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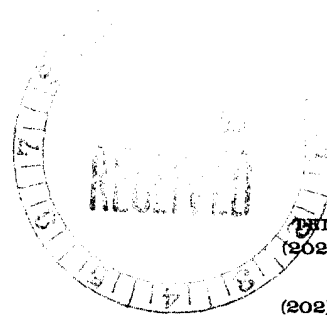
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May 31, 2006

BY HAND DELIVERY

Honorable Vernon A. Williams
Secretary
Surface Transportation Board
1925 K Street, N.W., Room 711
Washington, D.C. 20423

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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 referenced proceedings please find an original and 20 copies of the Joint Reply Comments of Western Coal Traffic League, Concerned Captive Shippers, Western Fuels Association, Inc., Edison Electric Institute, National Rural Electric Cooperative Association and American Public Power Association, along with a computer disk which contains the filing.

An additional copy of the Joint Reply Comments also is enclosed. Kindly indicate receipt and filing by time-stamping this copy and returning it to the bearer of this letter.

Thank you for your attention to this matter.

Sincerely,

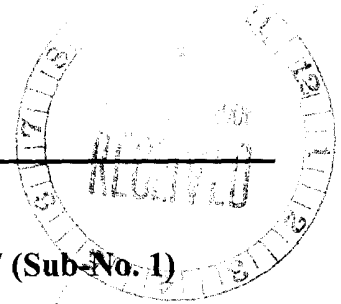
Kelvin J. Dowd

KJD:jml
Enclosure

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

MAJOR ISSUES IN RAIL RATE CASES

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



**JOINT REPLY COMMENTS
OF
WESTERN COAL TRAFFIC LEAGUE
CONCERNED CAPTIVE COAL SHIPPERS
WESTERN FUELS ASSOCIATION, INC.
EDISON ELECTRIC INSTITUTE
NATIONAL RURAL ELECTRIC COOPERATIVE ASSOCIATION
AND
AMERICAN PUBLIC POWER ASSOCIATION**

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Dated: May 31, 2006

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**BEFORE THE
SURFACE TRANSPORTATION BOARD**

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MAJOR ISSUES IN RAIL RATE CASES	)	Ex Parte No. 657 (Sub-No. 1)
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**JOINT REPLY COMMENTS
OF
WESTERN COAL TRAFFIC LEAGUE
CONCERNED CAPTIVE COAL SHIPPERS
WESTERN FUELS ASSOCIATION, INC.
EDISON ELECTRIC INSTITUTE
NATIONAL RURAL ELECTRIC COOPERATIVE ASSOCIATION
AND
AMERICAN PUBLIC POWER ASSOCIATION**

Now come the Western Coal Traffic League, the Concerned Captive Coal Shippers, Western Fuels Association, Inc., the Edison Electric Institute, the National Rural Electric Cooperative Association and the American Public Power Association (collectively, "Coal Shippers"), and submit these Joint Reply Comments in response to the Decision served on February 27, 2006 in this docket ("*Decision*"), and the opening comments filed by various parties on May 1, 2006.

A number of railroads, rail shippers, governmental entities and other interested parties filed opening comments in response to the *Decision*. For the most part, the points raised by the non-railroad parties are consistent with the positions taken by the Coal Shippers, and thus are not addressed directly in these Reply Comments. Herein, the Coal Shippers' focus principally will be on claims made and arguments raised in the

individual comments offered by three railroads – BNSF Railway Company (“BNSF”), Union Pacific Railroad Company (“UP”) and Canadian Pacific Railway Company (“CP”) – and the joint comments submitted by CSX Transportation, Inc. and Norfolk Southern Railway Company (“CSXT/NS”). On almost all of the issues raised in the *Decision*, one or more of these parties advance positions which, if adopted, would further erode or eliminate the already limited regulatory protections offered captive coal shippers from monopolistic rail pricing and market power abuse.

I. MAXIMUM RATE DETERMINATIONS

In their Joint Comments, the Coal Shippers endorsed the Board’s proposal to discontinue use of the percent reduction method of allocating surplus SARR revenues over SAC, for purposes of determining the measure of rate relief in cases brought under the Constrained Market Pricing (“CMP”) methodology. *Joint Comments* at 13-17. The Coal Shippers also explained that while the two alternatives proffered by the Board for comment¹ were a marked improvement over percent reduction, neither should be adopted as the *exclusive* methodology for allocating rate relief, and the Board should permit parties to individual cases to propose and support alternative approaches. Two in particular that the Coal Shippers advocate should be adopted are the Reasonable

¹ The two alternatives are the Maximum Contribution Method or “MCM”, and the Maximum Markup Method or “MMM”.

Allocation Method or "RAM," and the General Percent Reduction Method or "GPRM."
Id. at 22-25.²

For their part, the major coal-hauling railroads all support the retention of percent reduction, pursuant to which the rate set by a market dominant railroad in anticipation of litigation before the Board becomes a principal driver of the result of that litigation. *See BNSF Comments* at 18-45; *UP Comments* at 20-21; *CSXT/NS Comments* at 3-7. The Coal Shippers submit that the railroads' collective positions advocate retention of a regime wherein the regulated monopolist heavily influences, if not dictates, the outcome of the regulator's statutorily-mandated oversight, and should be rejected.

A. Coal is Paying its Fair Share

While as noted *infra*, UP does not devote much attention to the specifics of the Board's maximum rate proposals, UP stakes out a threshold position that railroad returns on coal are inadequate to support the infrastructure needed to handle coal traffic. *See UP Comments* at 8, 13-14. In short, UP claims that coal is not paying its fair share of railroad revenues, and on that premise rests an argument that the Board should significantly relax (if not eliminate) its regulation of captive coal rates. *Id.* at 15-19. The premise is false.

² RAM was proposed by the Complainant in Docket No. 42088, *Western Fuels Ass'n., Inc. & Basin Elec. Power Coop. v. BNSF Ry. Co.* ("Western Fuels"). GPRM was developed and presented in Docket No. 41191 (Sub-No. 1), *AEP Texas North Co. v. BNSF Ry. Co.* ("AEP Texas").

In 2004, then-Board Chairman Roger Nober led a delegation from the agency to tour Powder River Basin mine and rail facilities, together with representatives of the railroads and the coal shipping community.³ In August of that year, Chairman Nober publicly asked each of the major railroads to report their plans for meeting anticipated, higher demand for transportation service during the annual "Fall Peak" period. Both during the PRB visit and in response to the Chairman's "Fall Peak" request, the major coal-hauling railroads to varying degrees complained that their rates of return on coal were so anemic that they impaired the carriers' ability to invest in the infrastructure needed to serve that commodity sector.

In response to these complaints, the Western Coal Traffic League commissioned an analysis of the railroads' actual rates of return on coal, based on data assembled by the Board for 2001 and 2002, which at the time were the most recent available. That analysis, a copy of which is part of the public record in *Ex Parte No. 655*, showed that for the study years, the major coal railroads earned \$1.2 and \$1.4 *billion* in revenues over and above the full cost of service, which cost included a return on investment equal to the cost of capital (14.1% for 2001 and 13.7% for 2002). Since that time, railroad rates on coal and associated returns on investment have increased steadily, and the financial strength of the railroad industry has been widely recognized.⁴

³ Ex Parte No. 655, *Powder River Basin Site Visit*.

⁴ See e.g., "BNSF Experiences Record Loadings in Company's All-Time
(continued...)

The only arguably empiric support that UP offers for its claim regarding returns on coal traffic is provided by its Witness Thomas Haley, who testifies that a “straightforward analysis of UP’s revenue and cost data” shows that coal contributes considerably less on a mills per revenue ton-mile basis than other commodity groups, such as agricultural products or chemicals. *UP Comments*, V.S. Haley at 12. However, as the Coal Shippers’ Witness Thomas D. Crowley explains in his Reply Verified Statement, Mr. Haley’s “analysis” is both biased and incomplete. An accurate measure of a given commodity group’s contribution to a carrier’s bottom line is aggregate dollars. R.V.S. Crowley at 3. On an aggregate basis, the UP energy group (which is dominated by coal) ranks first among UP’s commodity groups, with a contribution of nearly \$660 million in 2004, the most recent year for which complete data is available. The next most profitable sector – chemicals – had a contribution nearly \$120 million lower than that of the energy group. *Id.* at 3-4.

When the relationship of revenues to costs is considered, coal still ranks near the top of UP’s profitability list. Using data included in Mr. Haley’s statement and information publicly available from UP’s website, Witness Crowley shows that energy ranks second among six major commodity groups in terms of the ratio of revenues to variable costs (at 137.8%, energy is surpassed only by chemicals at 146%), and produces

⁴(...continued)

Best First Quarter,” *U.S. Coal Review*, May 1, 2006 at 8; “Coal Growth Leads Norfolk Southern to First Quarter Revenue Record,” *Coal Outlook*, May 1, 2006 at 13; “CSX’s Coal Revenues, Profits Grow,” *Argus Coal Transportation*, Apr. 20, 2006 at 3.

a higher ratio than UP's total traffic base. *Id.* Clearly, coal makes a major and handsome contribution to UP's overall profitability.

UP's claims that current profit margins on western coal traffic somehow are inadequate to support capital investment in expanded capacity also are belied by the comprehensive, undeniably neutral 2003 rail infrastructure study prepared by the American Association of State Highway and Transportation Officials ("AASHTO").⁵ Among the "unique transportation corridors"⁶ analyzed in the AASHTO Study was the PRB corridor, which the study defined as extending "from the low-sulfur coal fields of the Powder River Basin in Northeastern Wyoming to the power plants throughout the Midwest and South."⁷ As is widely acknowledged, this corridor is the single largest rail market in the country,⁸ and has been marked for decades by consistent, significant growth that is expected to continue into the future. Unit train coal traffic dominates this corridor.

Surveying the western coal rail transportation market in 2003, when average rates on unit train and other utility coal shipments were lower than they are today, the

⁵ The AASHTO study is titled "Transportation – Invest in America, Freight - Rail Bottom Line Report (Jan. 2003) ("AASHTO Study"). It has been cited repeatedly as an authoritative source with respect to rail infrastructure requirements and the sources of capital to fund them. *See e.g.*, Testimony of Hon. Roger Nober before the House Committee on Transportation and Infrastructure's Subcommittee on Railroads, June 26, 2003 at 5-6.

⁶ AASHTO Study at 68.

⁷ *Id.* at 117.

⁸ *Id.*

AASHTO Study found that the profitability of coal traffic consistently supported any necessary capital investments in expanded capacity to meet demand growth:

Because of the volume and profitability of this market, there are no significant rail capacity constraints. From the building of the Powder River line, to triple-tracking where the corridor shows assets with transcontinental flows, to upgrading lines to handle 287,000-pound and 315,000 pound cars, the railroads have made the necessary investments.

AASHTO Study at 117. Equally important, the Study concluded that capacity in the PRB corridor should keep pace with traffic growth over the next twenty years, because the railroads “will remain effective at attracting, retaining, and financing unit trains business” *Id.* at 93.

Evidence from the public record, Mr. Crowley’s analysis and the AASHTO Study findings all undercut UP’s argument that coal traffic somehow is not contributing its “fair share” of the railroads’ revenue needs, and that the Board should look the other way when it comes to pricing on captive coal traffic. *UP Comments* at 13-14, 18-19.⁹

⁹ UP’s poster child for its alleged need for the Board to lift any meaningful regulatory constraints on captive coal rates is the agency’s 2001 ruling in Docket No. 42051, *Wisconsin Power & Light Co. v. Union Pac. R.R.*, Decisions served Sept. 13, 2001 and May 9, 2002 (“*Wisconsin Power & Light*”), which set a maximum rate at 180% of UP’s variable costs based on the record presented. UP claims here that the result in *Wisconsin Power & Light* “shocked UP, and it should have shocked the Board.” *UP Comments* at 16. However, the Board successfully defended its decision on appeal, and UP’s Comments in this proceeding were signed by the principal author of that decision.

**B. A Regulated Monopolist's Pricing Decisions should
Not Determine the Outcome of the Regulator's Review**

Three of the major coal-hauling railroads address the Board's proposal to replace the percent reduction formula for determining the measure of maximum rate relief.¹⁰ Each of them characterizes the Board's action as justified solely by a concern that a defendant carrier could "game" the outcome of a SAC analysis under percent reduction by establishing an artificially high common carrier rate in anticipation of a prospective challenge, thereby ensuring that it ends up with a rate that it would have been pleased to charge in the first place. *See, e.g., BNSF Comments* at 42.

CSXT/NS argue that because no instance of actual, intentional "gaming" by a defendant in a rate case has been proved, the concern cited by the Board¹¹ is purely hypothetical, and thus cannot support a change in the method for determining the measure of rate relief. *See CSXT/NS Comments* at 3-4. BNSF adds that if the Board is concerned about gaming, it should adopt an identifying test under which any challenged rate that is "commercially sustainable" – as defined by BNSF's Witness Gaskins – would be presumed *not* to have been set in order to influence the outcome of the case, and therefore

¹⁰ BNSF and CSXT/NS discuss the Board's proposal in varying degrees of detail. UP briefly registers a concern that aspects of MCM and MMM as substitutes for percent reduction bear resemblance to approaches previously considered and rejected by the Board's predecessor. *UP Comments* at 20. However, the carrier then states that it "reserves judgment" on the issue until it considers the comments of others. *Id.* at 21.

¹¹ *See, e.g., Decision* at 7-8.

could be used as the starting point to determine the outcome of that case. *BNSF*

Comments at 43.

It is perhaps unfortunate that a term such as “gaming” has come to be used to frame one of the flaws in the percent reduction method, for it allows the inappropriate introduction of questions of subjective, specific intent or malevolent motivation, and with them an implicit burden of proof which may be impossible to meet. *See, e.g.,* Docket No. 42072, *Carolina Power & Light Co. v. Norfolk S. Ry. Co.*, Decision served Dec. 22, 2003 (“*CP&L*”) at 31-32. In the Coal Shippers’ view, such a line of inquiry misses the true mark. The problem with percent reduction is not that it invites market dominant carriers to act with bad intent. The problem simply is that, by applying a method in which the rate chosen by the monopolist dictates the maximum rate level, the Board effectively has ceded its core responsibility under 49 U.S.C. § 10701(d)(1) to the railroads, and does not fulfill its statutory mandate to engage in “meaningful rate regulation.”¹²

BNSF wrongly asserts that allowing the carrier-established rate to determine the outcome of the rate proceeding is consistent with “a railroad’s statutory right to set rates of its own choosing in the first instance,” and that under the statute “it is expected to set a profit maximizing rate in response to demand.” *BNSF Comments* at 43. In fact, a railroad’s right to “establish any rate for transportation” (49 U.S.C. § 10701(c))

¹² *Farmers Union Cent. Exch. Inc. v. FERC*, 737 F. 2d 1486, 1507 (D.C. Cir. 1984).

is specifically limited by the following section, which provides that in the event market dominance exists, “the rate established by such carrier . . . must be reasonable” (49 U.S.C. §10701(d)(1)). The governing statute says nothing about a “profit maximizing rate,” and nothing in the Board’s statutory charge to determine the reasonableness of rates on market dominant traffic compels a method under which the higher the rate set by the defendant, the higher the resulting maximum “reasonable” level.

BNSF’s proposed test for “commercial sustainability,” that is, the rate level that it says presumptively should be the starting point for the Board’s rate analysis under the percent reduction method, confirms that securing this sort of power over the outcome of the rate reasonableness process is precisely BNSF’s intent. BNSF and its Witness Gaskins argue that so long as a rail rate “does not affect the dispatching of an electric generating facility” it should be considered commercially sustainable, and valid as a benchmark for determining the maximum rate level for the movement in question. *BNSF Comments* at 11; V.S. Gaskins at 2-6. In effect, BNSF is advocating a rate standard predicated on “what the traffic will bear,” a premise repeatedly (and properly) rejected as a valid regulatory model.¹³ *See Increased Rates and Charges, 1978, Nationwide, 365*

¹³ In the text of its Comments, BNSF is careful to acknowledge that a “commercially sustainable” rate still could exceed a reasonable maximum. *BNSF Comments* at 11. Its Witness Gaskins, however, paints with a broader brush, and characterizes such rates as the “maximum coal transportation rates based on Ramsey Pricing Principles.” V.S. Gaskins at 2. In the case of one study movement, the movement at issue in Docket No. 42047, *Public Serv. Co. of Colo. d/b/a/ Xcel Energy v. BNSF Ry. Co.*, Decision served June 8, 2004 (“*Xcel*”), Dr. Gaskins concludes that the maximum rate prescribed by the Board in that decision actually could more than double, (continued...)

I.C.C. 14, 16 (1981).

In his Reply Verified Statement, the Coal Shippers' witness, Professor George H. Borts, explains how such a complete expropriation of all available economic rents is proof positive that a railroad is engaging in unrestrained monopoly pricing, and hardly can serve as a proper regulatory measure of rate *reasonableness* under 49 U.S.C. § 10701 and the National Rail Transportation Policy. *See* R.V.S. Borts at 2-5. Additionally, however, the theory is unsustainable as a matter of law, as its fundamental underpinning was squarely rejected by the D. C. Circuit twenty years ago.

