a significant mischaracterization of the parties' positions in *Duke v. NS*, and the Board's resolution of the parties' dispute regarding allocation of cross-over traffic revenue in that case. See, e.g., Decision, *Duke v. NS*, STB Dkt. No. 42069 (Nov. 6, 2003), at 17-25. CSXT/NS will not burden the Board with a detailed refutation of the Joint Shippers' erroneous and misleading characterization of *Duke v. NS*, because they are confident that the Board understands what the issues were in *Duke v. NS*, and that any confusion created by the Joint Shippers' comments can be eliminated by reviewing the Board's decision, and the evidence and argument submitted by the parties in that case. Significantly, after spending nearly 20 pages in a confused attack on the Board's treatment of crossover traffic revenue allocation in *Duke* and subsequent cases, the Shippers conclude by endorsing the very approach the Board adopted in that case, the Modified Straight-Mileage Prorate ("MSP"). See J.S. Comments at 48, 52.

III. INDEXING OPERATING COSTS

The suggestion by the Joint Shippers that a SARR could realize substantial productivity gains in its first few years ignores one of the basic premises of a SAC presentation: the SARR is assumed to be optimally efficient at its inception. See, e.g., *Coal Rate Guidelines*, 1 I.C.C.2d 520, 542-44. In order to achieve such optimal efficiency, the SARR is presumed to take advantage of the most productive available work force, facilities, equipment, technology, and operating practices from the outset. In most cases, the operating efficiency and productivity attributed to the SARR is so great as to border on the fantastic. This hyper-efficiency confers on the hypothetical SARR a tremendous operating cost advantage over real world railroads, an advantage that an incumbent carrier could only hope to overcome over many years, if ever. If the SARR already has the most efficient and most productive operations possible, then, by definition, no further productivity gains are immediately available to it. Thus, while the types of changes and improvements cited in the Joint Shippers comments may hold significant potential for improving the productivity of real-world rail carriers, they do not offer similar potential for short- or medium-term productivity growth for the optimally efficient SARR. Put another way, RCAF-A productivity gains are primarily the product of real world railroads catching up to the place the hypothetical SARR starts.

One particular argument advanced by shippers regarding gains in SARR productivity merits specific discussion. The Joint Shippers assert that a "SARR will replace its assets at any time necessary to improve its efficiency." J.S. Comments at 82. This simplistic assertion fails to take into account the cost of such asset replacement. While the proponent of a SAC presentation may posit asset replacement at any time during the SAC analysis period, it should be allowed to do so only if it accounts for all of the costs and other effects of that replacement. Thus, for example, if a SARR were to replace its locomotive fleet after five years to take advantage of

improvements in locomotive technology, it would be required to bear the (likely substantial) cost difference between purchasing such new locomotives, and keeping the old ones. The Joint Shippers do not discuss these costs.

Similarly, installation of new Positive Train Control systems would require the SARR to make very significant additional investments. While several real world rail carriers are reportedly considering the implementation of such systems to improve the capacity of their networks, the cost of acquiring and implementing such systems would be substantial. Moreover, it is not clear that Positive Train Control would confer significant benefits to a SARR because the SARR's simplistic operations do not carry the diverse mix of traffic carried by real world railroads. Any calculation of possible benefits from the projected use of such new systems or technology by a SARR must take into account the cost of purchasing, installing, and integrating such new assets into the existing SARR -- it is not at all clear that any such benefits would outweigh the attendant costs.

In sum, while complainants should be allowed to present evidence in individual cases to support a claim that the SARR could achieve productivity improvements in the future, it is essential that any such productivity analysis fully account for the costs and other effects of any investments or changes required to achieve such projected improvements. Moreover, the simple unsupported assertion that the SARR would take advantage of opportunities for productivity improvements as they become available is insufficient to support a one-size-fits-all rule requiring adjustments to the indexing of SARR operating expenses. If, in a particular case, a complainant demonstrates that its SARR would likely achieve certain productivity benefits (net of the costs necessary to achieve them), the Board should adjust the indexing of operating expenses accordingly.

