

**BEFORE THE
SURFACE TRANSPORTATION BOARD**



MAJOR ISSUES IN RAIL RATE CASES

216654
Ex Parte No. 657 (Sub-No. 1)

WEST TEXAS UTILITIES COMPANY
Complainant,

v.

Docket No. 41191

BNSF RAILWAY COMPANY
Defendant.

216661
ENTERED
Office of Proceedings

AEP TEXAS NORTH COMPANY
Complainant,

v.

Docket No. 41191 (Sub-No. 1)

BNSF RAILWAY COMPANY
Defendant.

Part of
Public Record

216662

REPLY COMMENTS OF AEP TEXAS NORTH COMPANY

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Dated: May 31, 2006

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REPLY COMMENTS OF AEP TEXAS NORTH COMPANY

Pursuant to the Decision of the Board served in the above-captioned proceedings on February 27, 2006, AEP Texas North Company ("AEP Texas") submits these Reply Comments in response to the opening comments filed by BNSF Railway Company ("BNSF") on May 1, 2006. The Coal Shippers¹ this date are filing Joint Reply

¹ The Coal Shippers consists of the Concerned Captive Coal Shippers, Western Coal Traffic League, Western Fuels Association, Inc., Edison Electric Institute, National Rural Electric Cooperative Association and American Public Power Association. AEP Texas' parent company is a member of the Concerned Captive Coal Shippers.

Comments in this proceeding. AEP Texas subscribes to the Joint Reply Comments, and submits these additional comments specifically to address two issues relevant to its pending cases – the rate reduction methodology to be applied when stand-alone revenues are found to exceed stand-alone costs, and the standards for reopening and vacating rate prescriptions.

I. Rate Reduction Methodology

In its Decision, the Board proposed to discontinue use of the percent reduction method, and replace it with its Maximum Contribution Methodology (“MCM”) and/or Maximum Markup Methodology (“MMM”). AEP Texas herein replies to certain claims made by BNSF in opposition to this proposal.

A. Gaming is Not the Only Flaw in the Percent Reduction Method

BNSF wrongly asserts that the potential for “gaming” is the only flaw in the percentage reduction method that could justify its discontinuance. *BNSF Comments* at 40-45. As AEP Texas has shown in the evidence filed in *Docket No. 41191 (Sub-No. 1)*, the percent reduction method is flawed because it is inconsistent with Ramsey Pricing principles. AEP Texas Op. Evidence at III-G-26 to 30. It is this defect which makes the percentage reduction method unsuitable for use in *any* cases, including cases such as *Docket Nos. 41191 and 41191 (Sub-No. 1)*, in which “gaming” is not alleged.

Under Ramsey principles, the markup of price over marginal costs for a given consumer is presumed to be inversely related to that consumer's elasticity of demand. As a result, the allocation of unattributable costs is not proportional; the recovery of unattributable or fixed costs falls on all market participants, but with greater percentage markups for those with less elastic demand. Conversely, decreases in the revenue required to cover total costs also should not be proportional; reductions should follow a pattern of price relief wherein participants with less elastic demand (those that absorbed the greater increases) receive proportionately greater rate reductions. AEP Texas Op. at III-G-27.

The percentage reduction methodology ignores the relationship among the markups over marginal cost experienced by the members of a SARR traffic group, and instead reduces rates in an equal percentage for all participants. Because the percentage reduction method focuses solely on relative *prices* among participants, instead of markups, it is contradictory to Ramsey Pricing principles. *Id.* at III-G-29.

B. GPRM Addresses BNSF's Criticisms of MCM and MMM

BNSF claims that the alternative methodologies proposed by the Board are contrary to Ramsey and differential pricing principles. *BNSF Comments* at 28-29. BNSF also challenges the Board's proposal as being contrary to prior agency precedent, because MCM and MMM allegedly yield cost-based rates, and are not designed to preserve the railroad's rate structure *per se*. *Id.* at 33. Finally, BNSF argues that the proposals are

contrary to the Board's statutory authority because they do not "allow to the maximum extent possible, competition, and the demand for services to establish reasonable rates...."

Id. at 37, quoting 49 U.S.C. § 10101(1).

In its Opening Comments in this proceeding, AEP Texas proposed that the Board adopt the Generalized Percent Reduction Methodology ("GPRM"), a method set forth in detail in the *Docket No. 41191 (Sub-No. 1)* record, as a replacement for the percent reduction method. AEP Texas does not concur in BNSF's criticisms of MCM and MMM, and as referenced *supra*, AEP Texas subscribes to the Joint Reply Comments of the Coal Shippers in this regard. However, AEP Texas also submits that GPRM addresses each of BNSF's concerns regarding MCM and MMM, and should be applied in AEP Texas' pending rate case.

First, GPRM is consistent with Ramsey Pricing principles. Under GPRM, relief is allocated in the same manner as prices initially were presumed to have been set or increased; that is, shippers with the lowest demand elasticity experience a greater relative change in pricing (whether prices are increasing or decreasing). Such an approach is consistent with Ramsey principles, because GPRM ensures that shippers whose demand elasticities exposed them to the greatest price markups over marginal costs when overall carrier revenues were raised experience correspondingly greater price reductions when the SAC test points to a reduction in overall SARR revenues. *See Docket No. 41191*

(*Sub-No.1*), AEP Texas Op. at III-G-30 to 31; AEP Texas Reb. at III-G-37; AEP Texas Brief at 22.