In 1983, the ICC issued a decision which purported to exempt from regulation all rail shipments of coal bound for export.¹⁴ The heart of the ICC's ruling was a finding that the continued regulation of rail rates on export coal was not necessary to protect shippers from abuse of railroad market power, the standard for granting exemptions which remains in place today. *See* 49 U.S.C. §10502(a); 367 I.C.C. at 587-96. Such abuse would not occur, the ICC found, because railroads could and would set rates on export coal movements over which they held market power at levels which ensured the continued production of U.S. coal for export, by maintaining delivered prices at or below the strike price set by world markets. *Id.* at 592. On review, the Court of Appeals summarized the ICC's reasoning thusly:

¹³(...continued)
and still not reach his "Ramsey" level.

¹⁴ *Railroad Exemption – Export Coal*, 367 I.C.C. 570 (1983).

In other words, so long as coal shippers are not forced to reduce production (*i.e.*, so long as the rail rate leaves them a share of the revenue that covers their costs, including their costs of capital) and so long as they are not wholly excluded from any economic rents above that level, their rate is “reasonable” and there is no “abuse of market power.”

Coal Exporters Ass’n v. United States, 745 F.2d 76, 95 (D.C. Cir 1984) (quotation marks in original). One need only substitute rates that “knock the generating unit out of dispatch”¹⁵ for rates that “reduce American coal production,”¹⁶ and the Court’s summary neatly describes the BNSF/Gaskins theory as well. As the Court observed, a key characteristic of the theory is that “it views the distribution of economic rents between carriers with market power and shippers to be largely a matter of regulatory indifference,”¹⁷ so long as the transportation rate “would not displace”¹⁸ the shipper/seller’s product in its market.

After distilling the ICC’s export coal exemption theory, the Court of Appeals rejected it as contrary to the Staggers Act’s mandate that the agency *balance* the interests of market dominant railroads and their captive customers:

We vacate the Commission’s exemption decision because the stated standard is a wholly unreasonable construction of the Staggers Act’s accommodation between shipper and carrier interests . . . [I]t is clear that Congress did intend for the concept to embody certain considerations, and that the

¹⁵ V.S. Gaskins at 3.

¹⁶ 367 I.C.C. at 592.

¹⁷ 745 F.2d at 95.

¹⁸ V.S. Gaskins at 2.

division of revenues between monopolistic carriers and shippers (even when the shipper is still able to fully recover its costs) was certainly not a matter of regulatory indifference.

745 F.2d at 95-96. As Dr. Borts explains, the rate policy that BNSF's Witness Gaskins characterizes as "consistent with sound business"¹⁹ actually describes a regulatory regime in which the regulated monopolist – not the regulator – determines the balance of interests between the monopolist and its dependent customers. R.V.S. Borts at 4-5. The Court of Appeals' analysis and conclusion in *Coal Exporters* are equally applicable and dispositive here:

The rate reasonableness provision of Section 10101a(6) and the "abuse of market power" provision of Section 10505(a)(2)(B) should be read as reflecting the policies of the statutory scheme of which they are a part. It is unreasonable to view a statutory scheme that allows shippers to complain that a market dominant carrier is charging rates that unnecessarily generate excessive profits as being indifferent concerning the distribution of economic rents between monopolistic carriers and their captive shippers. Similarly, such an indifference seems incompatible with a scheme that allows a shipper to complain that its higher rate is unjustified because necessary carrier revenues could be more equitably generated elsewhere on the carrier's system.

745 F.2d at 98.

C. MCM and MMM are Superior to the Percent Reduction Method

In their Opening Comments, the Coal Shippers explained that while MCM and MMM were not optimal approaches to the issue of maximum rate determinations,

¹⁹ V.S. Gaskins at 5.

and should not be adopted as the exclusive methodologies to be used, they were superior to percent reduction from the standpoint of consistency with Ramsey Pricing principles and avoidance of the obvious problem of the regulated entity controlling the outcome of the regulatory process. *Joint Comments* at 17-24.

To varying degrees, the major railroads support the retention of the percent reduction method, and are critical of MCM and MMM. As discussed immediately below, these criticisms are centered around a few, specific arguments. Their single, common defense of percent reduction, however, is no defense at all: in the carriers' view, percent reduction simply yields higher rates.

BNSF and CSXT/NS argue that any methodological change that could result in lower maximum rates in certain circumstances than would occur under percent reduction cannot be considered. BNSF asserts that such a change would "drive railroads farther from revenue adequacy by reducing the revenues earned on demand-inelastic traffic,"²⁰ while CSXT/NS suggest that shippers might be emboldened by more meaningful regulation and less likely to readily accept railroad settlement offers. *CSXT/NS Comments* at 5. However, revenue inadequacy (as currently defined by the Board) has never provided a legitimate justification for unreasonable rates,²¹ and nothing

²⁰ *BNSF Comments* at 39.

²¹ *Coal Rate Guidelines, Nationwide*, 1 I.C.C. 2d 520, 536 (1985), *aff'd sub nom.*, *Consolidated Rail Corp. v. United States*, 812 F.2d 1444 (3rd Cir. 1987) ("*Guidelines*"). Separately, UP argues that because the Board found in *Ex Parte No. 347 (Sub-No. 2)* that UP would be revenue adequate if its rates on presumptively captive
(continued...)

is less conducive to negotiated settlements than percent reduction, which precludes a shipper from being able to calculate a SAC-based rate until litigation begins, and encourages “take it or leave it” railroad positions since the carriers’ pricing controls the regulatory answer.

All of the major railroads take the position that MCM and MMM are too close in design and effect to the “ton/ton-mile” and “ratio” methods of allocating constant costs that the Board’s predecessor declined to accept during its original formulation of the *Guidelines*.²² *UP Comments* at 20; *CSXT/NS Comments* at 6; *BNSF Comments* at 33-34. However, there are key distinctions which favor MCM and MMM as valid replacements for percent reduction. The earlier approaches focused on setting the maximum rates by allocating the *defendant’s* fixed and common costs, without regard to relative demand elasticities or the defendant’s existing rate structure. By contrast, MCM and MMM are

²¹(...continued)

traffic were set at 274% of variable costs on average (the “RSAM” level), a regulatory structure that could produce lower rates (*e.g.*, rates at the 180% jurisdictional threshold) is *per se* improper. *UP Comments* at 18. However, the Board has never used RSAM percentages to set maximum coal rates, and Congress specifically intended that railroads increase revenues by eliminating unprofitable traffic and maximizing returns on competitive traffic, not by exploiting captive shippers. *Coal Exporters Ass’n.*, 745 F.2d at 97-98; *Arkansas Power & Light Co. – Petition to Institute Rulemaking*, 365 I.C.C. 983, 988 (1982). Additionally, a key component of the definition of revenue adequacy references “honest, economical, and efficient management.” 49 U.S.C. §10704(a)(2). To date, neither the Board or its predecessor has undertaken to audit and/or monitor the railroads’ management practices and decisions in an effort to determine the extent to which “inadequate” revenues are attributable to such practices or decisions. The Coal Shippers submit that, unless and until the Board does so, it should not countenance a railroad’s assertion of revenue inadequacy as a justification for captive rate levels.

²² See *Guidelines*, 1 I.C.C. 2d at 523-26.

allocating SAC; that is, the maximum allowable revenue that could be collected from a designated traffic group by a hypothetical, optimally efficient competitor of the defendant. Moreover, the allocation takes place within the context of the defendant's existing rate structure (for the group in question), and respects relative elasticities of demand by assigning a proportionally greater revenue burden to the most demand-inelastic traffic, as determined by reference to revenues derived from the defendant's own rates.

The latter point also answers the arguments leveled by BNSF and CSXT/NS that MCM and MMM do not permit differential pricing and fail to respect a carrier's right to set rates based on elasticity of demand. *BNSF Comments* at 31-36; *CSXT/NS Comments* at 6-7. MCM and MMM are not rate reduction methodologies, as such. Rather, they "build" SAC-based rates from the ground up, using the defendant's rate structure as a measuring tool. To the extent that the revenues actually received by the defendant from a member of the traffic group are lower than its allocable share of the SARR's revenue requirement,²³ the higher demand elasticity reflected by those revenues likewise is reflected in the revenue allocation, as the excess revenue requirement is pushed "upstream" and assigned to higher-rated (and, therefore, presumptively less demand-elastic) traffic. *See R.V.S. Borts* at 1-2.

²³ It bears noting that the SARR revenue requirement is calculated at the full revenue adequacy level.

BNSF wrongly claims that MCM and MMM would violate the statutory policy that “competition and the demand for services” should be relied on to establish reasonable rates. 49 U.S.C. § 10101(1). *BNSF Comments* at 37-39. Competition is not a factor in this debate, as the Board’s proposal is addressed solely to the regulation of rates on market dominant traffic. And as noted above, MCM and MMM do reflect varying demands for service – at least to the same extent that the defendant’s rate structure does – as they assign a greater SARR revenue burden to the highest-rated, most demand-inelastic traffic. BNSF’s real objection is that MCM and MMM do not *start* with the carrier-established challenged rates, as percent reduction does, and thus take control of the regulatory outcome away from the regulated monopolist and return it to the regulator, where it belongs.

Finally, the fact that MCM and MMM in some cases would produce maximum rates consistent with the defendant’s calculated revenue levels (*i.e.*, leave lower-rated traffic unaffected) is not a flaw in the methodologies, as BNSF and CSXT/NS suggest, but is consistent both with the governing statute and with Ramsey principles. As the Board’s predecessor acknowledged in *Guidelines*, 49 U.S.C. § 10701(d)(2) obligates the agency to consider whether a carrier is maximizing revenues from lower-rated traffic before endorsing higher rates on less demand-elastic traffic.²⁴ It is entirely in keeping with that mandate that the Board’s methodology would keep unchanged a carrier-established rate that presumably is making a maximum contribution (based on the

²⁴ *Guidelines*, 1 I.C.C. 2d at 540-42.

movement's demand elasticity), but still cannot absorb a full allocation of SARR revenue requirements. Likewise, Ramsey Pricing principles support such an outcome, as it minimizes disruption of the existing rate structure, and limits the extent to which prices on demand-inelastic traffic must deviate from marginal costs in order to meet the SARR's revenue needs.²⁵ Cf. *Burlington N. R.R. Co. v. United States*, 984 F.2d 589, 598 (D.C. Cir. 1993).

D. BNSF's Proposed Methodology Violates the *Guidelines* and should Be Rejected

BNSF closes the portion of its comments addressing the issue of maximum rate determinations with a pitch for broad adoption of what it calls a "contestability pricing" approach to the establishment of maximum rates on captive coal traffic. *BNSF Comments* at 47. The core of this approach, which is sponsored by BNSF's Witness Kalt and also was promoted by BNSF in *Western Fuels*, is limiting the revenue available to the SARR from cross-over traffic to the incumbent's avoidable cost of handling that traffic. See, e.g., *BNSF Comments*, V.S. Kalt at 39-40.

²⁵ Nor is it improper that a complete allocation of SARR revenues under MCM or MMM might leave shippers at the highest end of the rate scale with more comparable rates than is the case under the defendant's current rate structure. A principal justification for differential pricing is the goal of revenue adequacy. Once a railroad eliminates any shortfall, CMP holds that further differential pricing is unnecessary and improper. *Guidelines*, 1 I.C.C. 2d at 539. A SARR by definition is revenue adequate. Once its revenue requirements are fully allocated, no further rate increases are imposed. The fact that some shippers in the traffic group might have some unused "tolerance" for further differential pricing (which the defendant used, but the SARR does not need) is of no consequence.

As the Coal Shippers explain in detail in Part II, *infra*, the BNSF/Kalt cross-over divisions methodology (like its UP counterpart) is squarely in conflict with one of the key principles of contestability as applied under the *Guidelines*: a SARR is deemed to be a *replacement* for the incumbent, not a competitor exposed to retaliatory pricing actions. *McCarty Farms Inc. v. Burlington N. Inc.*, 2 S.T.B. 460, 472 (1997); *West Texas Utils. Co. v. Burlington N. R.R. Co.*, 1 S.T.B. 638, 670 (1996); *Bituminous Coal – Hiawatha, Utah to Moapa, Nevada*, 10 I.C.C. 2d 259, 267 (1994) (“*Nevada Power II*”).²⁶ It is equally defective as a maximum rate determination methodology, because the end result is an allocation of all unattributable SARR costs to the issue traffic and any other traffic served by the SARR from origin to destination. Contrary to basic SAC theory and real-world practices, interchanged or cross-over traffic²⁷ would make no contribution whatsoever.

Whether cast in the context of cross-over revenue divisions or maximum rate determinations, the BNSF/Kalt “contestability pricing” model is but a euphemism for unrestrained monopoly pricing on captive coal traffic. As it has repeatedly done in the past, the Board should reject it.

²⁶ See also, Baumol, Danzar and Willig, *Contestable Markets and the Theory of Industry Structure* at 5 (Rev. Ed. 1988).

²⁷ In their steady campaign against this settled feature of SAC analyses, the railroads continuously refer to cross-over traffic in terms that suggest it is some sort of alien construct with no counterpart in real-world railroading. In truth, however, cross-over traffic is the functional equivalent of through traffic interchanged between two carriers, which of course is a staple of real-world rail transportation.

II. REVENUE DIVISIONS ON CROSS-OVER TRAFFIC

In their Joint Comments, the Coal Shippers urged the Board to continue to apply the Modified Straight Mileage Prorate ("MSP") or Modified Mileage Prorate ("MMP") methods to set divisions on cross-over traffic. These methods properly set cross-over traffic divisions on the basis of pertinent market and cost factors, and they have been used to set cross-over traffic divisions in the last *ten* STB maximum rate decisions involving cross-over traffic.²⁸

As discussed below, the burden is on a party proposing a new SARR divisions approach to show that its approach is superior to MSP/MMP. The same holds true for Board-proposed alternatives to MSP/MMP. The Board and the railroads have both failed this test.

The Coal Shippers demonstrated in their Joint Comments that the Board's new proposed SARR divisions methodology – the Average Total Cost ("ATC") method – was fatally flawed and clearly not superior to MSP. *See Joint Comments* at 48-53. Opening comments submitted by the railroads confirm the Coal Shippers' showing that ATC is not a viable alternative to MSP. Similarly, the two railroad-proposed alternatives to MSP/MMP are fatally flawed, and are clearly not superior to MSP. Both BNSF and UP propose to set SARR divisions at the incumbent carriers' avoidable variable costs for replicating the SARR service. These approaches were properly rejected in *Nevada Power II*, and should not be resurrected here.

²⁸ *See Joint Comments* at 32-33, 47-48.

A. The Burden is on the Board and the Railroads to Develop Superior Alternatives to MSP

Prior to the institution of the instant proceeding, the Board consistently and correctly acknowledged that “[t]he modified mileage proration process is an accepted and widely used tool for apportioning revenues between carriers.” Docket No. 42054, *PPL Montana, LLC v. Burlington N. and Santa Fe Ry. Co.*, Decision served Nov. 27, 2001 at 6 n.18. The Board also maintained that any party proposing to calculate cross-over traffic divisions using new methods had to prove that the new methods were superior to MSP, because the “norm of regularity” of administrative practice is presumably “best carried out if the settled rule is adhered to.”²⁹ As argued by Board counsel in defense of the decision in *Xcel*:

In [the *Xcel*] proceeding, while Xcel asked the Board to follow precedent by using the MSP method of allocating revenues from cross-over traffic, BNSF criticized MSP. . . . BNSF argued [for an] alternative method The burden was on BNSF to make a convincing showing that its alternative approach was superior to the general approach the agency had used since 1994, as there is a “norm of regularity” in government conduct that presumed an agency’s duties are “best carried out if the settled rule is adhered to.”

Id.

The same principles hold true for Board-sponsored alternatives to MSP/MMP. Where, as here, the Board has proposed a new methodology to replace

²⁹ *BNSF Ry. Co. v. STB and United States*, D.C. Cir. 05-1030, Joint Brief of Respondents, July 21, 2005 at 52.

MSP/MMP, the Board must demonstrate that its proposals are superior.

**B. Railroad Comments Confirm that the
ATC Divisions Method is not Superior to MSP**

In their Joint Comments, the Coal Shippers proved the ATC is fatally flawed because, among other things, it does not address relevant market factors and it arbitrarily allocates fixed costs.³⁰ On the latter point, the Coal Shippers explained:

The Board's ATC method attempts to allocate a defendant carrier's total system costs to a particular shipper's traffic. Significantly, the Board does not address the long-held, fundamental principle of railroad costing that fixed costs cannot be rationally allocated to particular customers on a cost of service basis. . .