Neither the *NPRM* nor any commenter has proposed an approach that would directly tie changes in the operating expense index to actual anticipated changes in SARR productivity. The Board's proposal would simply phase-in the RCAF-A in equal 5% increments over a period of 20 years. *NPRM* at 21. There is no reason to believe that actual productivity improvements would follow such a uniform, linear pattern.⁸ Similarly, despite submitting voluminous comments and statements of several experts, the Joint Shippers' Comments provide no specific numerical or analytical support for their proposal to adopt a 50% RCAF-U/50% RCAF-A starting point and to move to a 100% RCAF-A index after 10 years. *See* J.S. Comments at 84-86. Both the *NPRM* and the shippers' proposals would impose an arbitrary phase-in of the RCAF-A in order to account for unspecified and unquantified future productivity improvements. No commenter offers any more support for using the particular percentage phase-in of the RCAF-A that they advocate than any other percentage. On this record, adoption of any percentage phase-in would be entirely arbitrary and unsupported. *See, e.g.,* Comments of Albemarle Corporation, STB Ex Parte 657 (Sub-No. 1) (May 1, 2006) at 6 (shipper comments opposing such a uniform approach for all proceedings because it fails to consider "the specific productivity that may or may not be available in a particular stand-alone cost proceeding, and as such is arbitrary and capricious."). Such an approach would be particularly unwise in the present context, in which the Board proposes to promulgate a rule that would apply to all future SAC proceedings.

⁸ While it may be possible for the Board to justify a percent phase-in of the RCAF-A index as a reasonable and more administratively feasible approximation of the effects of likely productivity gains, it may do so only if there is solid evidence showing that the claimed productivity improvements are likely to occur and will be paid for by the SARR. No such evidence was presented in any participant's opening comments.

Nor has any commenter offered specific evidence to support the assertion that the optimally efficient SARR would realize significant productivity improvements in its first ten years. As CSXT/NS demonstrated in their opening comments, it is unlikely that the SARR – which is assumed to have taken advantage of every available productivity enhancement at its inception – would experience *any* net productivity gains in its first ten years. See CSXT/NS Open. at 10-11. Thus, given the near-consensus acceptance of a 10-year SAC analysis period (see *infra*, Section V), the Board could address two of the six issues raised in this proceeding by applying the RCAF-U to index operating expenses over a shorter 10-year SAC analysis period. This approach would avoid the distortions that would result from arbitrary phase-in of the RCAF-A without denying the SARR the benefit of any potential productivity gains, which would only be a realistic possibility in the longer term (*i.e.* gains that might arguably be available after ten years).⁹

IV. THE BOARD SHOULD CONTINUE TO ALLOW ADJUSTMENTS TO URCS, BUT REGARDLESS OF WHETHER IT DOES SO, IT IS IMPORTANT TO DEFINE “URCS SYSTEM AVERAGE COSTS” CORRECTLY.

The opening comments demonstrate that there is substantial confusion regarding what is meant by “unadjusted URCS” costs. The comments also make clear that, to one degree or another, all parties seek to maintain the right to propose adjustments to URCS costs. Consistent with the overwhelming majority of comments, CSXT/NS urge the Board not to sacrifice accuracy and justice in the name of speed, efficiency or simplicity in the calculation of variable costs. CSXT/NS submits that its proposal regarding the use of URCS in SAC proceedings is an appropriate middle ground that could reduce the costs and time necessary to litigate many SAC

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cases, without forsaking precision and painstaking analysis where it is essential to a fair outcome.

A. Consistent with the Overwhelming Majority of Comments, the Board Should Continue to Allow Movement-Specific Adjustments to URCS System Average Costs.

NS/CSXT, Canadian Pacific Railway Company, and most shippers agree that the Board should retain its longstanding preference for movement-specific adjustments to system-average URCS costs. *See, e.g.*, CSX/NS Open. at 11-15; J.S. Comments at 89-101. BNSF and UP also support the continued allowance of some limited adjustments to URCS system-average costs. *See* BNSF Opening Comments at 60-61, 64-67; Union Pacific Opening Comments at 35-44. It therefore appears that the overwhelming majority of comments favor the continued allowance of at least some URCS adjustments in SAC proceedings, and there is very little support for the Board's proposal to prohibit all such adjustments.

