



SIDLEY AUSTIN LLP
1501 K STREET, N.W.
WASHINGTON, D.C. 20005
202 736 8000
202 736 8711 FAX

phemmersbaugh@sidley.com
(202) 736-8538

BEIJING
BRUSSELS
CHICAGO
DALLAS

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June 1, 2006

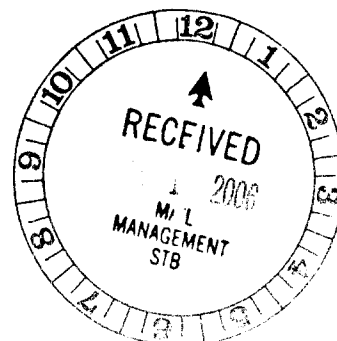
HAND DELIVERY

The Honorable Vernon A. Williams
Secretary
Surface Transportation Board
1925 K Street, N.W.
Washington, D.C. 20423-0001

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Re: Ex Parte No. 657 (Sub-No. 1), Major Issues in Rail Rate Cases

Dear Secretary Williams:

Enclosed for filing in the above-referenced proceeding are an original and twenty copies of the Reply Comments of Canadian Pacific Railway Company ("CPR"). A diskette containing an electronic version of the Reply Comments is also enclosed. Because the Board's office was closed yesterday afternoon, CPR filed its comments electronically via the Board's on-line filing service and served all parties of record in the customary manner.

Please acknowledge receipt of the enclosed Reply Comments for filing by date-stamping the enclosed extra copies and returning them via our messenger. If you have any questions, please contact the undersigned counsel.

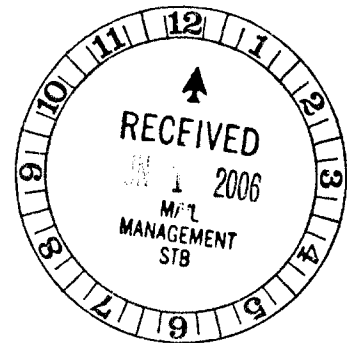
Sincerely,

Terence M. Hynes

Counsel for Canadian Pacific
Railway Company

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Enclosures

**BEFORE THE
SURFACE TRANSPORTATION BOARD**



**STB Ex Parte No. 657 (Sub-No. 1)
MAJOR ISSUES IN RAIL RATE CASES**

**REPLY COMMENTS
OF
CANADIAN PACIFIC RAILWAY COMPANY**

Paul Guthrie
Vice President - Legal Services
Canadian Pacific Railway Company
401 9th Avenue, S.W.
Gulf Canada Square, Suite 500
Calgary, Alberta T2P 4Z4 Canada

Terence M. Hynes
Sidley Austin LLP
1501 K Street, N.W.
Washington, D.C. 20005
(202) 736-8000
(202) 736-8711 (Fax)

Attorneys for Canadian Pacific Railway Company

Dated: May 31, 2006

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

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

MAJOR ISSUES IN RAIL RATE CASES

REPLY COMMENTS OF CANADIAN PACIFIC RAILWAY COMPANY

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

In its initial comments filed on May 1, 2006, CPR addressed two of the proposals set forth in the *NPRM Order*: (1) the Board's proposal to take account of productivity in indexing a SARR's operating expenses by applying the RCAF-A in 5 percent increments starting in the second year following the "base year" of the SAC analysis period (*NPRM Order* at 20-21); and (2) the Board's proposal to abandon the longstanding practice of permitting parties to submit evidence supporting movement-specific adjustments to the system-average costs generated by URCS (*NPRM Order* at 21-23). In these reply comments, CPR will respond to the initial comments filed by other parties with respect to those two proposals, as well as the Board's proposal to shorten the SAC analysis period from twenty (20) years to ten (10) years.