Similarly, the ICC held in the *Guidelines* that "[t]he differential between marginal costs and average costs cannot be assigned to specific movements by any conventional accounting methodology." 1 I.C.C. 2d at 526. And the ICC went on to hold that "[a]ny means of allocating these costs among shippers other than actual market demand is arbitrary" *Id.* The fundamental purpose of the *Guidelines* was to develop maximum rate constraints that were not dependent on arbitrary cost-based allocations of carrier fixed costs. The ATC method – or any other strictly "cost-based" divisions methodology – reinsterts into the SAC process the very problem the ICC was attempting to eliminate – the use of arbitrary cost formulas to allocate constant costs.

Id. at 52-53 (footnotes omitted).

³⁰ See *Joint Comments* at 48-53.

No railroad commentor espouses a position in conflict with the Coal Shippers' demonstration that the ATC method arbitrarily allocates fixed costs. Indeed, UP makes the very same point in its Comments. UP rejects the Board's proposed ATC method as "fundamentally flawed"³¹ because "there is no experiment capable of revealing the fixed costs associated with an individual traffic movement."³² UP goes on to conclude:

The Board's ATC proposal introduces into the maximum rate determination process the same type of arbitrary, economically unprincipled approach that courts have repeatedly rejected. It would in substance decree that a carrier's revenues in excess of variable cost be treated as allocable to discrete segments, and then test the reasonableness of the carrier's rates based in significant part on precisely that allocation, asking whether the allocated contribution exceeds the calculated fixed costs on the discrete segments. This approach deviates fundamentally from the basic principles of CMP.

UP Comments at 25.

The other railroad commentors do not claim that fixed costs can be fairly allocated to specific traffic movements on a cost-of-service basis. Instead, they offer, at best, only tepid support for ATC. See *CSXT/NS Comments* at 8 (ATC is "less than ideal"); *BNSF Comments* at 14 (ATC "has the potential for introducing significant bias

³¹ *UP Comments* at 23.

³² *UP Comments*, V.S. Neels at 3.

into SAC results”).

**C. Railroad-Sponsored Divisions
Methodologies are not Superior to MSP**

UP asks the Board to set divisions on cross-over traffic using what it calls the Efficient Component Pricing (“ECP”) Rule. BNSF proposes an “avoided cost” method to set divisions. While bearing different names, both proposals call for the establishment of a SARR division equal to the incumbent carrier’s avoided variable costs of providing the service replicated by the SARR.³³

**1. UP’s Divisions Proposals Properly were Rejected
In *Nevada Power II* and Subsequent Decisions**

In *Nevada Power II*, the ICC considered and rejected UP’s proposal to use the ECP Rule to set a SARR division at the incumbent carrier’s avoided variable costs. The ICC observed that UP’s divisions proposal was predicated on a theory that the incumbent carrier and the SARR would compete for the SARR’s business, with the resulting competition driving the SARR’s division down to levels that approximated UP’s avoidable costs. 10 I.C.C. 2d at 266. The ICC correctly rejected this theory as inconsistent with basic principles of contestability theory upon which the SAC test is based. *See id.*; *see also* R.V.S. Borts at 6-11.

³³ *See BNSF Comments*, V.S. Kalt at 48 (recommending adoption of “[an] URCS-based measure of avoidable costs”); *UP Comments* at 30 (under the ECP test, a SARR’s division should be set at “the incumbent’s variable cost avoided as a result of the SARR’s operation”).

Contestability theory is predicated upon a potential entrant evaluating “the profitability of entry at the incumbent firms’ pre-entry prices” without “fear of retaliatory price alterations” by the incumbent.³⁴ The ICC correctly held in *Nevada Power II* that UP’s proposal specifically assumed a competitive response from the incumbent – “price retaliation” – in direct contradiction of contestable market principles. 10 I.C.C. 2d at 265-66. The ICC went on to hold that a SARR is properly viewed as a replacement for, not a competitor of, the incumbent carrier. *Id.* at 267.

The ICC also held in *Nevada Power II* that setting SARR divisions at avoided or variable cost levels would produce SARR divisions that were too low. As the ICC observed, variable cost divisions produce “only a minimal contribution to the [SARR’s] joint and common costs” and, as a practical matter, “a potential entrant will shun a market where price retaliation by the incumbent reduces revenue before the entrant has a chance to recoup its costs.” *Id.* at 266 (internal quotation marks omitted). The ICC also correctly concluded that setting rate divisions at these low levels would prevent a SARR from earning revenue in excess of its costs, thus perpetrating the incumbent carrier’s “hold ... over captive market[s].” *Id.*

The ICC and the Board adhered to these principles in decisions following *Nevada Power II*. For example, in *McCarty Farms* the STB rejected BNSF’s proposal to set SARR divisions using the same ECP rule that UP advocated in *Nevada Power II*. *McCarty Farms*, 2 S.T.B. at 471. Likewise, the STB consistently has ruled in post-

³⁴ See *Contestable Markets* at 5, 349.

Nevada Power II decisions that a SARR is properly viewed as a replacement for, not a competitor of, the incumbent carrier. See, e.g. *McCarty Farms*, 2 S.T.B. at 472; *West Texas Utils. Co.*, 1 S.T.B. at 670; see also Docket No. 42058, *Arizona Elec. Power Coop., Inc. v. The Burlington N. and Santa Fe Ry. Co. and Union Pac. R.R. Co.* (“*AEPCO*”), Decision served Aug. 20, 2002 at 2.

The Board’s post-*Nevada Power II* decisions also have rejected carrier-sponsored divisions proposals which would set SARR divisions at variable cost levels. For example, the Board observed that setting SARR cross-over divisions “down close to variable cost levels” would require that non-cross-over traffic “bear[] most of the fixed cost of the [SARR]” and “[t]he end result would deprive each complainant shipper of the benefit of grouping traffic (*i.e.*, realizing the economies of scale, scope and density) held out to them in *Guidelines*.” Docket No. 42096, *Duke Energy Corp. v. Norfolk S. Ry. Co.*, Decision served Nov. 6, 2003 (“*Duke/NS*”) at 18-19.

2. BNSF’s Divisions Proposals also Violate *Nevada Power II* and its Progeny

BNSF presents the same avoidable cost divisions methodology it proposed in *Western Fuels*, and asserts that its methodology is consistent with “contestability theory.” *BNSF Comments* at 12-14. According to BNSF, “contestability theory” holds that a SARR should be viewed as a competitor to the incumbent railroad – *i.e.*, both serve the same market and compete with each other. Under this contestability scenario, BNSF posits that a SARR, and the incumbent, would compete for the SARR customers by “shouting out” rate offers until BNSF shouted out its final offer – providing the service at

its avoidable variable costs. This final offer, under BNSF's theory, sets the SARR's division. *See BNSF Comments*, V.S. Kalt at 37-46.

As discussed in detail in the Complainants' evidence submitted in *Western Fuels*, BNSF's proposed avoidable cost methodology suffers from exactly the same defect that led the Board to reject UP's ECP method in *Nevada Power II* – BNSF's avoidable cost method, like UP's ECP method, assumes that the SARR and the residual incumbent compete for the SARR business, with the resulting competition producing SARR divisions at the incumbent's variable costs (or subset thereof) to replicate SARR service.³⁵ This assumption, however, directly conflicts with governing contestability principles that expressly preclude "retaliatory price alterations" by the incumbent carrier. *Nevada Power II*, 10 I.C.C. 2d at 266; *Contestable Markets* at 349; *see also* R.V.S. Borts at 6-7.

Also, the end result of BNSF's avoidable cost method – setting SARR divisions at variable cost levels – will doom virtually all SARRs, since invariably SARR revenues will not exceed SARR costs when SARR divisions are set at variable cost levels. *See Nevada Power II*, 10 I.C.C. 2d at 266; *Duke/NS* at 18-19.

3. The STB should Adhere to the Revenue Division Principles Set Forth in *Nevada Power II*

Both UP and BNSF admit that their proposals to set SARR divisions at avoidable variable costs were rejected in *Nevada Power II*. BNSF and UP proceed to

³⁵ *See* WFA/Basin Opening Comments at Exhibit 2B, pp. III-A-32 to 41.

present conflicting contentions as why *Nevada Power II* should be overruled. None of these contentions have any merit.

(a) UP's Contrary Arguments are Wrong

UP acknowledges that the ICC rejected its ECP variable cost divisions approach in *Nevada Power II*, on grounds that the incumbent and the SARR should not be viewed as competitors for the SARR traffic. *UP Comments* at 31. In this proceeding, UP claims to have solved the *Nevada Power II* problem. According to UP, its current ECP variable cost division proposal “assumes no competitive response” from the incumbent. *Id.* at 31. However, this assertion directly conflicts with the testimony given by its principal economic witness – Kevin Neels. *See* R.V.S. Borts at 6-7.

UP Witness Neels provides “economic theory” supporting UP’s ECP variable cost divisions proposal. *UP Comments*, V.S. Neels at 16. According to Witness Neels, UP’s ECP proposal is predicated on a *competition* between the incumbent carrier (providing origin-to-destination service for cross-over traffic) and the incumbent SARR/residual incumbent (providing origin-to-destination service for cross-over traffic). *Id.* (“The incumbent will have an incentive to interchange traffic with the SARR if and only if the amount of the total end-to-end revenue that it pays to the SARR is less than the cost it would incur were it to carry the traffic itself. In a contestable market there would be nothing to prevent the incumbent from offering such end-to-end service.”). The current edition of ECP is just as flawed as the one rejected in *Nevada Power II*.

(b) BNSF's Contrary Arguments are Wrong

BNSF also concedes that setting SARR divisions at the incumbent's variable cost levels was rejected in *Nevada Power II*. However, BNSF argues that the Board should no longer follow *Nevada Power II*. None of its offered reasons has any merit:

(i) BNSF argues that the Board may wish to revisit *Nevada Power II* because “[i]t is reasonable to infer that at the time it rendered *Nevada Power*, the ICC did not anticipate that shippers would make such extensive use of cross-over traffic.”³⁶ BNSF's contentions here are belied by the facts in *Nevada Power II*, where cross-over traffic dominated the SARR. See *Nevada Power II*, 10 I.C.C. 2d at 265 (“cross-over traffic represents approximately 60% of the traffic in the [Nevada Power SARR]”).

(ii) BNSF argues that the Board should revisit *Nevada Power II* because UP did not appeal the *Nevada Power II* decision. BNSF's reply states in pertinent part:

because Union Pacific prevailed in the *Nevada Power* proceeding, it had no opportunity to appeal the ICC's decision that (1) permitted cross-over traffic, (2) employed a modified mileage prorate in estimating divisions on cross-over traffic, and (3) rejected Union Pacific's testimony on the application of contestability principles as the basis for establishing revenue divisions on cross-over traffic.

BNSF Comments, V.S. Kalt at 47.

³⁶ *BNSF Comments*, V.S. Kalt at 46.

While it is true that UP did not appeal *Nevada Power II*, UP has had the opportunity to address SARR cross-over traffic revenue divisions issues in two post-*Nevada Power II* cases – Docket No. 42022, *FMC Wyoming Corp. v. Union Pac. R.R. Co.*, Decision served May 12, 2000 (“*FMC*”), and *Wisconsin Power & Light*. In *Wisconsin Power & Light*, UP accepted, without contention, the use of the Board’s MMP methodology to set SARR divisions.³⁷ In *FMC*, UP asked the Board to apply a modified MMP methodology that relied on both market and cost factors to set SARR divisions.³⁸

(iii) BNSF maintains the ICC was wrong in concluding that setting SARR divisions at the incumbent’s variable costs for the service “would allow for only a minimal contribution to [the SARRs] joint and common costs.”³⁹ BNSF’s argument is absurd. UP candidly “*admitt[ed]*” in *Nevada Power II* that setting SARR divisions at the incumbent’s variable costs “would allow for only a minimal contribution to [the Nevada Power SARR’s] joint and common costs.” *Nevada Power II*, 10 I.C.C.2d at 266.

(iv) BNSF cites a reference in the *Guidelines* calling for potential modifications to the *Guidelines* to make the *Guidelines* “workable.”⁴⁰ However, it was clear in *Nevada Power II* – and has been clear ever since – that presuming a SARR to be a competitor of the incumbent, and setting SARR divisions at the incumbent’s variable

³⁷ See *Wisconsin Power & Light* at 24.

³⁸ See *FMC* at 30-31.

³⁹ See *BNSF Comments*, V.S. Kalt at 47 (quoting *Nevada Power II*, 10 I.C.C. 2d at 266).

⁴⁰ *Id.* at 47 (quoting *Guidelines*, 1 I.C.C. 2d at 525).

costs, would make the *Guidelines* fully unworkable.

The Board has urged parties to SAC cases not to reargue settled issues unless they can present new evidence or arguments:

the parties to SAC cases are cautioned not to attempt to relitigate issues that have been resolved in prior cases. Unless new evidence or different arguments are presented, we will adhere to precedent established in prior cases.⁴¹

BNSF presents no new arguments or evidence here – it simply repeats arguments that the ICC and the Board consistently have rejected in *Nevada Power II* and subsequent cases.

III. THE INDEXING OF SARR OPERATING EXPENSES

In the *Decision*, the Board proposed a limited amelioration of the acknowledged flaw in its current methodology for indexing SARR operating costs. Specifically, the Board proposed to index SARR operating costs using a hybrid of the RCAF-U and RCAF-A, “starting with RCAF-U and phasing in the productivity gains projected in RCAF-A incrementally over 20 years.” *Decision* at 21.

In their Joint Comments, the Coal Shippers explained that the Board’s proposal was a welcome – albeit insufficient – step toward the correction of the improper disparity between the manner in which the Board indexes SARR operating expenses and the manner in which the Board forecasts SARR revenues. *Joint Comments* at 69. This

⁴¹ See Ex Parte No. 347 (Sub-No. 3), *General Procedures for Presenting Evidence in Stand-Alone Coal Rate Cases*, Decision served Mar. 12, 2004 at 6.

disparity, which shippers have addressed on a number of occasions, ensures that a SARR ultimately will be driven towards bankruptcy, with its costs increasing at a faster pace than its revenues. There is no legal, economic, or logical basis for insisting that a SARR – a least-cost, efficient carrier – should be dragged inexorably towards net operating losses when incumbent carriers do not face such a predicament. The Board’s recent refusals to allow productivity to be considered when indexing SARR operating costs functioned as an improper barrier to rate relief for captive shippers, in violation of the National Rail Transportation Policy. *See* 49 U.S.C. § 10101(6) (“In regulating the railroad industry, it is the policy of the United States Government – . . . (6) to maintain reasonable rates where there is an absence of effective competition . . .”).

Under the Board’s proposal, a SARR would continue to experience a significant reduction in its profitability as a result of the inconsistencies between SARR cost indexing and SARR revenue forecasting. As the Coal Shippers explained in their Joint Comments, the net effect of the Board’s proposal to employ a hybrid index would be to limit SARRs to a 55% RCAF-U/45% RCAF-A split in the final year of the DCF period, thereby affording SARRs the benefit of less than 25% of the RCAF-A in nominal terms. *Joint Comments* at 72. The Coal Shippers also documented the many efforts being undertaken by rail carriers to improve their efficiency, and explained that such efficiency enhancements would be equally available to SARRs. *Id.* at 74 to 84. The expert witnesses submitting testimony on behalf of the Coal Shippers described the sources of productivity growth, and demonstrated that the two assumptions on which the

Board's proposal were based (*i.e.*, no SARR productivity at the outset of the DCF model and industry-equivalent productivity achieved only at the end of twenty years) were unfounded.

On the basis of this evidence, the Coal Shippers proposed that the Board modify its proposal to utilize 50% of the RCAF-A and 50% of the RCAF-U to index SARR operating expenses, beginning at the start of the DCF model, and then steadily increase the share of the RCAF-A used for this indexing until reaching 100% of the RCAF-A at the end of Year 10, the new DCF period proposed by the Board in its *Decision*.

Despite the modest nature of the adjustment proposed by the Board, the railroads oppose the Board's hybrid index. In their comments, UP, BNSF, CSXT/NS, and CP each address the subject of SARR cost indexing, and argue that the Board's proposal to utilize a hybrid of the RCAF-A and RCAF-U gives too much credit to the notion that a SARR will enjoy the benefit of some productivity. Each carrier encourages the Board either to refrain altogether from reflecting SARR productivity gains for indexing purposes (particularly if the Board adopts a ten-year DCF analysis period), or to defer or limit the application of any productivity adjustment to later years and/or limited expense categories. The railroads' objections are not well-founded, and would place improper burdens upon captive shippers seeking rate relief from the Board. Moreover, the railroads' comments fail even to acknowledge – much less attempt to justify – the Board-mandated disparity between cost indexing and revenue forecasting.

A. The Railroads' Hypothesis Regarding Super-Efficient SARR Operations is Inconsistent with STB Precedent

The underlying premise of the railroads' various comments regarding productivity is that a SARR begins its existence as a super-efficient improvement upon the incumbent carrier's operations, with none of the inefficiencies associated with Class I carriers' non-unit train operations, and with no possible room for any additional productivity improvement. *See, e.g., UP Comments* at 32; *BNSF Comments* at 57; *CSXT/NS Comments* at 9.