B. In All Events, the Board Should Properly Define "Unadjusted System Average URCS Costs."

The *NPRM* does not expressly define what it means by the term "URCS system average costs." *See NPRM* at 22-23 (discussing URCS and adjustments to system average, but not defining URCS system average). Because both the *NPRM* and the CSXT/NS proposal contemplate using unadjusted URCS system average costs in at least some contexts in SAC cases, it is important that the Board and the parties have a common understanding of the term unadjusted URCS system average costs. As explained below, system average URCS costs should use specific operating statistic inputs (service units) that reflect the way the movement(s) is handled by the incumbent carrier.

1. System Average Cost Calculations Should Use Accurate Service Units and System Average Unit Costs.

CSXT/NS understand the term “unadjusted URCS system average costs” (hereinafter referred to for convenience as “unadjusted URCS”) to mean URCS phase III costs that are generated by using (i) applicable service units for each movement; in combination with (ii) system-average unit costs, to generate a variable cost estimate for a movement. Only the *unit costs* of a movement are an actual cost measure. *Service units*, in contrast, simply reflect the actual operating attributes of a movement (*e.g.*, actual loaded miles, number of locomotives in movement’s consist, etc.). Use of the correct service unit inputs – which has no effect whatsoever on unit costs – is essential to allow the accurate calculation of the URCS system average variable costs of a movement. Moreover, the number of service units required for a given movement should not generate significant disputes – most rail carriers maintain data showing movement-specific operating statistics, which could be used as URCS service unit inputs.¹⁰

Use of accurate service unit inputs facilitates accurate calculation of URCS costs while avoiding the time and expense required to develop and present evidence concerning disputed unit costs. The critical difference between service units and unit costs is that the correct number of service units is an essential – and readily ascertainable – input to the cost calculation system. Thus, for example, if a movement uses a three locomotive consist, accurate system average costing would multiply the system average locomotive unit cost (*e.g.*, 30 cents per ton) by three to determine the applicable locomotive cost per ton (in this example, 90 cents per ton). Using

¹⁰ If disputes concerning the appropriate service units were to arise, they could be addressed readily and efficiently by the technical conferences the Board has successfully used to resolve such technical disputes in recent cases. *See, e.g.* STB Press Release, “Surface Transportation Board Announces Success of Technical Conference in a Major Rail-Rate Case” (May 14, 2004).

two locomotives rather than three (*i.e.*, using an incorrect number of service units) would understate the system average variable cost of locomotives for that movement by 33 percent. Unit costs, in contrast, are more difficult to determine and objectively verify, and therefore are the source of most of the costly and time-consuming disputes regarding URCS cost adjustments. Below, CSXT/NS briefly describe the URCS inputs and parameters necessary to implement the approach described above.

a. *Calculating Unadjusted URCS for a Specific Movement*

The first step in calculating URCS system average costs for a movement would be to input to the URCS Phase III program nine basic types of information, including: (1) the railroad; (2) loaded miles; (3) shipment type; (4) number of freight cars; (5) tons per car; (6) commodity; (7) type of movement; (8) car ownership (railroad or private); and (9) type of car. *See, e.g., NPRM* at 26, n. 30. Second, the preliminary URCS output based on those nine rudimentary inputs must be refined, using URCS “Detailed Parameters,” to account for relevant operating statistics. *See URCS Users Manual* at 7.3.1 (“Detailed Parameters”).¹¹

b. *URCS Costs Must Be Calculated Based Upon the Way the Defendant Carrier Handles the Traffic and the Terms of the Challenged Common Carrier Rate.*

Also essential to the accurate estimation of the URCS variable cost of a movement is the use of inputs that reflect the way the incumbent carrier actually handles the traffic. Thus, for example, if the direct rail miles from an origin to destination are 500, but the defendant carrier

¹¹ Although the URCS manual lists 64 detailed parameters as potential inputs, for any given movement only a fraction of those parameters are relevant and necessary inputs. The detailed parameters that often represent the most significant service unit inputs include the following: tare weight; empty loaded car-mile ratio; number of through locomotives; number of way locomotives; number of unit locomotives; and charge per car-mile.

first takes the cars from the origin to a classification yard to build a train, and that segment adds 50 miles, the one-way mileage for that trip would be 550 miles.

In addition, variable costs of the issue movement(s) should be determined in accordance with applicable terms and conditions of the challenged common carrier rate. For example, if a carrier quotes a zero-mileage rate in private cars, any car mileage payments the carrier must make to the shipper under the terms of that rate quote are properly included as variable costs of the issue movement.