I. THE BOARD'S PROPOSED HYBRID INDEX FOR ADJUSTING SARR OPERATING COSTS IS NOT SUPPORTED BY THE RECORD EVIDENCE.

CPR's initial comments demonstrated that the Board's proposed "hybrid" method for indexing SARR operating expenses, under which the RCAF-A would be applied in 5% increments starting in the second year after the base year (*NPRM Order* at 21), is inconsistent with the Board's prior pronouncements recognizing that a SARR cannot realistically achieve the types of "real-world" productivity gains that are reflected in the RCAF-A, particularly during the initial years of its existence. CPR Comments at 2-5. As the initial comments filed by other parties — including both carriers and shippers — convincingly show, the proposed hybrid index is arbitrary and cannot be supported by credible evidence.

In a SAC analysis, it is assumed that the SARR is "[b]lessed with perfect knowledge of future traffic volume and composition (UP Comments at 33)," including the precise origins at which all of its traffic will be generated during the entire 20-year SAC analysis period. Armed with such prescience, the complainant can design a SARR with the optimum mix of facilities, equipment and work force to handle its selected traffic. As a result, the SARR "starts out with a highly efficient route structure and with the most efficient operations that are possible based on available technology." BNSF Comments at 14, V.S. Baranowski. Given the enormous efficiency advantage that a SARR possesses as a result of these assumptions, it is not rational to assume further that the SARR would achieve any significant productivity gains in the early years of its existence.

Indeed, most sources of productivity improvements for real world railroads are simply not available to a SARR even in the later years of the SAC analysis period. Real world railroads can improve productivity by adjusting their physical plant (through abandonments, line sales or the construction of new facilities) and work force in response to changes in demand. Because its

track, facilities and work force are configured from the outset to include precisely what is needed to handle its selected traffic, a SARR cannot take advantage of such “structural” productivity gains. *See, e.g.*, UP Comments at 32; BNSF Comments at 56-57; CSXT/NS Comments at 9-10. Productivity enhancements generated by adopting more efficient operating practices (such as greater use of unit train service and reduced switching) are likewise unavailable to a SARR, because its operations are already optimally designed and its traffic base rarely (if ever) includes individual carload traffic. *See* UP Comments at 33-34; BNSF Comments at 57-58. Because the SARR also deploys state-of-the art technology at its inception, it cannot, in the short term, garner the productivity benefits that real world railroads may achieve by replacing older technology. Therefore, the RCAF-A, which incorporates those sources of carrier productivity, is not an accurate barometer of the productivity potential of a hypothetical SARR.

Moreover, a methodology that applies the RCAF-A mechanically in 5 percent increments makes no attempt whatsoever to correlate a SARR’s operating expenses with the actual level of productivity likely to be achieved by the SARR at any point during the SAC analysis period. Even if it were appropriate to assume that a SARR would realize some productivity gains in each year of its existence – and, as the initial comments show, such an assumption is not justified – the record provides no evidentiary support for such a “linear” phase-in of the RCAF-A. Indeed, several shipper parties agree that the Board’s approach is analytically unsound. Albemarle Corporation (correctly) asserts that the Board’s proposal:

“has no recognition of the specific productivity that may or may not be available in a particular stand-alone cost proceeding and as such is arbitrary and capricious It is inappropriate to pre-judge all proceedings by stating the specific amount of productivity that can or cannot be achieved by a stand-alone carrier.”

Albemarle Corp. Comments at 6 (emphasis added). Likewise, Arkansas Electric Cooperative Corporation (“AECC”) believes that the Board’s proposal is fraught with “risks of inaccuracy”

and urges the Board instead to apply a “case-specific” productivity adjustment based upon the evidence presented in each proceeding. AECC Comments at 17-18. Based upon the record in this proceeding, the Board should not adopt its proposed hybrid formula for indexing SARR operating expenses.

For the same reasons, the Board should reject the alternative proposal set forth in the initial comments of the Western Coal Traffic League, *et al.* (the “Coal Shippers”). Asserting that the Board’s proposal “does not go far enough” in addressing the purported need to take account of productivity in indexing SARR operating expenses, the Coal Shippers urge the Board to adopt an alternative formula under which the RCAF-A and the RCAF-U would be applied on a 50/50 basis in the first year, with application of the RCAF-A increasing in 5 percent increments thereafter until, in years following the tenth year, the full RCAF-A would be applied to the SARR’s operating expenses. Coal Shippers’ Comments at 69-70, 84-86. However, the Coal Shippers offer no quantitative analysis or other evidence to support their alternative proposal. The Coal Shippers’ proposal is patently arbitrary and (like the proposal set forth in the *NRPM Order*) untethered to any credible measurement of the level of productivity likely to be achievable by a SARR at any point during the SAC analysis period.