Under SAC precedent, however, a SARR typically is constrained to operate in a manner that falls far short of such optimal efficiency. Recent Board decisions confine SARRs to operations that at best match the operations of the incumbent, and at worst result in service that is provided in a manner that is demonstrably less efficient than the service of the incumbent carrier. The Board has rejected operating plans advocated by shippers in a number of maximum rate cases, defaulting to the less efficient operations described by the carriers. *See, e.g., Xcel* at 23-27 (rejecting Xcel's operating plan as infeasible and accepting BNSF's plan as "the only other evidence of record"); Docket No. 42056, *Texas Municipal Power Agency v. The Burlington N. & Santa Fe Ry.*, Decision served Mar. 24, 2003 at 74 (rejecting TMPA's evidence of running times and accepting BNSF's proposal as the "only other evidence of record as to running times"); *FMC* at 37-39 (rejecting FMC's operating plan as unsupported and accepting UP's plan).

Even more troublesome than these examples, however, is the Board's acceptance in the eastern cases of operating plans that were far less efficient than the

incumbents' own operations. As the Complainant in *CPL* explained, the supposition that a Board-approved SARR is optimally efficient is flatly inconsistent with recent precedent:

[T]he Board's logic that "... the potential impact of [productivity] improvements [for the P&SH] is far less than it would be for existing railroads, which make changes incrementally as older technology assets wear out or become obsolete" (*Decision* at 27) fails to take into account its own rulings on other issues in the case. Specifically, the Board's *Decision* adopts the NS's operating plan (*id.* at 26), and operating assumptions (*id.*). There are numerous respects in which such operations could be significantly improved. *See, e.g.,* CP&L Reb. at III-B-1 to 4, III-C-6, and III-C-29 to 56. For example, as CP&L explained at oral argument, *NS's SARR gathering operation is vastly less efficient than NS's existing operations, much less anything akin to a "least cost, most-efficient" operation.* Specifically, NS treats each and every less-than-trainload coal shipment as a separate train for the movement from origin mines to gathering yards. (Tr. at 23-26, Counsel's Ex. 1). [This major deficiency in NS's operating plan is not mentioned anywhere in the *Decision* and there is no indication that it was considered by the Board in any fashion.] *Obviously, a railroad starting off with this type of hugely inefficient operations has the opportunity for early and major productivity improvements.*

Docket No. 42072, Petition for Reconsideration, Jan. 20, 2004 at 5 and n.1 (emphasis added).

Likewise, in *Docket No. 42070*, *Duke Energy Corp. v. CSX Transp., Inc.*, the Board adopted CSXT's operating plan even though this plan resulted in substantial inefficiencies relative to real-world CSXT operations. As Duke explained in its Petition for Reconsideration, the "ultra-high cost plan" accepted by the Board included significant inefficiencies associated with "mini-train" service and substantial locomotive

overpowering when compared with CSXT's actual operations over the lines in question:

After rejecting Duke's SARR operating plan as infeasible for the reasons discussed, the Board, without even attempting to analyze CSXT's ultra-high cost plan, simply pronounces CSXT's plan as "realistic" and summarily accepts it. *See* Decision at 28. . . .

. . . Had the Board reviewed CSXT's evidence as it reviewed Duke's, it would have easily discerned at least two obvious and unacceptable artifices employed by CSXT to generate the huge inflation in the locomotive and crew components of SARR operating costs. Each artifice contravenes least cost SAC principles.

The first artifice used by CSXT to inflate SARR operating costs is its "mini-train" operating plan. A significant portion of the SARR's locomotive- and crew-related operating expense (*see* Decision at 52, Table C-1) is a direct function of train size. Duke's SARR runs trains with as many as 115 cars and the real-world CSXT moves coal trains ranging from 75 to 150 cars. Astoundingly, however, CSXT's version of the SARR – as accepted by the Board – operates hundreds of trains in road service with consists of only 2 to 15 cars in each trainload.[] Where one or more locomotives hauls so few cars over long distances in road haul service, locomotive costs per ton soar! The mini-train is the driving force of CSXT's ultra-high cost SARR operating plan. Its pervasive use refutes CSXT's assurances to the Board that its SARR operating plan was "efficient."

. . . . CSXT's second SARR operating cost artifice inflated costs by egregiously overpowering the SARR

Of course, no real-world railroad, let alone an optimally efficient SARR, would invest in such an enormous amount of excess locomotive capacity

. . . . Plainly, CSXT's calculation of SARR locomotive requirements fails the very "sanity check" it urged the Board to apply to Duke's operating plan. The Board's acceptance of CSXT's calculations resulted in another vast overstatement

of an important component of SARR operating costs in the peak year, and in every other year of the SARR's projected operations.

Docket No. 42070, Petition for Reconsideration, filed Mar. 25, 2004 at 11-16.

CSXT's Reply in *Duke Energy* did not dispute the fact that the Board-accepted SARR was far less efficient than the incumbent:

First, Duke points out that CSXT's operating plan for the ACW included hundreds of "mini-trains" containing a small number of cars. *Id.* at 12-13. Any purported inefficiency in the handling of that traffic under CSXT's operating plan is the direct result of Duke's decision to select thousands of cars of coal traffic that (in the real world) move in very small shipments. . . . [I]n the absence of gathering yards throughout the ACW's mine service area – which Duke vociferously argued were not needed . . . – the ACW could not handle these shipments as CSXT does today (*i.e.*, by moving them from the mine to a local gathering yard, and consolidating them into larger trains for shipments to points beyond). . . .

Second, Duke contends that CSXT "egregiously overpower[ed] the SARR" by basing the ACW's locomotive fleet on peak day requirements. *Duke Pet.* at 13-14. According to Duke, CSXT's methodology is erroneous because it would leave the ACW with excess locomotive capacity during much of the year. However, as the Board has previously held, the fact that a SARR would have a substantial number of spare locomotive units in non-peak periods "is not a defect in the analysis, as [Duke] argues, but simply an inescapable consequence of the seasonality of the traffic and a carrier's obligation to have sufficient locomotives to serve its customers during peak periods." *TMPA* at 84 (emphasis added). *See also McCarty Farms*, 2 S.T.B. 460, 482 ("for the [SARR] to meet the service needs of shippers in peak periods, excess locomotives would be unavoidable at nonpeak times").

Docket No. 42070, Reply to Complainant's Petition for Reconsideration, Apr. 14, 2004 at 14-15. These excerpts demonstrate the fundamental fallacy of the carriers' arguments that productivity improvements are impossible in the stand-alone context because SARRs are configured and operated in an optimal manner.

A second, related theme of the railroads' comments regarding productivity is that since SARRs typically replicate unit train operations, no productivity improvements could be possible because most Class I railroad productivity gains are associated with improvements in traffic that does not move in unit train service. For example, UP states that productivity gains are derived from efforts to eliminate the train work events that already are absent from unit train service:

A significant source of recent and future productivity gains for incumbent carriers is simplification of operations to remove as many train work events as possible. Under its Unified Plan, UP has targeted costly work events for reduction or elimination. UP has designed new service products that resemble unit train operations for bulk and other perishable customers. . . .

. . . [A] SARR by design avoids handling carload traffic and the associated obligation to provide local switching service and classification yards – precisely where railroads find the most opportunity to become more productive.

UP Comments at 32-33; *id.* V.S. Haley at 14; *BNSF Comments*, V.S. Baranowski at 5-6 (“[i]ndeed, because unit coal train operations are already some of the most efficient movements on any railroad, the typical SARR is already vastly more efficient than the average Class I carrier”). However, these claims are belied by UP's own study of

productivity gains for unit train service, which the Board relied upon in *Wisconsin Power & Light* in holding that the SARR's operating costs should be presumed to escalate at only 1.5% per year, well under the expected pace of the RCAF-U. *Id.* at 106.

Moreover, even though unit train operations are more efficient than other forms of railroad service, the railroads are mistaken to conclude that unit train service cannot continue to benefit from productivity improvements. The Coal Shippers' Joint Comments documented a number of areas in which the Class I rail carriers are continuing to explore – and to obtain – improvements to the efficiency of their operations that are equally applicable to unit train and non-unit train operations. *Joint Comments* at 74-82. It is also entirely reasonable to expect that the inherent limitations of non-unit train operations may prevent them from sharing equally in the productivity enhancements that are available to unit train traffic. In this regard, even UP's Witness Haley acknowledges that there are "obvious limits" to the ability to realize productivity gains in non-unit train operations "given the inherent nature of manifest traffic" *UP Comments*, V.S. Haley at 14.

The railroads also seek to preclude any consideration of productivity in indexing SARR operating costs by insisting that SARRs enjoy the benefit of a perfect alignment between their traffic base and their capacity to provide service. *See, e.g., UP Comments* at 33 ("Blessed with perfect knowledge of future traffic volume and composition, the complainant proposes an operating plan that supplies just enough line capacity, yards, crews, locomotives, and cars, all located or positioned for optimal use.

Throughout the entire forecast period, a SARR has no underutilized assets that can be eliminated, resources ripe for redeployment, or inefficient work practices to improve.”). As with the other arguments raised by the railroads, this argument is misguided. As the Coal Shippers explained in their Joint Comments, “SARRs typically have substantial over-capacity because they necessarily are configured to handle their peak year traffic volumes for the life of the DCF model.” *Joint Comments* at 84. (“It is reasonable to assume that such excess capacity would give a SARR the flexibility to improve its operations relative to real-world carriers that do not build their systems to meet traffic levels that they know they will not achieve for twenty (or ten) years.”). The Coal Shippers also observed that a “SARR’s train cycle times are also modeled to meet peak year demands” (*id.*), which usually are not imposed upon the SARR system until its final year of operations.

The Board’s decisions in SAC cases confirm that SARRs begin their operations in a manner that can be similar to – or even less efficient than – the operations of the incumbent carriers. Moreover, there is ample reason to expect that unit train operations (such as those typically employed by SARRs) can enjoy many of the future productivity enhancements that would be realized across a railroad’s service profile. Finally, there can be no question that SARRs are forced to bear the burden associated with significant excess capacity, thus making productivity improvement far more likely.

B. The Railroads are Wrong that Productivity Gains are Unavailable to SARRs Because of Associated Costs

The railroads' next line of attack upon the Board's proposal to permit some consideration of productivity is to insist that the process of enhancing railroad efficiency imposes substantial costs upon the carriers. *See, e.g., UP Comments* at 34 ("productivity-enhancing technologies come only at a steep price, have many ancillary costs, and deliver productivity benefits only over many years as they are fully developed"); *BNSF Comments* at 57.

These arguments are unfounded in the context of the current inquiry. There can be no question that rail carriers continuously engage in efforts to improve their efficiency through productivity advances. Carriers engage in these efforts because it is anticipated that they will result in net savings. The purpose of a cost index, such as the RCAF, is to provide a mechanism to approximate the overall net impact of cost changes on a carrier. The "costs" that the railroads argue here already are factored into the calculation of the RCAF-A. Moreover, since under both the Board's proposal, and the Coal Shippers' modification of that proposal, SARR costs would bear a significant share of the RCAF-U, the overall SARR operating expenses already would increase by a margin that exceeds the productivity-based change in actual industry costs. Therefore, it is entirely reasonable to conclude that the costs that the carriers would impose upon shippers already appear in the cost indexing component of the DCF model.

Finally, the carriers ignore the fact that SARRs already are forced to bear costs associated with, *e.g.*, the replacement of locomotives during their operating lives. As the Coal Shippers demonstrated in their Joint Comments, the Board reasonably can assume that a SARR will incur the marginal cost associated with an earlier expenditure of capital on replacement locomotives, for example, because the productivity-based cost savings will exceed any implicit costs of accelerating asset replacement.

C. The Railroads would Place Insurmountable Evidentiary Burdens upon Complaining Shippers

After insisting that productivity would be impossible during the early years of a SARR's life, with those early years identified by the railroads as anywhere from as little as five years to more than ten, and contending that no productivity adjustment should be considered at all in the event that the Board adopts a 10-year DCF model, the railroads purport to offer additional solutions to the Board which allegedly would allow complainants to obtain the benefit of productivity in cost indexing where specific evidentiary showings may be made. Given the burdens associated with the proposed showings, however, the railroads' suggestions amount to little more than additional arguments that productivity should never be reflected in the index for SARR operating expenses.

The carriers argue that a complainant should be permitted to obtain the benefit of RCAF-A indexing solely for those specific expense categories as to which the complainant can demonstrate that the SARR would obtain productivity benefits. These

arguments include the suggestions that rebuttable presumptions be adopted against the use of the RCAF-A for the second ten years of the DCF model, or that complainants be forced to seek reopening to demonstrate that a “fully matured” productivity improvement should be deemed to be available to the SARR. *See, e.g., CSXT/NS Comments* at 10-11 (“CSXT/NS accordingly propose that the Board use the RCAF-U to index operating expenses for the first 10 years, and that it *apply a rebuttable presumption* that the RCAF-U is the appropriate index for operating expenses in the second ten years of the SAC analysis period”) (emphasis added); *UP Comments* at 35 (“In the event that a complainant can identify a new, fully-matured technology suitable for implementation following the commencement of SARR operations, it should be *permitted to seek reopening* to present evidence of savings from use of that new technology”) (emphasis added).

Each of these proposals seeks to place the complainant in the position of being forced to demonstrate future events regarding productivity improvements – a virtually impossible task. The Coal Shippers’ Witnesses Caves, Eakin, Meitzen, and Schoech explained in their Verified Statement that efforts to quantify productivity on a line-by-line basis is neither necessary nor productive:

While numerous sources of productivity growth can generally be identified, a line-by-line or bottom-up quantification of where future productivity gains will come from is not necessary or cost-effective. Even when analyzing the historical performance of the railroads, it is not always possible to quantify the impact of each productivity source. This in part is due to the fact that these factors are often

interconnected. For example, a new process innovation may lead to increased demand for transportation, which further reduces cost through economies of density.

Joint Comments, V.S. Caves, et al., at 7.

The carriers' proposals regarding category-by-category productivity evaluation also seek to impose an evidentiary burden upon the determination of SARR costs that does not exist with respect to SARR revenues. The Board utilizes an index procedure to develop future SARR revenues without evidence as to the exact revenue progression likely for each individual SARR movement. If the Board were to hold shippers to the heightened standard of proof (on a category-by-category basis) that the carriers advocate regarding twenty years worth of anticipated productivity enhancements, then for the sake of consistency, it also would be imperative to require specific evidence from defendant carriers as to the future escalation of each rate paid to a SARR by its customers. Under such an approach to determining the future revenues of a SARR, the Board would be compelled – in the absence of specific evidence regarding future shipper-by-shipper rate relief – to assume that the SARR would decline to pass any productivity gains along to a given customer, thus leading to an increase in overall SARR revenues.

D. BNSF Proposed Adjustment to the Indexing of the Asset Inflation Implicit in the Board's DCF Model

Finally, BNSF's Witness Baranowski contends that if the Board determines that a productivity adjustment to SARR operating expenses is warranted, the Board should apply a "comparable" productivity adjustment to the asset inflation implicit in the Board's DCF model as well. Baranowski V.S. at 19. Witness Baranowski argues that this adjustment is necessary for two reasons:

First, it is reasonable to expect that productivity will occur in the construction of railroad assets as improvements in materials and machinery help to further streamline construction activities. Second, the indexes used within the DCF to inflate the SARR asset base are components of the RCAF, which itself is subject to a productivity adjustment by the Board.

Id.

As Witness Crowley explains in his Reply Verified Statement, Mr. Baranowski makes a valid observation that as technology and material science improve, the construction and replacement of railroad assets will become more efficient. R.V.S. Crowley at 6. However, the adjustment that Mr. Baranowski proposes would raise a SARR's cost of capital above that experienced by the railroad industry as a whole. This is improper, because as the Board frequently has recognized, a SARR cannot be assumed to face any greater capital risks than those faced by the incumbent. *See Wisconsin Power & Light* at 32. The simpler and more appropriate way to recognize future asset productivity without revising the entire DCF model, is to adjust the life of the assets to be

replaced, and thus reflect the increased asset efficiency (*e.g.*, greater work for the same price). R.V.S. Crowley at 7-12.

IV. MOVEMENT-SPECIFIC VARIABLE COST ADJUSTMENTS

In their Joint Comments, the Coal Shippers opposed the Board's proposal to preclude movement-specific adjustments to URCS-based variable cost determinations. *Joint Comments* at 89-101. The Coal Shippers provided responses to each of the seven points raised by the Board in connection with its proposal, and explained in particular that movement-specific cost adjustments "are not the driving factor behind the expense of maximum rate cases, and they are not the cause of the substantial uncertainty associated with the outcome of such cases." *Id.* at 91. Rather, they noted that "[t]he principal effect of eliminating adjustments will be to raise the jurisdictional threshold rate level and rate prescription floor, to the railroads' benefit and coal shippers' detriment." *Id.* at 92.