2. The "Make-Whole" Adjustment to System Average Costs

Another essential component of accurate URCS cost calculation is the so-called "make-whole" adjustment. Although it is described as an "adjustment," the cost re-allocation effected by the "make-whole" process is fairly routine and non-controversial. The Board consistently makes this adjustment in URCS Phase III cost calculations in order to more accurately allocate costs between high volume and low volume movements on a system-wide basis. As the ICC explained,

The make-whole procedure is a two-step process used to reallocate costs so as to reflect properly cost savings realized on high volume movements to lower volume movements. The first step accumulates the cost reductions generated by the higher volume movements to lower volume movements. The second step distributes the costs that have been saved on the high volume movements. The make-whole process is necessary because the costs produced by the general purpose costing system are "average" costs. Adjusting the costs of the high volume traffic to recognize that such traffic moves at lower than average costs requires an offsetting adjustment to recognize that lower volume traffic moves at higher than average costs.

Cost Recovery Percentage Review of the General Purpose Costing System, ICC Ex Parte No. 431 (Sub-No. 2) (March 1, 1993), at 1. It does not appear that any party's opening comments opposed the use of a standard "make-whole" adjustment. *See, e.g.*, Initial Comments of BP

Amoco Chemical Co. at 4 (supporting the inclusion of the make-whole adjustment in the calculation of “unadjusted” URCS costs). CSXT/NS therefore simply seek to clarify that any “unadjusted URCS” cost calculation will include the make-whole adjustment.

C. CSXT/NS’ Proposals Would Save Time and Expense Without Unduly Compromising Accuracy of Variable Cost Calculations.

CSXT/NS continue to believe that the procedural approach they suggested in their opening comments could significantly reduce the overall expense of litigating variable cost issues in SAC proceedings. *See* CSXT/NS Open. Comments at 15-17. In many – perhaps most – cases, under the CSXT/NS proposal, variable cost evidence would not be necessary for purposes of determining whether the revenue-to-variable cost ratio generated by the challenged rates exceeded the jurisdictional threshold. *See id.* In many other cases, variable cost evidence also would not be required to determine the rate prescription floor, either because the parties choose not to present such evidence or because the SAC analysis demonstrates the challenged rate is below a maximum reasonable level. Thus, under CSXT/NS’ proposal, the overall frequency, number, and expense of variable cost analyses would decline substantially, without undermining the accuracy of movement-specific variable cost evidence in those cases in which it is important.

CSXT/NS also continue to advocate the second alternative proposal described in their opening comments, to continue to allow URCS unit cost adjustments, but to limit them to those cost categories that tend to vary most substantially from system average costs. *See* CSXT/NS Open. at 17. At a minimum, those cost categories should include: fuel costs, equipment ownership costs, crew wages, mine loading times, car mileage allowances and payments to third parties (*e.g.*, payments to short lines, payments for trackage and haulage, payments to mines, payments for coal conveyer belts, etc.). *Id.*

D. The Board Should Reject BP Amoco Chemical Company's Proposal Regarding *Simplified Guideline* Benchmark Ratios as Beyond the Scope of this Rulemaking.

After the Board issued its *NPRM*, commenter BP Amoco Chemical Company filed a "Petition to Clarify Scope of Proceeding, or to Broaden It" (March 26, 2006) ("BP Amoco Petition"). BP Amoco Chemical requested that, in addition to the issues raised in the *NPRM*, the Board also consider issues concerning adjustments to URCS system average costs in cases brought under the *Rate Guidelines – Non-Coal Proceedings*, 1 STB 1004 (1996) (the "*Simplified Guidelines*"). BP Amoco Petition at 6-7. The Board denied BP Amoco's request to expand the rulemaking to address "whether adjustments to URCS should be permitted when applying the three-benchmark standard of rate reasonableness described in *Simplified Guidelines*." See Decision, STB Ex Parte No. 657 (Sub-No. 1) "Major Issues in Rail Rate Cases" (served April 14, 2006), at 2.