The concern that motivated the Board to propose a hybrid index -- i.e., that applying the RCAF-U throughout a 20-year SAC analysis period might result in an overstatement of SARR operating expenses in the “outward years” of the analysis (*NPRM Order at 20*) -- would, as a practical matter, be resolved if the Board implements its proposal to reduce the SAC analysis period from 20 years to ten years. As discussed in Part III below, the initial comments indicate broad-based support among both carriers and shippers for that proposal. Accordingly, CPR urges the Board to adopt a ten year SAC analysis period and to continue its practice of applying

the RCAF-U in indexing SARR operating expenses during that shortened period. In order to prevent unjust results, the Board may also choose to afford the complainant an opportunity to demonstrate, in a particular case, that the SARR it has designed would, in fact, be able to realize measurable productivity gains that ought to be taken into account in calculating SARR operating expenses in subsequent years. However, such a showing must account for the additional expenses that the SARR would necessarily incur to generate the claimed productivity benefits.

II. THE BOARD SHOULD RETAIN ITS LONGSTANDING PRACTICE OF PERMITTING PARTIES TO PRESENT EVIDENCE SUPPORTING MOVEMENT-SPECIFIC ADJUSTMENTS TO URCS-BASED SYSTEM AVERAGE OPERATING COSTS.

In its initial comments, CPR argued that the Board's proposal to prohibit movement-specific adjustments to the system-average costs generated by URCS in calculating the variable costs of handling the issue traffic would compromise the accuracy of variable cost calculations without significantly reducing the cost or complexity of SAC cases. For that reason, CPR opposed the Board's proposal. CPR Comments at 6-9. The initial comments filed by other parties express similar concerns, and confirm that this proposal is misguided.

As Albemarle Corporation observed, "movement-specific variable costs have been a cornerstone of rate reasonableness proceedings." Albemarle Corp. Comments at 6. While AECC sees the Board's proposal as "a bold step to streamline and simplify the rate case process," it expresses concern that adoption of that proposal "would produce an unacceptable loss of accuracy [in calculating variable costs] for specific movements." AECC Comments at 20 (emphasis added). The Coal Shippers likewise argue that movement-specific data are essential to produce reliable variable cost calculations for the types of traffic that are typically the subject of SAC proceedings. Coal Shippers' Comments at 89-91. The South Carolina Office of Regulatory Staff objects to the Board's proposal, arguing that "[i]f a party is able to

demonstrate that its figures are based upon more accurate cost determinations than a system average, the Board should permit the use of those figures.” South Carolina ORS Comments at 7 (emphasis added). CSXT and Norfolk Southern express concern that a refusal to consider any adjustments to URCS-based system average costs “could significantly affect the accuracy, integrity, and reliability of SAC analyses and results.” CSXT/NS Comments at 11 (emphasis added). These comments echo CPR’s fundamental objection to the Board’s proposal – i.e., that the wholesale elimination of movement-specific adjustments would “sacrifice the very precision that the Board has sought to achieve in evaluating railroad rates under the SAC test.” CPR Comments at 7.

Other parties likewise concur with CPR’s view that an outright ban on movement-specific adjustments would do little to expedite, or reduce the cost of, SAC proceedings. The Coal Shippers agree that “movement-specific cost adjustments are not the driving factor behind the expense of maximum rate cases,” and their elimination “will not expedite SAC cases.” Coal Shippers’ Comments at 91-92. Moreover, the Board’s proposal “will not expedite rate case schedules” because variable cost evidence is submitted simultaneously with the evidence addressing stand-alone cost issues. *Id.* at 92, n. 73. The Coal Shippers’ initial comments demonstrate that, from the perspective of shippers, the concerns underlying this proposal are either misplaced or could be addressed by means short of wholesale elimination of movement-specific adjustments. *Id.* at 93-101.