While the rail carriers filing comments in response to the Board's proposal were notably divergent in their views, no carrier expressed unequivocal support for the complete elimination of movement-specific URCS adjustments. At one end of the carrier spectrum, CP opposed the Board's proposal in a manner generally consistent with the comments of the Coal Shippers. Although CP's support for movement-specific cost adjustments clearly appears to stem from a desire to try to demonstrate that coal-specific variable costs should exceed URCS-based levels, CP's reaction to the Board's proposal at least has the virtue of procedural even-handedness. At the other end of the carrier

spectrum, however, BNSF and UP essentially argued for a one-way street: eliminating movement-specific adjustments proposed by complaining shippers, while allowing defendant carriers multiple opportunities to adjust variable costs in their favor through various manipulations of procedural schedules and evidentiary guidelines. These same carriers also seek a blanket ruling from the Board that any payments made by a carrier to a third-party should be treated as a variable cost, and subject to a 180% mark-up that would be immune from challenge.

Rather than indulge the carriers whose proposals charitably can be characterized as over-reaching, the Board should decline to make any modification to its current handling of variable cost matters. The Board should continue the long established and well-supported practice of accepting movement-specific adjustments to URCS cost calculations in order to obtain the most accurate costing information.

A. The Railroads' Opposition to the Board's Proposal

Of the four sets of carrier comments addressing the subject of movement-specific variable cost adjustments, two (CP and CSXT/NS) either oppose the Board's proposal outright, or advocate a variation which, as discussed *infra*, would exacerbate rather than reduce procedural complexity. However, each of these correctly stresses that the Board should not sacrifice the accuracy of its cost determinations for the sake of simplicity in what already has become a fairly standardized aspect of maximum rate reasonableness litigation. For example, CP challenges the Board's justifications for eliminating movement-specific variable cost adjustments:

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. . . . 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. . . .

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 burdens placed on the parties (and the Board’s staff) in future SAC proceedings.

CP Comments at 8-9.

Likewise, CSXT/NS argue against the Board’s proposal:

CSXT/NS understands the Board’s concern that allowing movement-specific adjustments to URCS system average costs may, in some instances, result in substantial expenditure of time and resources by the parties without sufficient net adjustments to those costs to justify the effort and expense. The Board’s proposed solution, however, would throw out the baby with the bath water . . . CSXT/NS urge the Board to reconsider its proposal to prohibit all movement-specific adjustments to URCS, because such an approach could significantly affect the accuracy, integrity, and reliability of SAC analyses and results.

CSXT/NS Comments at 11.

These comments are consistent with the views expressed by the Coal Shippers, and provide additional support for the retention of movement-specific variable cost adjustments.

B. The Railroads' Proposed Rules Changes should be Rejected

In contrast to CP and CSXT/NS, UP and BNSF each support the Board's proposed elimination of movement-specific variable cost adjustments, then suggest additional policy modifications that would further bias results in their favor.⁴² *UP Comments* at 35 ("UP supports the Board's proposal to simplify variable cost calculations by discontinuing the use of movement-specific adjustments to URCS system-average unit costs, with two important reservations."); *BNSF Comments* at 60 ("BNSF agrees with the Board's proposal to use system-average URCS costs in SAC rate reasonableness cases to determine the jurisdictional threshold However, BNSF urges the Board to make two clarifications to the proposal."). The two principal suggestions from these western carriers are: (1) a Board ruling that defendant carriers will be permitted to adjust variable costs upward for any payments made to third parties for any transportation-related purpose; and (2) the introduction of various procedural or evidentiary mechanisms that would allow certain movement-specific adjustments to be made if they would *increase*

⁴² As the Coal Shippers explained in their Joint Comments, a move toward sole reliance on system average variable costs all by itself would favor the railroads, by ignoring the acknowledged efficiencies associated with unit train coal transportation. *See Joint Comments* at 89-91.

the maximum reasonable rate on the movement in question.⁴³ Neither suggestion is proper.

Both UP and BNSF open with self-serving expressions of concern that they may be going too far in supporting the Board's proposal. *UP Comments* at 36 ("Even if the Board clarifies and modifies its proposal as we suggest, we believe that the Board's use of unadjusted URCS costs will result in lower jurisdictional thresholds than UP could establish using movement-specific adjustments to URCS costs. This is a significant concern for UP."); *BNSF Comments* at 60 ("[a]lthough BNSF is concerned that system-average URCS costs may understate the variable costs of BNSF's unit coal train movements in areas such as locomotive ownership[] and fuel[] costs, the benefits of the Board's proposal outweigh this concern"). Obviously, characterizations such as these should not sway the Board in its evaluation of the parties' comments. The carriers supporting the Board's proposal (or a modified version) have done so to advance their interests in litigation. If they did not perceive the proposal as serving their cause, they would oppose it outright, as they did in response to the proposed retirement of the percent reduction method.

⁴³ As discussed in greater detail, *infra*, although CSXT/NS oppose the Board's proposal in their joint comments, they raise the same third-party payment issue as the western carriers, and likewise propose two alternative procedural approaches for the Board's consideration.

1. Third-Party Payments

The railroads' first qualification on outright support for the Board's proposal to eliminate movement-specific variable cost adjustments relates to the subject of third-party payments. The carriers contend that any payment made to a third party ostensibly for any purpose related to the subject transportation should be counted as a variable cost. *BNSF Comments* at 64-65; *UP Comments* at 39-40; *CSXT/NS Comments* at 19. Not only would such a broad rule represent a sharp break from longstanding precedent – under which such determinations are made on a case-by-case basis depending upon the facts of record – but it would allow railroads to immunize significant portions of their rates on captive traffic from challenge simply by “outsourcing” various service elements.

As an example of the type of payments that would be covered by the railroads' proposed rule, BNSF refers to certain payments made to the Southwestern Railroad that were at issue in *AEPCO*:

The Board should add to its list of nine operating characteristics that should be included in the initial estimate of the movement's variable costs the use of a third-party transportation service provider. Railroads often sub-contract out a portion of the transportation service. For example, in *FMC*, UP paid a third party to provide terminal switching. In the *AEPCO* case, BNSF paid Southwestern Railroad, a bridge carrier, to operate approximately 50 miles of the issue move between Deming, New Mexico and Rincon, New Mexico. The third parties in these examples charged the railroads, not the shippers, directly for these services on a per car basis. Payments to third parties are not included in URCS and therefore URCS will not accurately reflect the railroad's costs

where third parties provide a portion of the transportation service.

BNSF Comments at 64-65.

As AEPCO's evidence in that proceeding demonstrated, however, the payments to the Southwestern Railroad were in the nature of revenue divisions, not subcontractor payments, and properly could not be considered part of UP/BNSF's "variable cost." AEPCO pointed out that it was the Southwestern Railroad – not BNSF – that had common carrier responsibilities over the line in question, and that the service provided by that carrier was line-haul service, not switching.⁴⁴ And the use of per-unit payments as opposed to rate percentages to set divisions was fully consistent with established precedent. *See* Docket No. 40298, *The Society of the Plastics Indus., Inc. v. Consolidated Rail Corp.*, Decision served Oct. 22, 1990; *In the Matter of the Applications of Carriers in Official, S. and W. Classification Territories for Authority to Increase Rates*, 58 I.C.C. 220, 254 (1920). Under the governing statute, the proper focus is on the variable cost of the *transportation* at issue,⁴⁵ which in AEPCO included the line-haul service provided by the Southwestern Railroad. Consistent with established costing practices, that carrier's division would be treated as a revenue offset, not a cost. Indeed, as AEPCO showed, any other result would incent railroads to artificially pad their margins simply by increasing "third party payments," which under the railroads'

⁴⁴ Both factors distinguished AEPCO from FMC.

⁴⁵ 49 U.S.C. §10707(d)(1)(A).

interpretation then would be subject to a 180% mark-up that could not be challenged before the Board.

In similar fashion, UP advocates a blanket rule that would categorize any payment made to another carrier as a variable cost to the payor, and cites as its example the divisions payments that it makes to the Missouri & Northern Arkansas Railroad (“MNA”) that are at issue in Docket No. 42095, *Kansas City Power & Light Co. v. Union Pac. R.R. Co.*:

UP pays a fixed amount per car to another railroad, Missouri & Northern Arkansas (“MNA”), to complete the haul [to KCPL’s Ladue, Missouri plant] by handling the traffic between Kansas City and Ladue. Again, UP would have to pay the same amount to MNA even if the Board ordered UP to reduce the rate it charges to KCPL. In this situation as well, it would not be accurate to cost the movement using the URCS Phase III model as if the movement ended at Kansas City. Nor would it be accurate to cost the movement as if UP itself handled the traffic all the way to Ladue. The most accurate approach, and the one that is consistent with both Board precedent and the proposal to use the URCS Phase III model, would be to develop UP’s costs for the portion of the movement between the PRB and Kansas City (including the payments to third-party loaders) and UP’s costs (sic) any services it provides between Kansas City and Ladue,[] and then add the fee that UP pays MNA for handling the traffic between Kansas City and Ladue.

UP Comments at 39-40.⁴⁶

⁴⁶ Cf. *CSXT/NS Comments* at 14 (“[a]nother recurring example of the need for movement-specific variable cost adjustments is payments made by rail carriers to short lines (or other carriers) for haulage or trackage rights necessary to transport coal or other freight from origin to destination”).

In many respects, UP's claim that revenue payments to MNA should be counted as part of Union Pacific's variable cost is even more extreme than BNSF's argument regarding the Southwestern Railroad. MNA hauls coal for KCPL over 100 miles in each direction, and performs all services incident to line-haul carriage. The lease between Union Pacific and MNA specifically provides for MNA to receive a "revenue division" for its participation in the movement, and addresses MNA's concurrence – as a through route participant – in Union Pacific's pricing for the overall origin-destination service. MNA is designated as solely responsible for common carrier operations over the leased lines, and Union Pacific is precluded from providing service over those lines so long as MNA is operating them. Nothing in the lease remotely suggests that MNA acts as a subcontractor for Union Pacific.

It also is noteworthy that the MNA revenue division is part of the *quid pro quo* for MNA's agreement to the erection of a paper interchange barrier, which ensures KCPL's continued captivity to UP and its pricing policies. Permitting UP to count that payment as a variable cost not only would grant the carrier an improper, immunized 80% mark-up on a through route division, but it would allow the same mark-up on any premium paid by UP to preserve KCPL's status as a captive shipper. Indeed, following UP's view to its logical conclusion, there would be nothing to stop one railroad from outsourcing an entire line-haul movement from origin to destination to another, at whatever rate the latter demanded, then charging the shipper 180% of that rate and claiming immunity from challenge under 49 U.S.C. §10707(d)(1)(A). No rational

regulatory regime could allow such manipulation.

The Board should continue to approach the issue of “third party payments” on a case-by-case basis. Certainly, a *bona fide* subcontract arrangement that allows the railroad to fulfill part of its transportation responsibilities at a lower cost than it would incur itself (*e.g.*, the use of a loading contractor at an origin) warrants different treatment than a line-haul division paid to a shortline whose variable costs are lower than the incumbent’s. In the latter case, variable costs should be calculated for the entire movement using the participant carriers’ respective costs, with any payments transferred between them properly counted as offsets to revenue.

2. The Railroads’ Procedural and Evidentiary Proposals

In addition to suggesting that the Board modify its proposal to permit the treatment of all third-party payments as variable costs of service, the railroads present a number of different procedural and evidentiary proposals regarding movement-specific cost adjustments. The Coal Shippers oppose each of these proposals as demonstrably unfair and/or unnecessarily burdensome.

(a) **BNSF.** BNSF proposes that the Board should allow a railroad to present movement-specific adjustments to system-average costs “at the end of a SAC case if the railroad can show by clear and convincing evidence that such adjustments are more accurate than system-average costs and would affect the level of any prescribed rate.” *BNSF Comments* at 61. BNSF argues that “[t]he types of adjustments that could become relevant at this stage of the SAC proceeding would include refinements to the URCS

Phase III analysis to include additional train and operating characteristics” (*id.* at 66), and that defendant carriers should be permitted to override the default assumptions made by the URCS Phase III program with regard to movement-specific characteristics such as “tare weights, empty miles and number of locomotives” (*id.* at 67).

BNSF’s proposal is biased and improper, and should be rejected.

Essentially, BNSF is promoting a rule under which the only movement-specific cost adjustments that would be allowed are those advanced by defendant carriers that would have the effect of increasing the maximum reasonable rate. Moreover, since BNSF proposes that this movement-specific cost analysis would only occur at the end of a SAC proceeding (once the carrier knows whether it needs to dedicate any time and energy to boosting its variable cost numbers), the rule necessarily would result in substantial delays. Given the time needed for the carriers to prepare and submit their evidence, the time for any shipper response, and the time for the Board to issue a decision, an additional year or more easily could elapse after the issuance of the principal SAC decision before a final ruling is served by the Board.

(b) Union Pacific. Like BNSF, UP purports to support the Board’s proposal to abandon movement-specific variable cost adjustments, then insists that the Board “allow parties to increase the accuracy of variable cost calculations for the issue traffic by substituting a limited number of readily obtainable and non-controversial movement-specific inputs for values calculated by the URCS Phase III model.” *UP Comments* at 36; *id.* at 41 (“[s]pecifically, the Board should allow parties to substitute for

calculated or system-average inputs the actual (i) number of locomotives; (ii) empty miles; (iii) tare weight of cars; and (iv) railroad and private line car costs”). Although UP’s proposed modification lacks the overt unfairness evident in BNSF’s “carriers only” formulation, UP’s proposal is still defective because it would restrict the categories of movement-specific evidence that could be submitted – by either party – to those issues that are likely to benefit carriers. To that end, UP suggests that its actual ownership costs for locomotives used to move coal unit trains are “substantially above system-average costs and that its actual road property and maintenance-of-way costs for coal traffic are “substantially above system-average costs.” *Id.* at 41. Union Pacific’s proposal mimics BNSF’s to the extent that it amounts to a rule that movement-specific variable cost adjustments will not be considered, unless they could be beneficial to defendant carriers.

(c) **CSXT/NS.** Although they state opposition to the Board’s proposal to prohibit movement-specific variable cost adjustments, CSXT/NS also present two “intermediate” approaches for the Board’s consideration. First, they suggest that if defendant carriers elect at the outset of a SAC case not to contest quantitative market dominance, then the parties would only present evidence under the SAC test. *CSXT/NS Comments* at 15. If the Board subsequently determines that the challenged rates exceed the SAC threshold, then either party would be allowed to elect whether to contest URCS system average costs for purposes of establishing a jurisdictional threshold rate floor. *Id.* The Coal Shippers submit that CSXT/NS’ proposal is procedurally cumbersome and would cause unnecessary delay. This proposal would obligate the parties to engage in a

second round of discovery following the issuance of the Board's SAC determination, and then present additional rounds of evidence with regard to variable costs. The proposal would extend significantly the length of a maximum rate reasonableness case, likely would double the number of rounds of evidence filed by the parties, and would require variable cost discovery to be undertaken as much as two years after the filing of a complaint. At that time, it is not hard to imagine one of the parties objecting that the discovery on which the SAC prescription was based had grown stale, and the entire proceeding dragged through the argument that the Board should update its SAC prescription to reflect recent developments.

Second, CSXT/NS suggest that the Board consider limiting the categories of costs for which it will consider movement-specific evidence (*i.e.*, "fuel costs, equipment ownership, crew wages, mine loading times, car mileage allowances, and payments to mines or other transportation providers"), but nevertheless "allow parties to present arguments for presentation of evidence regarding other specific costs, if the proponent can demonstrate that movement-specific costs for those items are likely to be substantially different from system average costs." *Id.* at 17. Like UP's proposal, this "limitation" primarily would permit adjustments to those cost categories more likely to be favorable to carriers. While this proposal purports to be more flexible in its treatment of other potential adjustments, it still appears to place a greater burden on shippers seeking to demonstrate that the Board should accept cost-reducing adjustments that are not on CSXT/NS' pre-ordained list.

In sum, the Coal Shippers reiterate their prior opposition to the Board's proposal to preclude movement-specific variable cost adjustments.

V. STAND-ALONE COST ANALYSIS PERIOD

Most of the railroad commentors appear to generally support use of a 10-year DCF period in new cases.⁴⁷ However, this support comes with caveats. For example, BNSF supports the use of a 10-year DCF period only if SARR operating expenses contain no productivity adjustment during the period and only if the Board makes clear that "its proposal to shorten the DCF period would limit any rate prescription to a maximum of 10 years." *BNSF Comments* at 70. Similarly, CSXT/NS supports a 10-year DCF period, but only as a "presumptive length," subject to case-by-case adjudication of longer or shorter periods proposed by the parties. *CSXT/NS Comments* at 45.

The Coal Shippers generally support the use of a 10-year DCF period in future cases if appropriate changes are made to DCF Table E⁴⁸ and rate prescriptions are not limited to 10 years. *See Joint Comments* at 102-104. The Coal Shippers oppose BNSF's proposal calling for no productivity adjustments to SARR operating costs during a 10-year DCF period for the reasons set forth in their *Joint Comments* and these Reply

⁴⁷ See, e.g., *BNSF Comments* at 70-71; *UP Comments* at 45; *CSXT/NS Comments* at 19.

⁴⁸ BNSF proposes two other mathematical changes in the DCF procedure which are also acceptable to Coal Shippers if the Board adopts a 10-year DCF period. *See R.V.S. Crowley* at 14.