BP Amoco's comments disregard the Board's ruling by asserting, *inter alia*, that the Board should prohibit adjustments to URCS for "all other purposes" in *Simplified Guidelines* cases, including the determination of the "comparison traffic" benchmark measure. See BP Amoco Comments at 2-3, 6 (May 1, 2006). CSXT/NS understand that the Board's April 14 Order remains in effect and that any discussion of URCS adjustments in cases brought under the *Simplified Guidelines* that is outside the scope of the Order (*e.g.* comments regarding the use of URCS in determining benchmark ratios) is not germane to this proceeding and will be disregarded.

V. STAND-ALONE COST ANALYSIS PERIOD

CSXT/NS do not oppose the Board's proposal to shorten the standard SAC analysis period from twenty years to ten years. Adopting a shorter period would eliminate some of the inherent uncertainty in a twenty-year analysis period and might modestly reduce the expense of

SAC presentations. *See* CSXT/NS Open. at 18-19. Indeed, there seems to be a near consensus among shippers and carriers that a ten year SAC analysis period would be an appropriate modification to SAC procedures. *See, e.g.*, BNSF Open. Comments at 70-71; Union Pacific Open. Comments at 45; J.S. Comments at 102-03. CSXT/NS urge the Board to adopt this proposal, but suggest that it be adopted as a rebuttable presumption—not a requirement. Parties should be permitted to present evidence and argument demonstrating that the circumstances of a particular case make a longer or shorter SAC analysis period appropriate.

The Joint Shippers' suggestions that the Board change its approach to the amortization of debt capital and that it maintain a rate prescription after the expiration of the SAC analysis period are both baseless and outside the scope of the rulemaking, and should be rejected without further consideration. Contrary to the Joint Shippers' suggestion, the use of a 20-year period for the amortization of assets purchased with debt capital has nothing to do with the length of the SAC analysis period. *See* J.S. Comments at 103 (implicitly acknowledging the lack of relationship between the debt amortization period and the SAC analysis period by stating that the amortization period should be changed "regardless of whether a 10-year or 20-year analysis period is utilized."). For good and sound reasons unrelated to the length of the SAC analysis period, the Board and the ICC before it have consistently amortized the debt used to purchase assets over a 20-year period. The Shippers' new proposal to change the Board's longstanding debt amortization approach is outside the scope of this proceeding, and should not be considered here.¹²

¹² As with the several other new proposals offered by commenters but not included in the *NPRM*, CSXT/NS requests that, if the Board decides to consider the Joint Shippers' new debt amortization or prescription length proposals in the present proceeding, the Board issue notice of this intent and provide ample opportunity for CSXT/NS and other interested parties to comment on the new proposal(s).

There is no principled basis for the Joint Shipper's proposal that the Board maintain a rate prescription beyond the expiration of the SAC analysis period. *Id.* at 104. At bottom, the primary purpose of a SAC analysis is to determine the maximum reasonable rate during the time period covered by that analysis. Creating a new presumption to effectively extend a rate prescription beyond the end of the SAC analysis period (and potentially into perpetuity) would destroy the fundamental logic and rigor of the analysis. If the Joint Shippers prefer a longer SAC analysis period, with the accompanying potential for a longer rate prescription, they should express that preference in their comments. What they may not do is have their cake and eat it too, by supporting a shorter SAC analysis period while simultaneously seeking to extend any resulting rate prescription beyond the end of that period. Not only is such a proposal outside the scope of this proceeding, it is logically inconsistent and fundamentally unfair.

VI. STANDARD FOR REOPENING, VACATING, AND FILING A NEW CASE

CSXT/NS support the Board's proposal to adopt a fair and uniform approach and standards for reopening decided rate cases. The Board's approach is a reasonable and efficient way to assess whether re-opening is warranted and whether changed circumstances warrant a re-opened proceeding using the same SARR or an entirely new complaint. Moreover, the Board's proposal is an appropriate response to the D.C. Circuit's decision in *BNSF Co. v. STB*, 403 F.3d 771, 777 (D.C. Cir. 2005) ("*West Texas Remand*"). In *West Texas Remand*, the D.C. Circuit rejected the Board's prior standard for reopening that treated shippers and carriers differently. *See* Docket No. 41191, *West Texas Utils. Co. v. BNSF Ry. Co.* (Mar. 19, 2004). Nevertheless, several commenters have objected to the Board's proposal, arguing both that the Board ought to treat a shipper's request to reopen differently from a carrier's request to reopen and that rate prescriptions should not be vacated until after the conclusion of a re-opened proceeding. Neither

objection has merit; indeed, both fly in the face of *West Texas Remand*'s mandate to treat shippers and carriers evenhandedly.