The Board’s proposal to eliminate movement-specific adjustments received qualified endorsement from UP and BNSF. While both carriers express concern that exclusive reliance upon URCS-generated system-average data may result in an understatement of the variable costs for the issue traffic, they view the Board’s proposal as a reasonable measure to reduce the cost

and complexity of SAC litigation. BNSF Comments at 60- 61; UP Comments at 35-37.

However, both UP and BNSF argue that, even if the Board decides to prohibit most movement-specific adjustments, it must continue to accept evidence with respect to several categories of movement-specific information. First, they argue that carriers must be able to include in variable cost calculations payments made to third parties, such as loading/unloading charges and haulage fees paid to carriers who perform a portion of the transportation on the defendant railroad's behalf. UP Comments at 35, 37-40; BNSF Comments at 60, 64.¹ Such payments, which may substantially impact variable cost calculations in particular cases, are not reflected in URCS. UP Comments at 35; CPR Comments at 8. In addition, UP urges the Board to permit the parties to substitute certain movement-specific operating inputs -- including the number of locomotives, empty miles, tare weight of cars, and car costs -- for system-average values in order to "increase the accuracy of variable cost calculations for the issue traffic." UP Comments at 36, 40-44 (emphasis added).

CPR believes that the potential for reducing the expense and complexity of SAC cases by eliminating all movement-specific adjustments is at best marginal, and that the likely benefits of the Board's proposal do not justify abandoning the agency's longstanding practice of permitting the parties to present movement-specific variable cost evidence. For that reason, CPR urges the Board not to make any change to its existing practice with respect to such adjustments.

However, if the Board decides to adopt a rule restricting the introduction of evidence relating to movement-specific costs, it should incorporate into that rule the limited exceptions suggested by UP and BNSF. Information regarding the number of locomotives actually used in moving the

¹ Both CPR and CSXT/NS also argued in their initial comments that the Board should continue to permit evidence regarding payments to third parties. CPR Comments at 8; CSXT/NS Comments at 14.

issue traffic, the tare weight of the cars in which the traffic moves, the ownership of those cars, the actual empty miles involved in the movement, and the cost of any services provided by a third party on the defendant carrier's behalf should be both readily discernable and (in most instances) non-controversial. Consideration of those movement-specific characteristics of the issue traffic will substantially improve the accuracy (and fairness) of variable cost calculations without affecting the overall cost or complexity of a SAC proceeding.

In addition, CPR urges the Board to continue its practice of permitting parties to present movement-specific evidence with respect to fuel consumption. As the testimony presented to the Board at its recent hearing in Ex Parte No. 661, *Rail Fuel Surcharges*, demonstrates, the cost of diesel fuel has skyrocketed over the past several years. Moreover, the specific type of traffic (bulk, carload or intermodal) and the speed and other service requirements for an issue movement can have a substantial impact on the amount of fuel consumed in handling that movement. Reliance upon URCS-generated system-average fuel cost information is likely to produce an inaccurate measure of the fuel costs associated with the issue traffic, particularly where such URCS-based cost data is one or more years old at the time the analysis is conducted. Accordingly, the Board should permit the parties to introduce movement-specific evidence regarding the current cost of fuel consumed in handling the issue traffic.

Finally, the Board should reject BP Amoco Chemical Company's ("BP Amoco's") proposal that the Board prohibit movement-specific adjustments to URCS-generated system-average costs for "all" purposes in cases brought under the Board's *Small Case Guidelines*. BP Amoco Comments at 2-3. On March 27, 2006, BP Amoco filed a "Petition to Clarify Scope of Proceeding, or to Broaden It," in which it asked the Board to consider in this proceeding issues relating to movement-specific adjustments to URCS system average costs in the context of cases

brought under *Small Case Guidelines*. In response to that petition, the Board issued a decision on April 14, 2006, in which it held that “if our proposal to disallow movement-specific adjustments to variable costs is adopted, that policy would apply to the calculation of the jurisdictional floor in all rate reasonableness cases,” including those brought under the *Small Case Guidelines*. See Decision served April 14, 2006 at 2. However, the Board held further that “this rulemaking will not be broadened to provide for a debate over whether adjustments to URCS should be permitted when applying the three-benchmark standard of rate reasonableness described in [the Small Case Guidelines].” *Id.* (emphasis added).