Comments. The Coal Shippers also oppose BNSF's proposal to limit rate prescriptions to ten years. As the Coal Shippers explained in their *Joint Comments*, if the Board adopts a 10-year DCF period, the rate prescription should remain in effect after year 10 and until such time as a party can demonstrate that the prescription should be modified or vacated. *See Joint Comments* at 104.

The Coal Shippers also explained in their *Joint Comments* that the Board's 10-year DCF proposal should not apply in pending cases. The only rail carrier to specifically address this issue – BNSF – agrees. *See BNSF Comments* at 71 (“the Board should not change the DCF period in the pending *AEP Texas* and *WFA/Basin* cases”).

VI. STANDARDS FOR VACATING RATE PRESCRIPTIONS

BNSF is the only major railroad whose opening comments address the Board's proposed standards for evaluating requests for the vacation and/or reopening of existing rate prescriptions in any meaningful way.⁴⁹ Even so, BNSF offers only that the Board's proposed approach appears to be “even-handed,” and in the carrier's view comports with the Court of Appeals' decision in *Burlington Northern & Santa Fe Ry. Co. v. STB*, 403 F.3d 771 (D.C. Cir. 2005). *BNSF Comments* at 72-73. BNSF closes with a reference to an issue now before the Board in *Docket No. 41191*:

[T]he prescriptive effect of an existing rate prescription can

⁴⁹ The joint comments of CSXT/NS do not mention this portion of the Board's *Decision*. UP states only that it is “strongly inclined” to support the Board's proposal, and that it would review any comments submitted by other parties. *UP Comments* at 45.

be lifted only after the Board has concluded that there is evidence raising a serious question about the continued validity of the rate prescription. No retroactive effect can be given to such a finding. Thus, in the context of the *West Texas Remand* . . . , it is clear that the existing rate prescription . . . will remain in effect unless and until the Board finds grounds for reopening and reopens *Docket No. 41191*.

Id. at 73.

In their Joint Comments, the Coal Shippers explained that the Board's proposal to "lift the prescriptive effect" of a rate prescription before considering *all* the evidence that would be presented in support of or opposition to vacation or revision cannot be reconciled with binding Supreme Court precedent,⁵⁰ and should be rejected in favor of a rule requiring the completion of a single, full evidentiary hearing *before* any prospective vacation or modification of a rate prescription lawfully can take place. *Joint Comments* at 106-108. Assuming *arguendo* that the D.C. Circuit's 2005 ruling requires that both shippers and carriers must satisfy 49 U.S.C. § 722(c) before a prescription can be disturbed, merely raising "genuine questions" about the proper rate for the future does not meet the *Arizona Grocery* test, and in no event does the Board have the power to apply any changes to a prescription retroactively. *Joint Comments* at 108-109; see *Arizona Grocery*, 284 U.S. at 389-90; *San Antonio, Texas v. Burlington N., Inc.*, 364 I.C.C. 887, 896 (1981).

⁵⁰ *Arizona Grocery Co. v. Atchison, Topeka & Santa Fe Ry. Co.*, 284 U.S. 370 (1932).

The Coal Shippers noted that the Board appeared to be proposing to “codify” the approach that was followed in the *Arizona Public Service* proceeding.⁵¹ However, that approach contradicted the very same goals of rate stability, reduced administrative burdens and complete evidentiary records that the Board professes a commitment to serve. *Joint Comments* at 112-114. And far from reflecting an “even-handed” approach to the question of prescription vacations or revisions, the multi-tier structure proposed by the Board is biased in favor of defendant railroads, who are far more likely to come before the Board with claims of “changed circumstances” that can be integrated into the prior SAC analysis without complication. *Id.* The Board should modify its proposed standards in the manner described by the Coal Shippers in their *Joint Comments*; clarify its intended treatment of index and forecast changes (*id.* at 114-115); and affirm that any changes made in the standards or procedures for implementation of the *Guidelines* that might be adopted in this proceeding – standing alone – will not be grounds to reopen a rate prescription that is not presently before the Board on reconsideration or court remand. *Id.* at 115-117.

Finally, with respect to BNSF’s claims concerning *Docket No. 41191*,⁵² the Coal Shippers adopt and incorporate herein by reference the points and authorities

⁵¹ Docket No. 41185, *Arizona Pub. Serv. Co. & PacifiCorp v. BNSF Ry. Co.*, Decision served May 12, 2003.

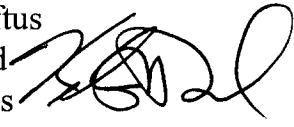
⁵² *BNSF Comments* at 73-74.

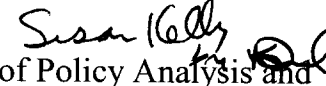
presented by AEP Texas North Company in its June 7, 2005 Reply to Defendant's Second Motion to Dismiss, filed in *Docket No. 41191(Sub-No. 1)*.

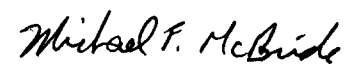
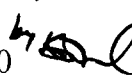
CONCLUSION

The Coal Shippers commend these Joint Reply Comments to the Board's favorable consideration.

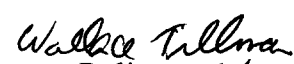
Respectfully submitted,

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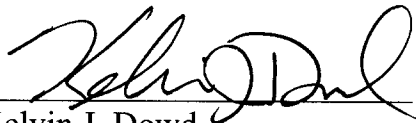
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Dated: May 31, 2006

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 the Western Coal Traffic League, Concerned Captive Shippers, Western Fuels Association, Inc., Edison Electric Institute, National Rural Electric Cooperative Association and American Public Power Association and accompanying cover letter to be served upon all parties of record in this proceeding.



Kelvin J. Dowd

**REPLY VERIFIED STATEMENT
OF
THOMAS D. CROWLEY**

I. INTRODUCTION

My name is Thomas D. Crowley. I am the same Thomas D. Crowley who submitted a verified statement on May 1, 2006 in this proceeding. My qualifications and statement of experience are included with that statement as Attachment No. 1.

The Coal Shippers¹ have requested that I address two issues raised by Union Pacific Railroad Company ("UP") and BNSF Railway Company ("BNSF") in their May 1, 2006 comments in this proceeding. The two issues are: 1) the statement by UP Witness Haley that "coal contributes relatively less than other commodities that share UP's network"²; and 2) the statement by BNSF Witness Michael Baranowski that if the Board decides to reflect changes in railroad productivity in its index for Stand-Alone Railroad ("SARR") operating expenses in the execution of its discounted cash flow ("DCF") model, then the indicies for depreciable fixed assets also should be adjusted for productivity to reflect productivity in railroad construction.

The remainder of my verified statement and accompanying attachment address these two issues under the following topical headings:

II. Coal Makes An Impressive Contribution to UP's Financial Condition

III. The DCF Model Cost of Capital Reflects the Appropriate Asset Inflation

¹The Western Coal Traffic League, the Concerned Captive Coal Shippers, Western Fuels Association, Inc., Edison Electric Institute, National Rural Electric Cooperative Association and American Public Power Association.

²V.S. Haley at 12.

IV. The DCF Model Time Period

V. Conclusions

**II. COAL MAKES AN IMPRESSIVE
CONTRIBUTION TO
UP'S FINANCIAL CONDITION**

UP's Witness Haley states that "coal contributes relatively less than other commodities that share UP's network".³ Haley states that a "straightforward analysis of UP's revenue and cost data shows that UP's coal traffic generates 1.9 mills per revenue ton-mile of contribution which is substantially less than the 3.0 mills per revenue ton-mile generated by UP's agricultural traffic, and a fraction of the 9.8 mills per ton-mile produced by UP's chemical traffic."⁴

Witness Haley's conclusions are suspect for several reasons. Mr. Haley provides *no* support for his statements or analyses. The reader is provided only with the statement that Mr. Haley has performed a "straightforward analysis".⁵ We are given no information about the source for the input data, we are not told what is included in the input data, and we are not told what methodology is used to generate the results. But for Mr. Haley's text, which discusses the specific results for coal, agricultural and chemical commodity groups, the reader is left to guess what the mills per revenue

³Id.

⁴Id. Witness Haley's Exhibit TCH-6 is a bar graph showing the 2004 contribution per revenue ton-mile produced by each of seven commodity groups, ranging from 1.9 mills per revenue ton-mile for "coal" to 11.5 mills per revenue ton-mile for "other energy".

⁵Id.

ton-mile are for the remaining commodity groups by estimating the values from Mr. Haley's Exhibit TCH-6.

Mr. Haley's metric of contribution per revenue ton-mile provides a very limited and biased picture of the relative contribution to UP's overall financial health that is derived from various commodity groups, for two reasons. First, the most accurate measure of the contribution to a carrier's bottom line from any given commodity group is the aggregate dollars of contribution, not revenue per ton-mile. A particular commodity may generate very high revenue on a ton-mile basis and yet contribute very little to a railroad's overall profits, if the volume handled is low. Using Mr. Haley's relative contribution per revenue ton-mile figures for each commodity group and combining these figures with data published on UP's web site related to revenue and volumes handled, it is possible to estimate the total contribution from each commodity group handled by UP in 2004. I have performed such an analysis, which shows that the energy commodity group⁶ contributed \$659.6 million to UP's net operating income in 2004, or \$118.4 million more than chemical shipments, which is the next most profitable UP commodity group. In fact, coal accounts for 31.1 percent of the total contribution from all commodity groups handled by UP.

⁶In Exhibit TCH-6 to his verified statement, Mr. Haley provides the contribution per revenue ton-mile for each of seven commodity groups handled by UP. These include agricultural, automotive, chemicals, coal, industrial, intermodal and other energy. In the Investors section of UP's website, UP provides its "Union Pacific Revenue and Overview & Outlook - 2005" which identifies UP's revenue and ton-miles for these same commodity groups, however, the Union Pacific Revenue and Overview & Outlook - 2005 does not distinguish between "coal" and "other energy" and instead provides just an "Energy" commodity group. As a result, in my analysis I considered coal and other energy as the same group.

Second, the contribution per revenue ton-mile does not consider the relationship of revenues (rates) to the cost of providing service, which is another key to assessing the role played by a particular commodity in a railroad's financial strength. Mr. Haley acknowledged in his verified statement that coal shipments are the most productive traffic handled. Mr. Haley stated that "the most efficient railroad operation as measured by the production of *ton-miles* moved relative to the resources used (i.e. crews, horsepower hours, line and terminal capacity and car days) is the unit train moving in a continuous shuttle."⁷ Thus, even if the contribution per revenue ton-mile is low for coal shipments relative to other commodities, when compared with the cost of providing the service only chemicals produce a greater aggregate revenue to variable cost relationship than coal shipments. However, as noted above, coal still contributes more to UP's bottom line than does chemical traffic.

Table 1 below compares the aggregate contribution and the revenue to variable cost ratios for each UP commodity group, based on the information provided in Mr. Haley's verified statement and the information contained in the Union Pacific Revenue Overview & Outlook – 2005 available on UP's website.⁸

⁷V.S. Haley at 14 (emphasis added).

⁸Attachment No. 1 to this verified statement provides an explanation of the sources for information and derivation of the information shown in Table 1.

Table 1
Comparison of UP 2004
Contribution by Commodity Group

<u>Commodity</u>	<u>Aggregate Contribution (Millions)</u>	<u>Revenue to Variable Cost Ratio</u>
(1)	(2)	(3)
1. Agriculture	\$190.4	112.8%
2. Automotive	\$39.0	103.3%
3. Chemicals	\$541.2	146.0%
4. Energy (coal)	\$659.6	137.8%
5. Industrial	\$239.8	111.0%
6. Intermodal	<u>\$449.7</u>	<u>125.1%</u>
7. Total	\$2,120	122.1%

Source: Table 2 of Attachment No. 1.

It is clear that Mr. Haley's reliance on contribution per revenue ton-mile is a misleading indicator of the substantial contribution that coal makes to UP's overall profitability. In 2004, energy (coal) produced a total contribution to UP of \$659.6 million, or 31.1% of UP's total contribution. When viewed on a revenue to variable cost ratio basis, coal produced a 137.8% relationship, and was second only to chemical traffic (146.0% relationship) in this metric. Viewed objectively, the data provides no support for the charge that coal makes an inadequate contribution to the support of UP's rail network.

**III. THE DCF MODEL COST OF CAPITAL
REFLECTS THE APPROPRIATE ASSET INFLATION**

BNSF's Witness Baranowski suggests that if the STB were to include a productivity adjustment for stand-alone operating costs, then a comparable adjustment should be applied to the asset inflation included in the STB's DCF model.⁹ According to Mr. Baranowski, the reasons for this adjustment are twofold. First, Mr. Baranowski says it is reasonable to expect that productivity will occur in the construction of railroad assets as improvements in materials and machinery help to further streamline construction activities. Second, he argues that the indexes used within the DCF to inflate the SARR asset base are components of the RCAF, which itself is subject to a productivity adjustment by the STB.¹⁰

I agree with Mr. Baranowski that as technology and material science improve, the construction and replacement of railroad assets will become more productive. The methodology Mr. Baranowski suggests for reflecting future asset productivity, however, is improper because it would explicitly raise a SARR's cost of capital above that of the railroad industry average cost of capital. As the STB has repeatedly ruled, a SARR cannot be required to bear risks not faced by existing Class I railroads, and as such, cannot be burdened with a higher cost of capital than the real-world railroads. The proper approach to future asset productivity is to reflect the productivity were it occurs, namely, in longer average asset lives.

⁹V.S. Baranowski at 19.

¹⁰Id.

**A. MR. BARANOWSKI'S ADJUSTMENT
IMPROPERLY RAISES THE SARR'S COST OF CAPITAL**

Mr. Baranowski indicates that the STB's standard DCF model applies an index of future inflation to the SARR asset base as a means of adjusting the SAC quarterly capital recovery for inflation, and when calculating the cost of replacing assets in the future as the assets are projected to wear out and require replacement.¹¹ Relating Mr. Baranowski's statement in terms of the STB's DCF model, a SARR's average annual inflation in asset prices calculated in Table H of the STB's DCF model is used to adjust the quarterly levelized capital carrying charges in Table L of the DCF model, and to adjust the present value of SARR replacement costs in Table F.¹²

Mr. Baranowski's proposed approach for applying productivity to a SARR's capital costs improperly increases the SARR's cost of capital, because it fails to adjust the SARR's cost of capital for the revised rate of inflation.

It is well understood in economics that interest rates generally can be expressed in two ways: in real terms or in nominal terms. In real terms, the real rate of interest (" r_{real} ") is the price which equates the supply and demand for capital. The supply of capital depends on people's willingness to save – that is, to postpone consumption, while the demand depends upon the opportunities for productive investment.¹³ Because the value of money changes over time due to inflationary forces,

¹¹Id.

¹²The replacement costs from Table F subsequently are included in the DCF worksheet contained in the DCF model's Table L.

¹³For a complete discussion of real and nominal interest rates, see Irving Fisher's *The Theory of Interest: As Determined by Impatience to Spend Income and Opportunity to Invest It*, Augsutus

savers will demand compensation for the changing value of the assets. This takes the form of an interest rate that takes changes in prospective inflation into consideration. This inflation adjusted interest rate is known as the nominal interest rate ("r_{nominal}"), and can be expressed mathematically as:

$$(1 + r_{\text{nominal}}) = (1 + r_{\text{real}}) \times (1 + \text{inflation})$$

When analyzing cash flows on a present value basis, it does not matter if the r_{nominal} or the r_{real} are used in developing the discount factor, so long as the cash flows being discounted are expressed in terms consistent with the interest rate used. This can be seen in the example contained in Table 2 below.

Table 2
**Hypothetical Example of The
Present Value of Real and Nominal Cash Flows**

1. $r_{\text{real}} = 10.0\%$
2. inflation = 2.0 %
3. $r_{\text{nominal}} = 12.2\%$

<u>Real Cash Flows</u>			<u>Nominal Cash Flows</u>	
<u>Year</u>	<u>Cash Flow</u>	<u>Present Value ^{1/}</u>	<u>Cash Flow ^{2/}</u>	<u>Present Value ^{3/}</u>
(1)	(2)	(3)	(4)	(5)
4. 1	\$100	\$91	\$102	\$91
5. 2	100	83	104	83
6. 3	100	75	106	75
7. 4	100	68	108	68
8. 5	<u>100</u>	<u>62</u>	<u>110</u>	<u>62</u>
9. Total	\$500	\$379	\$531	\$379

^{1/} Column (2) $\div (1 + r_{\text{real}} \text{ from Line 1})^{\text{Year from Column (1)}}$
^{2/} Column (2) $\times (1 + \text{inflation from Line 2})^{\text{Year from Column (1)}}$
^{3/} Column (4) $\div (1 + r_{\text{nominal}} \text{ from Line 3})^{\text{Year from Column (1)}}$

As is shown in Table 2 above, total cash flows on a real basis equal \$500, while total cash flows are \$31 higher when inflation is taken into consideration and cash flow is expressed in nominal terms. Both cash flow streams, however, have a identical present values of \$379 when discounted using the appropriate interest rate.