First, Xcel Energy openly asks the Board to create a double standard that would make it easier for shippers than for carriers to reopen proceedings. See Comments of Xcel Energy at 4-5 (May 1, 2006). According to Xcel, shippers should be able to reopen cases more easily than carriers because shippers supposedly face a greater risk that reopening will lead to "the burdensome ordeal of another SAC case." *Id.* This claim is both factually incorrect and completely at odds with *West Texas Remand*. In the first place, *West Texas Remand* firmly rejected the idea that disparate treatment of shippers and carriers could be justified by "[r]eference to the[ir] relative procedural postures." 403 F.3d at 777. *West Texas Remand* was based upon the recognition that shippers and carriers are equally affected by a rate prescription and have equal interests in vacating prescriptions when circumstances change. See *id.* This principle of equal treatment may not be abandoned based on vague assertions that shippers face a greater "risk" than carriers. Moreover, Xcel's suggestion that shippers are especially burdened by a reopened SAC case is patently false; carriers and shippers are both affected by the cost of litigating a new rate complaint.¹³

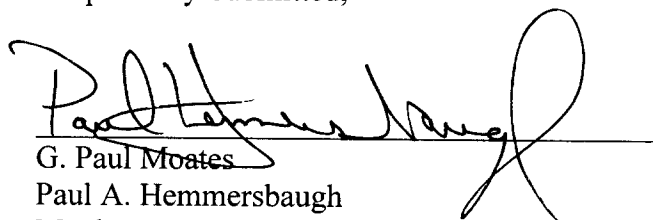
Second, some commenters object to the Board's proposal to vacate rate prescriptions upon reopening, claiming that this approach is somehow inconsistent with *Arizona Grocery Co. v. Atchison, Topeka & Santa Fe Ry. Co.*, 284 U.S. 370 (1932). See J.S. Comments at 106. This objection is based on a fundamental misunderstanding of *Arizona Grocery*, which does not limit the Board's power to alter rate prescriptions for future movements. *Arizona Grocery* held only that the ICC could not award *retroactive* reparations for shipments that had

¹³ Indeed, the Board's proposed framework for handling requests to reopen will limit new rate complaints to circumstances where a new complaint is absolutely necessary.

moved under a rate prescription previously approved by the ICC. *See Arizona Grocery*, 284 U.S. at 388-89. The Court made clear that its holding prohibited only retroactive changes to rate prescriptions, not prospective alterations. *See id.* at 389 (“[The ICC] was bound to recognize the validity of the rule of conduct prescribed by it, and not to repeal its own enactment with retroactive effect. It could repeal the order as it affected future action, and substitute a new rule of conduct as often as occasion might require.”). The Board has correctly recognized that *Arizona Grocery* has no effect on its ability to withdraw a prescription for future movements. *See NPRM* at 38; Docket No. 41185, *Arizona Pub. Serv. Co. v. BNSF Ry. Co.*, slip. op. at 6-7 (Oct. 10, 2003).

Indeed, the Board’s proposal to vacate rate prescriptions upon reopening is fully consistent with *West Texas Remand*’s mandate that shippers and carriers receive equal treatment in reopening proceedings. If a rate prescription were not vacated at the outset of a re-opened proceeding, a railroad that proves that the prescription was too low could never recover the accumulated deficit between the lower prescribed rate and the (higher) rate ultimately found reasonable. Shippers would therefore receive a windfall in any case where a prescription was eventually reduced or eliminated. The Board’s proposal would prevent such windfalls, and put each party on an equal footing.

Respectfully Submitted,

A handwritten signature in black ink, appearing to read "Paul A. Hemmersbaugh", is written over a horizontal line.

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Dated: May 31, 2006

Certificate of Service

I hereby certify that on this 31st day of May 2006, I caused a copy of the foregoing **"Joint Reply Comments of Norfolk Southern Railway Company and CSX Transportation, Inc."** to be served upon all parties on the service list for this proceeding by first class mail or more expeditious method of delivery.