BP Amoco ignores this unequivocal holding by proposing a rule that would prohibit movement-specific adjustments not only for purposes of determining the jurisdictional threshold, but also for “all other purposes,” in cases under the *Small Case Guidelines*. BP Amoco Comments at 6. The Board should reject BP Amoco’s proposal, which contravenes the Board’s clear ruling regarding the proper scope of this proceeding.

III. THE BOARD SHOULD ADOPT ITS PROPOSAL TO REDUCE THE SAC ANALYSIS PERIOD TO TEN YEARS.

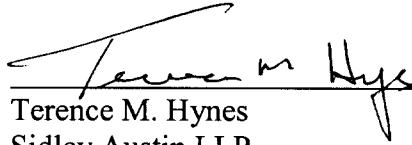
The initial comments reflect a near unanimous consensus among both carriers and shippers that the Board’s proposal to reduce the SAC analysis period from 20 years to ten years is a good idea. See, e.g., BNSF Comments at 70-71; UP Comments at 45; CSXT/NS Comments at 18-19; Coal Shippers’ Comments at 102-03. As those commenters observe, projecting traffic volumes and operating costs 20 years into the future is inherently difficult, and poses a significant risk that the outcome in a particular case may be rendered inaccurate by (as yet unknown) future market developments. Adopting a shorter DCF period will eliminate much of that uncertainty, and may also reduce the cost of litigating a SAC case by reducing somewhat the

scope of the evidence that must be presented. Accordingly, CPR supports the Board's proposal to adopt a ten year SAC analysis period.

However, the Board should reject the Coal Shippers' suggestion that any rate prescription resulting from application of the revised ten year SAC analysis continue in effect even after the analysis period expires unless the defendant carrier can demonstrate a "material change in circumstances" that would support modification or vacatur of the prescribed rate. *See* Coal Shippers' Comments at 104. As an initial matter, this proposal is not part of the modified rule noticed in the *NPRM Order*, so it cannot be adopted without formal notice and opportunity for parties to comment on it. Moreover, there is no rational basis for automatically extending a rate prescription beyond the term of the SAC analysis that supports the prescribed rate. A SAC analysis determines the maximum reasonable rate for a specified time period by comparing the revenues and expenses that the SARR would experience during the DCF period. That analysis does not provide evidentiary support for a rate prescription covering years beyond the DCF period. It would be both illogical and fundamentally unfair to extend a rate prescription beyond the SAC analysis period, or to require a carrier to demonstrate (undefined) "changed

circumstances” in order to be relieved of a rate prescription upon expiration of the SAC analysis period. Such a procedure would also be inconsistent with the ratemaking initiative granted to carriers under 49 U.S.C. § 10702.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Terence M. Hynes", is written over a horizontal line.

Terence M. Hynes
Sidley Austin LLP
1501 K Street, N.W.
Washington, D.C. 20005
(202) 736-8000
(202) 736-8711 (Fax)

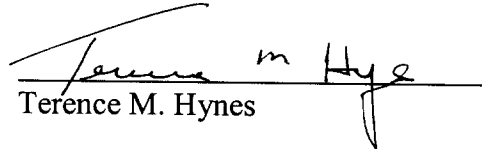
Paul Guthrie
Vice President - Legal Services
Canadian Pacific Railway Company
401 9th Avenue, S.W.
Gulf Canada Square, Suite 500
Calgary, Alberta T2P 4Z4 Canada

Attorneys for Canadian Pacific Railway Company

Dated: May 31, 2006

CERTIFICATE OF SERVICE

I hereby certify this 31st day of May 2006 that I have served all parties of record in this proceeding by first class mail, postage prepaid.


Terence M. Hynes