The weighted average cost of capital ("WACC") developed in Table A of the STB's DCF model is a nominal cost of capital, i.e., it includes an adjustment for prospective inflation. Because the SARR's WACC is expressed in nominal terms, all cash flows that will be discounted using the WACC also must be in nominal terms. Conversely, if the cash flows are expressed in real terms, the WACC must be converted to a real basis by removing the rate of prospective inflation. The

STB's DCF model makes both adjustments in its DCF analysis. First, in Table I where the present value of future capital carrying charges are determined using the WACC, the STB's DCF model adjusts the quarterly levelized capital carrying charges from a real to a nominal basis by adjusting quarterly charges for the prospective inflation developed in Table H. Second, in Table F where the DCF model develops the present value of the replacement cost of assets that the SARR will replace in the future, the STB's DCF model calculates the real cost of capital by dividing one (1) plus the WACC by one (1) plus the annual weighted rate of inflation in assets for the last two quarters of the DCF period developed in Table H. The SARR's real cost of capital is then used to develop the SARR's replacement cost of assets adjusted for infinite lives, and to develop the terminal value of future cash flows in the Table I DCF analysis.¹⁴

Mr. Baranowski proposes adjusting the prospective inflation rate in assets developed in Table H of the DCF model for productivity gains that will occur in the future. However, unless the WACC is also adjusted to reflect the change in prospective inflation, the implicit impact of Mr. Baranowski's adjustment is to raise the SARR's WACC. As I indicated above, the r_{nominal} is equal to the r_{real} adjusted for prospective inflation. Any raising or lowering of the prospective rate of inflation will lead to a raising or lowering of the r_{nominal} as well. If the rate of prospective inflation in assets is lowered as suggested by Mr. Baranaowski and the nominal SARR WACC is not adjusted accordingly, the implicit impact is a WACC that is too high given the inherent risk in the SARR.¹⁵

¹⁴With regard to the development of the infinite life asset costs, the "Replacement" level of the STB's DCF model subsequently converts infinite life costs back to nominal terms so that they can then be used in the nominal DCF analysis in Table I.

¹⁵A SARR's WACC is priced by the market to provide a rate of return equal to the return of all investments with the same inherent risk. As investments become more risky, the market will demand a higher return to compensate for the additional risk. Similarly, as investments become less

Stated simply, Mr. Baranowski's adjustment will force a SARR to pay a higher rate of return than is currently paid by the real world railroads with no commensurate increase in risk.

The STB repeatedly has ruled that changes to a SARR's WACC to reflect risks not incurred by the incumbent Class I railroads are improper. In FMC,¹⁶ the UP attempted to justify increasing the WACC for the FMC SARR to account for supposed higher risks faced by the SARR from competing SARR's entering the market. The STB rejected UP's adjustment as unrealistic, opining that "it would be inappropriate and unfair to allow UP to charge captive shippers a higher rate than would otherwise be justified based on a risk that its investors do not face."¹⁷ UP subsequently proposed the same adjustment to the SARR's WACC in its evidence in WPL,¹⁸ and, once again, the STB rejected the adjustment as being "inappropriate," and placing on the SARR risks the incumbent carriers do not face.¹⁹ Because Mr. Baranowski's proposed adjustment to asset inflation effectively would raise

risky, the market will tolerate lower required returns.

¹⁶Docket No. 42022, FMC Wyoming Corp. v. Union Pacific Railroad Company, Decision served May 12, 2000.

¹⁷Id at 178

¹⁸Docket No. 42051, Wisconsin Power & Light Company v. Union Pacific Railroad Company, Decision served September 13, 2001.

¹⁹Id. at 32. The STB's ruling in WPL is especially relevant to the application of Mr. Baranowski's proposed adjustment in this rulemaking. In its WPL evidence, UP attempted to maneuver around the STB's FMC ruling that UP's cost of capital adjustment was inappropriate by arguing that the adjustment proposed by UP was not directly made to the WACC, and therefore, was permissible. The STB rejected UP's argument stating that while UP's approach was not a direct WACC alteration, the proposed adjustment would have the same result as directly increasing the SARR's WACC, and, therefore, was impermissible. At some future date, Mr. Baranowski could argue that his proposed adjustment to asset productivity should be allowed because it too does not directly adjust a SARR's WACC. However, as the STB found in WPL, any adjustment that would

the WACC incurred by a SARR without any changes in the SARR's risk profile, it cannot be accepted.

**B. FUTURE PRODUCTIVITY IN RAILROAD
ASSETS CAN BE INCLUDED IN THE STB'S DCF
MODEL WITHOUT IMPACTING A SARR'S WACC**

As I stated above, I agree with Mr. Baranowski that as technology and material science improve, the construction and replacement of railroad assets will become more productive. This productivity can be expressed in terms other than through changes in prospective inflation, and in ways that do not implicitly and inappropriately raise a SARR's WACC, as Mr. Baranowski's method does.

The Replacement Level within the STB's standard DCF model calculates the future costs of replacing a SARR's assets as the assets wear out. The STB's DCF model takes into consideration many factors to develop these future costs, including the average life of each asset group, its replacement cost after one replacement cycle, the asset's salvage value, taxes and depreciation. One approach to reflecting asset productivity would be to adjust the prices of assets replaced in the future to account for productivity advances. This is the approach proposed by Mr. Baranowski, and can lead to incorrect and inappropriate answers if adjustments are not made to all the DCF model's inputs to account for the change in future prices, i.e., adjusting the WACC for lower future inflation.

Another approach, which is much simpler and straightforward, is to adjust the life of the assets to be replaced in the future to account for increases in productivity. As assets become more productive, they can be viewed as performing the same amount of work for a lower price. An

effectively raise a SARR's WACC, either directly or indirectly, is unjustified.

equivalent way of viewing productivity is through the perspective that the asset is performing a greater amount of work for the same price. The STB's DCF model implicitly reflects the amount of work a SARR's asset performs through the asset's useful life. Therefore, an increase in the life of the asset for the same cost input will reflect the increased productivity in the asset. It would be a simple matter for users of the STB's DCF model to make adjustments to the asset lives portion of the Replacement Level of the STB's DCF model to reflect the future asset productivity. Adjusting a SARR's asset lives effectively incorporates the future asset productivity that will occur on the SARR without the disruption and risk associated with changing a multitude of other inputs to reflect future changes in asset inflation.

IV. THE DCF MODEL TIME PERIOD

Mr. Baranowski states that if the Board adopts a 10 year DCF period, two changes in the Board's DCF Model would be required: (1) operating expense forecasts would be eliminated for years 11 through 20, and (2) netting calculations would be made in year 10, not year 20.

Mr. Baranowski's proposed changes reflect the correct mathematical implications of a 10 year DCF period. More importantly, however, as I explained in my Opening Verified Statement, the DCF Table E procedures must be modified to amortize the SARR facilities over the actual asset lives, not the shorter DCF model life.

IV. CONCLUSIONS

As demonstrated above, Mr. Haley's reliance on the contribution per revenue ton-mile by commodity group does not accurately reflect the contribution made by coal to UP's bottom line. Comparison of the total dollar contribution made by each commodity group demonstrates that coal contributed \$659.6 million to UP's bottom line in 2004, or 31.1 percent of the total contribution. Coal's contribution exceeds that of every other commodity group. Further, when viewing coal revenues in relation to the cost of providing the service, coal produces a revenue to cost ratio of 137.8%, second only to chemicals.

The DCF model cost of capital reflects the appropriate asset inflation. Mr. Baranowski's proposal to include a productivity adjustment to asset inflation is improper, as it would have the effect of raising the SARR's cost of capital to a level above that of the railroad industry's average cost of capital. The proper approach for reflecting future asset productivity is to recognize productivity where it occurs, specifically in an increase in asset lives.

Finally, if the DCF Model period is shortened to 10 years, DCF Table E must be modified in the manner and for the reasons set forth in my Opening Verified Statement.

DEVELOPMENT OF UP 2004 CONTRIBUTION BY COMMODITY GROUP

To measure UP's 2004 contribution from each commodity group, I examined two sets of data. I also made one adjustment to reflect economies inherent in transporting unit coal train traffic as found by the Surface Transportation Board ("STB" or "Board") in STB Docket No. 42051, *Wisconsin Power & Light Co. v. Union Pacific Railroad*, served September 13, 2001 ("WPL"). I then confirmed the results of this analysis by developing UP's variable cost of providing service for the average shipment in each commodity group using both the Board's 2004 Public Use Waybill File and UP's 2004 Uniform Railroad Costing System ("URCS") unit costs and the Board's URCS Phase III costing model. My confirming analysis produced similar results. Both of these analyses are described in this Attachment.

**A. CONTRIBUTION BASED ON
WITNESS HALEY AND UNION PACIFIC DATA**

In Exhibit TCH-6 to his verified statement, Mr. Haley provided the contribution per revenue ton-mile for each of seven commodity groups handled by UP. These include agricultural, automotive, chemicals, coal, industrial, intermodal and other energy. In the Investors section of UP's website, UP provides its "Union Pacific Revenue Overview & Outlook - 2005" which identifies UP's revenue and ton-miles for these same commodity groups.¹ By simply dividing the aggregate revenue for each commodity by the corresponding aggregate ton-miles for each commodity, the

¹The Union Pacific Revenue and Overview & Outlook - 2005 does not distinguish between "coal" and "other energy" and instead provides just an "Energy" commodity group. As a result, in my analysis I considered coal and other energy as the same group.

DEVELOPMENT OF UP 2004 CONTRIBUTION BY COMMODITY GROUP

revenue per ton-mile is calculated. Then, subtracting Mr. Haley's contribution per ton-mile produces the UP's cost per ton-mile. Dividing the revenue per ton-mile by the cost per ton-mile yields a revenue to cost ratio for each commodity group. Finally, multiplying the contribution per ton-mile times the ton-miles generated by each commodity group, produces the aggregate contribution for each commodity group. Table 1 below shows the development of the aggregate contribution and the revenue to cost ratios for each commodity group.

Table 1
Union Pacific 2004 Contribution and Revenue to Cost Ratio by Commodity Group

<u>Commodity</u>	<u>Revenue</u> ^{1/} (Millions)	<u>Ton-Miles</u> ^{1/} (Millions)	<u>Revenue/ Ton-Mile</u> ^{2/} (Mills)	<u>Contribution Per Ton-Mile</u> ^{3/} (Mills)	<u>Cost</u> ^{4/} (Mills)	<u>Revenue to Cost Ratio</u> ^{5/}	<u>Total Contribution</u> ^{6/} (Millions)
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
1. Agricultural	\$1,675	77,097	21.7	3.0	18.7	116.0%	\$231.3
2. Automotive	\$1,235	17,987	68.7	4.0	64.7	106.2%	\$71.9
3. Chemical	\$1,719	58,536	29.4	9.8	19.6	150.1%	\$573.7
4. Energy	\$2,405	233,645	10.3	1.9	8.4	122.6%	\$443.9
5. Industrial	\$2,419	85,667	28.2	3.5	24.7	114.2%	\$299.8
6. Intermodal	\$2,240	73,389	30.5	6.8	23.7	128.7%	\$499.0
7. Total	\$11,693	xxx	xxx	xxx	\$9,573	122.4%	\$2,120.0

^{1/} Union Pacific Revenue Overview & Outlook - 2005.

^{2/} Column (2) / Column (3).

^{3/} Verified Statement of Thomas C. Haley, Exhibit TCH-6.

^{4/} Column (4) - Column (5).

^{5/} Column (4) / Column (6).

^{6/} Column (5) x Column (3) / 1,000.

DEVELOPMENT OF UP 2004 CONTRIBUTION BY COMMODITY GROUP**1. WPL Adjustment for Coal Shipments**

In WPL, the Board found UP's maximum reasonable rate to equal 180 percent of variable cost based on a movement specific cost analysis. In the interest of evaluating the difference in the results of using a movement specific cost methodology and URCS Phase III costs for unit coal train movements, I used the movement characteristics for the WPL move that were accepted by the Board in WPL as input into the Board's URCS Phase III cost program and calculated Phase III cost for the WPL movement. The results of this analysis showed the movement specific costs accepted by the Board in WPL were 11.0 percent lower than URCS Phase III costs for the same movement.

Historically, the Board has found that movement specific costs are more accurate than URCS Phase III costs.² Therefore, to accurately reflect the contribution from UP's energy (coal) commodity group relative to those yielded by other commodities, I have reduced the total costs associated with the energy commodity group by \$215,718,000³ to reflect the Board's WPL findings. I then allocated the reduction in cost of handling coal to the other commodity groups. The reduction in cost applied

²See for example, Docket No. 42072, *Carolina Power & Light v. Norfolk Southern Railway Co.*, (Dec. 23, 2003); Docket No. 42057, *Pub. Serv. Co. of Colo. D/b/a Xcel Energy v. BNSF Ry. Co.* 2004 WL 1428724 at 77 (June 7, 2003); Docket No. 42056, *Texas Municipal Power Agency v. BNSF Ry. Co.* 2003 WL 1523335 at 19 (Mar. 21, 2003); Docket No 42051, *Wisconsin Power & Light Co. v. Union Pacific R.R. Co.*, 2001 WL 1075821, at 18 (Sept. 13, 2001); Ex Parte 346 Sub-No. 29A), *FMC Wyoming Corp. & FMC Corp. v. Union Pacific R.R. Co.*, 2000 WL 33527851, at 25, (May 12, 2000); *Pozzolanic v. Union Pacific RR*, I.C.C. No. 39919, 1989 WL 246868 at 4.

³8.4 mills in Table 1 above, times 233,645 million ton-miles times 11 percent.

DEVELOPMENT OF UP 2004 CONTRIBUTION BY COMMODITY GROUP

to the other commodity groups equaled the reduction in coal costs as a percent of total cost less the cost of handling coal. The results of my analysis are shown in Table 2 below.

Table 2
**Union Pacific 2004 Contribution and Revenue to Cost
Ratio by Commodity Group With the WPL Cost Adjustment**

<u>Commodity</u>	<u>Revenue ^{1/}</u> (Millions)	<u>Ton-Miles ^{1/}</u> (Millions)	<u>Revenue/ Ton-Mile ^{2/}</u> (Mills)	<u>Contribution Per Ton-Mile ^{3/}</u> (Mills)	<u>Cost ^{4/}</u> (Mills)	<u>Revenue to Cost Ratio ^{5/}</u>	<u>Total Contribution ^{6/}</u> (Millions)
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
1. Agricultural	\$1,675	77,097	21.7	2.5	19.3	112.8%	\$190.4
2. Automotive	\$1,235	17,987	68.7	2.2	66.5	103.3%	\$39.0
3. Chemical	\$1,719	58,536	29.4	9.2	20.1	146.0%	\$541.2
4. Energy	\$2,405	233,645	10.3	2.8	7.5	137.8%	\$659.6
5. Industrial	\$2,419	85,667	28.2	2.8	25.4	111.0%	\$239.8
6. Intermodal	\$2,240	73,389	30.5	6.1	24.4	125.1%	\$449.7
7. Total	\$11,693	xxx	xxx	xxx	\$9,573	122.1%	\$2,120

^{1/} Union Pacific Revenue Overview & Outlook - 2005.

^{2/} Column (2) / Column (3).

^{3/} Column (4) - Column (6).

^{4/} [(Contribution per ton-mile - Energy (8.4 mills) from Table 1 x .11) x 233,645 ton-miles / cost for all other commodities, i.e. the sum of lines 1, 2, 3, 5, 6, column (3) x column (6)] = percent increase in cost for all other commodities x lines 1, 2, 3, 5 and 6 of Table 1 col. (6).

^{5/} Column (4) / Column (6)

^{6/} Column (5) x Column (3) / 1,000.

As is evident from Table 2 above, energy (coal) contributes substantially more to UP's bottom line than any other commodity group and, in fact, provides nearly one-third of the total contribution made

DEVELOPMENT OF UP 2004 CONTRIBUTION BY COMMODITY GROUP

by all commodity groups. Mr. Haley's reliance on contribution per revenue ton-mile is a misleading indicator of the substantial contribution that coal makes to UP's profitability.

**B. CONTRIBUTION BASED
ON URCS PHASE III COSTS**

In order to verify the results of my analysis based on Mr. Haley's contribution per revenue ton-mile and the data obtained from UP's website, I undertook a separate analysis based on information contained in the STB's 2004 Public Use Waybill file, UP's 2004 URCS unit costs and the STB's URCS Phase III costing model. This section of Attachment No. 1 describes my analysis and presents the results of the analysis, which confirm those determined through my previous analysis.

Using the STB's 2004 Public Use Waybill file, I identified all shipments that originated or terminated in the Western Trunkline, Mountain Pacific and Southwest regions.⁴ These shipments were then assigned to UP's six commodity groups based on their corresponding STCC codes (with shipments assigned to the intermodal commodity group based on the intermodal designation in the waybill file). Any shipments that did not have an entry in the car type, car ownership or shipment size fields were eliminated from the data base. The average lading weight per carload was then calculated for each commodity group.