Second, GPRM is consistent with Board precedent and statutory requirements, because it takes into account competition and demand elasticity and does not attempt to set rates based on uniform rate markups or mark-downs. BNSF argues that the *Coal Rate Guidelines* prohibit methods which require uniform markups for captive traffic, and that section 10101(1) of Title 49 requires that the Board set rates in a manner that allows “competition and demand for services” to guide rate levels. *BNSF Comments* at 33. AEP Texas does not agree with BNSF that the Board’s MCM and MMM proposals violate these principles. Nevertheless, AEP Texas and its experts took these considerations into account when developing GPRM, and ensured that GPRM allows for differential mark-ups and applies differential pricing based on demand elasticity for rate reductions, consistent with the presumed characteristics of the railroad’s rate structure.

C. BNSF’s Proposed Methodology is Flawed

BNSF proposes that the Board adopt the methodology that it presented in Docket No. 42088, *Western Fuels Association, Et Al. v. BNSF Railway Company*. This methodology is set forth in BNSF Reply Exhibit III.A-1, and is directed at the issue of revenue divisions on cross-over traffic as well as maximum rate reductions.

BNSF’s proposed methodology should be rejected, as it is plainly designed to ensure that little if any rate reduction ever occurs, regardless of the level of SAC.

Under BNSF's approach, if the SARR revenues exceed its costs, the excess is used to reduce the rates on the issue traffic. BNSF Reply at III.H-6 to 8. However, when the methodology is used to determine divisions for cross-over traffic, it ensures that this result rarely (if ever) occurs, because BNSF would limit the SARR's cross-over traffic division to the incumbent's avoidable cost. Under BNSF's proposed approach, the issue traffic must pay all unattributable SARR costs above URCS variable costs. This results in the issue traffic paying a significantly higher share of total SAC than the other traffic along the line, thereby unreasonably narrowing (or completely removing) any measure of potential rate relief. *See* WFA/Basin Reb. at III-H-37-38.

D. BNSF Advocates Unrestrained Monopoly Pricing

BNSF and its witness Darius Gaskins claim that so long as a rate is not so high that it affects the dispatching of an electric generating facility, it is commercially sustainable and should be considered valid under Ramsey Pricing principles. *BNSF Comments* at 11, 43-44; V.S. Gaskins at 2-3. This approach essentially is unrestrained monopoly pricing, and tantamount to allowing the railroads to charge whatever the traffic will bear. It has been squarely rejected both by the courts and the Board's predecessor. *See, e.g., Coal Exporters Ass'n, Et Al. v. United States*, 745 F. 2d 76, 95 (D.C. Cir. 1983); *Increased Rates and Charges, 1978, Nationwide*, 365 I.C.C. 14 (1981). As the D.C. Circuit once observed in another case:

[a]t some point the availability of an alternative such as the horse and buggy or even people carrying [the involved commodity in] buckets theoretically prevents railroads from raising their rates beyond an outer bound.

Arizona Pub. Serv. Co. v. United States, 742 F.2d 644, 650-51 (D.C. Cir. 1984). BNSF's witness Gaskin argues that any rate short of the point at which a utility would reduce its coal burn is consistent with Ramsey Pricing. Under this view, BNSF claims that AEP Texas could be charged a rate of up to \$33.44 per ton, or 30.3 mills per ton-mile for the 1100-mile movement at issue in *Docket No. 41191 (Sub-No. 1)*. V.S. Gaskins at 2. Without conceding the mathematical accuracy of any calculations offered by witness Gaskins, AEP Texas submits that this would be equivalent to no regulation at all and contrary to law, as agencies charged with determining maximum rates must engage in "meaningful rate regulation." *Farmers Union Cent. Exch. Inc. v. FERC*, 737 F.2d 1486, 1507 (D.C. Cir. 1984).

II. Standards for Reopening and Vacating Rate Prescriptions

In its Opening Comments, AEP Texas endorsed the Joint Comments of the Coal Shippers with respect to the modifications that must be made to the Board's proposed criteria for evaluating requests to vacate or revise a rate prescription, in order to ensure even treatment of shippers and carriers, and consistency with the requirements of established law.

Essentially confirming the clear tilt of the Board's proposed criteria in the railroads' favor, BNSF offers its unqualified support for the standards outlined in the February 27, 2006 Decision. *BNSF Comments* at 72-73. Appended to this endorsement is the claim that under the proposed criteria the 1996 rate prescription in *Docket No. 41191*, which was vacated by the Board in 2004 and now is back before the Board on remand from the D.C. Circuit, should be deemed to have had its effectiveness restored, such that BNSF's Rawhide rates now are insulated from challenge in *Docket No. 41191 (Sub-No. 1)* until a second vacation order is entered. *BNSF Comments* at 73-74. BNSF's argument was addressed in full by AEP Texas in its June 7, 2005 Reply to Defendant's Second Motion to Dismiss in *Docket No. 41191 (Sub-No. 1)*, which AEP Texas hereby incorporates by reference. As shown therein, BNSF's "revival" theory is squarely contradicted by the Supreme Court's ruling in *Burlington Northern Inc. v. United States*, 459 U.S. 131 (1982). There, the Court reversed a D.C. Circuit ruling that the Court of Appeals' prior vacation of two decisions of the I.C.C. which had modified an earlier rate prescription had the effect of reinstating the initial prescription. The Supreme Court held that the initial prescription was not reinstated when the agency decision was vacated, because a court does not have the authority to establish rates. BNSF's attempted reprise of its argument in this proceeding is both unfounded and out of place, and should be ignored.

CONCLUSION

The Board should resolve the issues raised in this proceeding in the manner described herein, in AEP Texas' Opening Comments, and in the Joint Opening and Reply Comments of the Coal Shippers.

Respectfully submitted,

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Dated: May 31, 2006

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CERTIFICATE OF SERVICE

I hereby certify that on this 31st day of May, 2006, I caused a copy of the foregoing Reply Comments of AEP Texas North Company to be served upon all parties of record in this proceeding.


Kelvin J. Dowd