⁴As specific data for UP shipments was not available, I used all shipments originating or terminating in the Western U.S. as a surrogate for UP actual data. This assumes that traffic moving on UP and on BNSF has similar characteristics in terms of mix of lading weight, car type, car ownership, shipment size and shipment type (i.e. local, interline forwarded, interline received and overhead).

DEVELOPMENT OF UP 2004 CONTRIBUTION BY COMMODITY GROUP

This data was combined with the data available from the Union Pacific Revenue Overview & Outlook – 2005 file to determine UP's total tons by commodity group and the average length of haul by commodity group. Specifically:

1. The total tons by commodity group were determined by multiplying the average lading weight by the number of cars by commodity group found in Union Pacific's Revenue Overview & Outlook – 2005 file;
2. The average length of haul was determined by dividing the total ton-miles by commodity group reported in Union Pacific's Revenue Overview & Outlook – 2005 file by the tons for that commodity group; and
3. URCS Phase III costs were developed for each shipment in the data base by commodity group using the car type, lading weight, car ownership, shipment size and shipment type reported in the Public Use Waybill file combined with average length of haul calculated as described above and using UP's 2004 URCS unit costs.

Based on the results of this analysis, the average cost per carload was determined for each commodity group.

The Union Pacific Revenue Overview & Outlook – 2005 file provides the average revenue per car by commodity group. Dividing this amount by the average cost per car (developed above) produces the average revenue to variable cost ratio for each commodity group. The average revenue per car less the average variable cost per car produces the average contribution per car. In turn, the average contribution per car multiplied by the number of carloads by commodity group yields the aggregated contribution by commodity group.

REPLY VERIFIED STATEMENT OF
GEORGE H. BORTS, Ph. D
Professor of Economics
Brown University

Introduction.

My name is George H. Borts. I am Professor of Economics at Brown University, Providence, Rhode Island. My Verified Statement of May 1, 2006 was submitted to the Board in the opening phase of this proceeding. My professional qualifications were attached to that statement as Appendix A.

This Reply Verified Statement is submitted in support of the Joint Comments of Western Coal Traffic League, Concerned Captive Coal Shippers, the Edison Electric Institute, the National Rural Electric Cooperatives Association, and the American Public Power Association, in this proceeding.

I. Maximum Rate Regulation.

In its proposed rule making the Board investigated two possible methods of providing rate relief to shippers whose SARR was found to have revenues in excess of SAC: the Maximum Contribution Methodology (MCM) and the Maximum Markup Methodology (MMM). Both methods are consistent with the economic principles that underlie the Guidelines, because they guarantee that rail rates do not generate revenues in excess of SAC, and they allocate SAC among the SARR's shippers in a manner that respects their relative elasticities of demand. Moreover, the allocation procedures under MCM and MMM are sufficiently flexible to preserve the existing structure of the defendant's freight rates, by leaving relatively intact the ranking of shippers from high to

low rates per ton-mile. Indeed, this is consistent with the Guidelines, which state at p. 527 that SAC prices only qualitatively reflect relative elasticities of demand. And by using the shippers' current rates as a ceiling for SAC allocation, the Board's proposed methodologies effectively shift the greater share of unattributable costs to those shippers whose higher rates reflect a greater dependence on and valuation of the SARR's service. For these reasons, both MCM and MMM are superior to the Percent Reduction Method (PRM) used in recent Board decisions. Moreover, both MCM and MMM avoid the core practical problem associated with PRM: that the regulated carrier's rate decisions control the outcome of the regulatory process.

In the course of the debate over PRM, this flaw frequently has been described as an incentive for the railroad to "game" the case result. However, "gaming" is a misnomer, for it implies a subjective intent which is irrelevant to the regulatory policy question that genuinely is in issue; that is, to what extent the rate set by a railroad in anticipation of litigation should play a determinative role in the regulator's finding as to the maximum reasonable rate under the governing statutes.

As seen in the testimony of its expert witnesses, BNSF's response to the issue is to define the problem away.¹ Its witnesses, Joseph Kalt and Robert Willig endorse using the rate chosen by the defendant as the starting point in the reasonableness analysis so long as it maximizes profits for the defendant. Dr. Willig states,

If a new rate established by a rail carrier is one that would have been set for ordinary business purposes in the absence of rail regulation, it cannot be deemed

¹ Union Pacific's economic witness, Dr. Kevin Neels, did not address the Percentage Reduction Methodology.

manipulative. A rate increase would meet this criterion if it were expected to increase net revenues from market transactions, inasmuch as it would not repress so much traffic as to outweigh the increased price per unit of traffic that remains. (V.S. Willig, p. 26).

Dr. Kalt echoes this view,

Indeed, if a rate is profit-maximizing it is, by definition, not a gamed rate.
... At its heart, the challenge is to assess whether or not a challenged rate is commercially reasonable in the sense that it can be rationally sustained as the rate which maximizes the carrier's profits in light of market supply and demand conditions. (V.S. Kalt, p. 26).

In BNSF's view, the Board should only decline to use the rate set by the defendant as the starting point if it is shown that the rate is not "commercially reasonable." However, BNSF considers any profit maximizing rate to be commercially reasonable. Therefore, no rate set by the railroad could be ruled out, no matter how high, unless it reduced the railroad's profits. Thus, irrationality becomes the criterion that determines whether the defendant is allowed to control the outcome of the regulatory process. The proponents of this point of view do not explain the difference between such a scheme and complete deregulation, since presumably no railroad would argue that a regulatory authority is needed to show the railroads how to set the prices that maximize their profits. Nor do they explain how their theory of profit maximization is consistent with the Guidelines, or whether there is any ground for this new goal of regulatory policy.

As specifically applied to the electric utility sector, BNSF's witness Dr. Darius Gaskins asserts that under the carrier's theory, a rate should be considered commercially sustainable and rational (and by implication not beyond a reasonable maximum) so long as it does not force a reduction in net generation. So long as the generating station earns a penny more than its variable costs, Dr. Gaskins would judge the rate acceptable and therefore, by definition, appropriate for use as a starting point under PRM. This use of economic dispatch to justify rates that have the effect of transferring all economic rents from the shipper to the railroad is a clear example of monopolistic pricing. It is a reversion back to the "whatever the traffic will bear" notion of captive coal pricing which the Board's predecessor rejected long ago as inconsistent with a regulatory structure that requires that captive rates be "reasonable."

Nevertheless, an attempt is made by Dr. Gaskins to justify such rail freight rates on the grounds that they bring the prices of electric power closer to marginal costs of generation. The argument is that under cost of service regulation of power rates, rates are set to cover the costs of each generating unit, not the cost of the marginal generating plant. Economic efficiency requires that consumers face the cost of the marginal plant, otherwise they will have an incentive to overconsume. So in the interests of arriving at a more efficient allocation of resources, Dr. Gaskins posits that the railroads should be allowed to raise freight rates on the deliveries of coal to the infra-marginal plants, and thus bring their costs and power rates up to the cost of the marginal plant. Again, Dr. Gaskins is asserting that railroad rate regulation should rest on the concept of a consumer's ability to pay. The law requires that market dominant railroads be monitored by the Board, and when challenged, that their rates be shown to be reasonable. Under the

Guidelines, the reasonableness of rates is judged by their relationship to the rate that would be charged by an optimally efficient, hypothetical competitor. Unless the standard of regulation is to be changed to monopoly pricing, an otherwise unreasonable utility coal rate cannot be justified by its impact on the marginal cost of electric power generation.

In summary, the railroad witnesses' defense of PRM amounts to a stance of regulatory indifference, and if adopted by the Board, would eliminate its role in protecting captive shippers against railroad monopoly pricing.

II. Allocation of Revenue on Cross-Over Traffic.

A. The Board's proposed ATC method is faulty and inferior to other methods.

On this first point, all of the participants appear to agree that ATC is an inferior method of allocating cross-over traffic revenue between the SARR and the incumbent railroad. But that is the only point of agreement. The railroads argue for methodologies that have been rejected in the past by both the Board and the ICC, while shippers continue to maintain, correctly in my view, that the best way to determine rate divisions is to use actual market data of surrogates like MMP or MSP.

1. UP's Views.

The Union Pacific, through its expert witness, Dr. Neels first argues that the stand-alone methodology was never designed to permit cross-over traffic. "The Board's proposal fails to reflect that in a stand-alone cost test, the stand-alone entity is supposed to *stand alone*." (OVS, p. 4) In Dr. Neels' view, a SARR that fails to originate and terminate all of its traffic is dependent on the truncated incumbent to cover some of its costs. This is the basis of his ultimate complaint that the Board continues to tolerate

methods of revenue allocation such as ATC that are “biased in the direction of increasing the cross-over traffic revenue allocated to the truncated SARR”. Id. at 6.

In preference to ATC, Dr. Neels argues for an Efficient Component Pricing Rule, a device that UP introduced during consideration of Nevada Power II.² Under this rule, which the ICC rejected, the SARR and the incumbent are viewed as rivals in a contestable market. Moreover, the incumbent is not truncated to make way for the SARR, but maintains its system intact. Each railroad then vies against the other to win the traffic that the SARR wishes to carry. The railroad that offers the lowest rate will win the traffic. For each movement on the SARR, this rate is a penny less than the “avoided variable cost” (Neels OVC, p. 15) of the higher cost railroad. If the SARR wins a shipper’s business away from the incumbent the most it can charge is the incumbent’s avoided variable cost, and if the incumbent wins the shipper’s business, the most it can charge is the SARR’s avoided variable cost.

Dr. Neels’ approach suffers from several problems – the same problems that led the Board to reject ECP in Nevada Power II.³ First, Dr. Neels assumes that the SARR and the incumbent will compete for the SARR’s business, with the resulting competition setting the SARR’s rates at the incumbent’s avoidable variable costs for providing the SARR service. However, contestability theory is predicated upon a SARR evaluating “the profitability of entry at the incumbent firm’s pre-entry prices” without “fear of retaliatory price alterations” by the incumbent.⁴ Simply stated, contestability theory does

² Bituminous Coal - Hiawatha, Utah to Moapa, Nevada, 10 I.C.C. 2d 259 (1994).

³ The Board also rejected ECP in McCarty Farms, Inc. v. Burlington Northern, Inc., 2 S.T.B. 460, 471-72 (1997).

⁴ William Baumol et al., Contestable Markets and the Theory of Industry Structure at 5,

not envision or permit the competition between the incumbent and the SARR that Dr. Neels postulates.

The ICC recognized this fundamental precept in Nevada Power II. The ICC correctly found that “we cannot take into account any post-entry responses by the incumbent” (*id.* at 267) because “a potential entrant will shun a market when price retaliation by the incumbent reduces revenues before the entrant has a change to recoup its costs.” *Id.* at 266. To the same effect is the Board’s ruling in Duke/NS I.⁵ In Duke/NS I, the Board found that setting a SARR’s divisions “down close to variable cost levels” would require that non-cross over traffic would “bear most of the fixed cost of the [SARR]” producing an “end result [that] would deprive each complainant shipper of the benefit of grouping (*i.e.*, realizing the economics of scale, scope and density) held out to them in Guidelines.” *Id.* at 18-19.

Second, Dr. Neels’ approach assumes that the SARR does not replace the incumbent for SARR service. This postulate was also rejected in Nevada Power II. The ICC correctly found that a SARR should be viewed as a replacement carrier for the incumbent: “we view the entrant as if it were a replacement for that segment of the rail system whose services the entrant would be offering.” *Id.* at 267. This result logically flows from contestability theory and has been routinely followed in subsequent cases before the Board, including McCarty Farms, WTU and AEPCO:

- “As the ICC explained at some length in Nevada Power I... it would be inconsistent

349 (Rev. Ed. 1988).

⁵ Duke Energy Corp. v. Norfolk Southern Ry, STB Docket No. 42069 (STB served Nov. 6, 2003).

with the nature and purpose of a SAC analysis to treat the SARR as a competitor of the incumbent railroad rather than its replacement". McCarty Farms, 2 S.T.B. at 472.

* * *

- "A SARR is "a replacement carrier that steps into the shoes of the incumbent carrier for the segment of the rail system that the SARR would serve." WTU, 1 S.T.B. at 670.⁶

* * *

- "[C]ontestable market theory allows for the simulation of a competitive price by calculating what a hypothesized efficient producer would need to charge to provide replacement service." AEPCO,⁷ (STB served Aug. 20, 2002) at n.9.

Third, Dr. Neels' assertions that SAC theory requires consideration of off-SARR SAC costs is also wrong. In Nevada Power II, the ICC correctly found that cross-over traffic should be included in the SARR interchanged with the incumbent carrier at the appropriate endpoints of the SARR. Id. at 267. The ICC went on to conclude that a SARR, like any other carrier, would negotiate market-based divisions with the residual incumbent, and that, like any other carrier in the marketplace, a SARR is not required to negotiate a division that insures its interline partners recover their off-SARR SAC costs:

Viewing a SARR's interline rail partners simply as additional customers of the SARR means that the captive shipper is not required to ensure that far-flung rail lines are earning their full replacement cost of capital.

Id. at 280 (Chairman McDonald concurring).

⁶ West Texas Utilities Co. v. Burlington Northern R.R., 1 S.T.B. 638 (1996).

⁷ Arizona Electric Power Coop., Inc. v. Burlington Northern and Santa Fe Ry., STB Docket No. 42058.

Dr. Neels' contrary views also place an impermissible barrier to entry on a SARR. Under his approach, a SARR is required to negotiate divisions with the incumbent using non-market based measures that are not applied in real-world division negotiations between carriers. Indeed, ECP divisions are designed to reduce SARR divisions well below market levels. The result is an artificial barrier to entry – i.e., the SARR is subject to an artificial division requirement not faced by the incumbent or any other carrier in the marketplace. These types of barriers to entry directly conflict with contestability theory. Contestability theory assumes that there are no artificial barriers to entry and that SARR's can use the same productive techniques (including divisions arrangements) as those used by incumbents. See Coal Rate Guidelines⁸ at 528.

Fourth, a major implication of ECP is that the most the SARR can collect from interchange traffic is the avoidable variable cost of the incumbent. Any higher rate would imply that the incumbent could bid the traffic away. This asymmetry in rate divisions is an attempt to apply the results of contestability to the world of sunk costs, restricted entry, and market power that characterizes a railroad market consisting of five firms in the entire country. It would be useful to examine actual data on revenue divisions between railroads to see how many agreements limit revenue to no more than avoidable cost.

2. BNSF's Views

BNSF presents three witnesses to evaluate the ATC method: Joseph Kalt, Robert Willig, and John Klick. They appear to reject the UP complaint that the Board fails to recognize the inherent error in allowing the SARR to carry cross-over traffic, as well as

⁸ Coal Rate Guidelines – Nationwide, 1 I.C.C. 2d 520 (1985).

the claim that any truncated SARR is going to rely on revenues from the incumbent to cover its costs. Instead they focus on their version of the ECP theorem that relies on the assumption that the SARR is in competition with the incumbent, and must charge a rate that the incumbent cannot beat in order to capture traffic that otherwise will belong to the incumbent.

Dr. Kalt complains that in the Western Fuels case, its SARR is but 220 miles long, yet depends on more than 9,300 miles, or approximately 40% of BN's overall network. He uses this piece of information to buttress his opinion that "the design of the SARR is not being driven by the economics of an efficient competitor seeking to win by offering rates that beat the next best alternative, but by the incentive to include many short-haul movements that are highly profitable due to the arbitrary rules that have evolved to allocate revenue between the SARR and the residual incumbent." (Kalt, OVS p. 36)

As we have seen, however, under UP's proposed ECP and BNSF's proposed "Contestability Pricing" the so-called efficient SARR would be forced into a price war with the incumbent. This result is neither consistent with contestability nor recognized in the Guidelines for the same reasons discussed above regarding UP's ECP proposal.

Summary

Nevada Power II got it right. The SARR does not have to build a line connecting the origins and destinations of all of its traffic. Walmart does not grow its own food. General Motors does not make all of the parts that go into its cars and trucks. Contestability does not imply that a firm has to make every component of its product. One of the fundamental implications of contestability is that the SARR can choose what

portion of the route to serve, and purchase transportation service from the incumbent or other railroads for the remainder.

The best evidence on the division of revenues on cross-over traffic comes from railroad revenue sharing agreements. The Board should require that the railroads provide such information. In the absence of revenue sharing agreements, the Board's MSP or MMP methodology is preferable to the ATC method. As I indicated in my OVS, there is no non-arbitrary method of allocating fixed costs on a cost-of-service basis. Railroad witnesses agree with this position. The only costs that can be allocated are those that vary with dimensions of input or output, and these are not fixed.

VERIFICATION

STATE OF RHODE ISLAND

SS:

COUNTY OF PROVIDENCE

GEORGE H. BORTS, being duly sworn, deposes and says that he has read the foregoing Verified Statement, that he knows the facts set forth therein, and that the same are true to the best of his knowledge, information, and belief.

George H Borts

Subscribed and sworn to before me

This 30 day of May 20 06

Angela C Spertini
Notary Public

My commission expires 11/08