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June 30, 2006

HAND DELIVERY

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

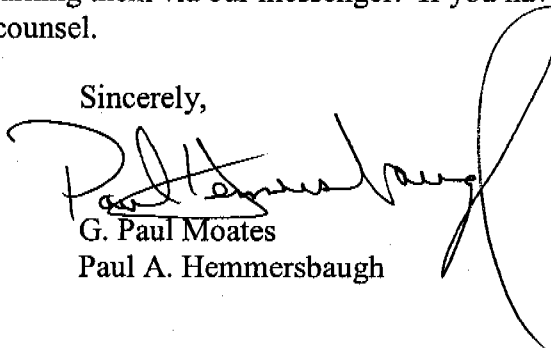
Re: Ex Parte No. 657 (Sub-No. 1), Major Issues in Rail Rate Cases

Dear Secretary Williams:

Enclosed for filing in the above-referenced proceeding are an original and twenty copies of the Joint Rebuttal Comments of Norfolk Southern Railway Company and CSX Transportation, Inc. in the above-referenced proceeding. A diskette containing an electronic version of the Comments is also enclosed.

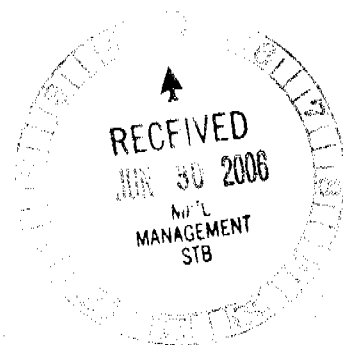
Please acknowledge receipt of the enclosed Rebuttal Comments for filing by date-stamping the enclosed extra copies and returning them via our messenger. If you have any questions, please contact the undersigned counsel.

Sincerely,

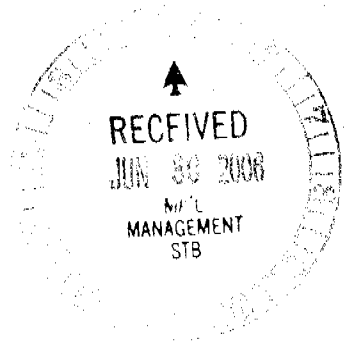


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Paul A. Hemmersbaugh

Enclosures



**UNITED STATES OF AMERICA
SURFACE TRANSPORTATION BOARD**



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

MAJOR ISSUES IN RAIL RATE CASES

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

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Dated: June 30, 2006

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

**ANY PROPOSALS ADOPTED IN THIS RULEMAKING MUST BE
CONSISTENT WITH THE STATUTE, THE *GUIDELINES*, AND
SOUND ECONOMICS.**

The Notice of Proposed Rulemaking ("NPRM") makes clear that the purpose of this rulemaking is to improve and refine the application of the Stand Alone Cost ("SAC") test. The SAC test, and the principles of constrained market pricing on which it is based, are the products of an extensive seven-year effort by the ICC to develop rate reasonableness guidelines that are compatible with the competing goals of the Interstate Commerce Act ("ICA"). See *Coal Rate Guidelines – Nationwide*, 1 I.C.C. 2d 520 (1985) ("*Guidelines*").

The *Guidelines* balance three critical statutory principles. First, under ICA, rail carriers have the authority to "establish any rate for transportation or other service provided by the rail carrier." 49 U.S.C. § 10701(c); STB Docket No. 41191 (Sub-No. 1), *AEP Texas N. Co. v. Burlington Northern & Santa Fe Ry. Co.*, 2004 WL 542863, at *2 (served Mar. 19, 2004) ("under 49 U.S.C. 10701(c), a rail carrier is free to establish any common carrier rate it chooses and has the rate freedom to increase its rates without precondition."). Second, for certain types of traffic, the ICA charges the Board with ensuring that rail transportation rates are "reasonable."

See 49 U.S.C. §§ 10701(d), 10702, 10707.¹ Third, the Board is charged with maintaining policies that allow railroads to earn adequate revenues. See 49 U.S.C. § 10101(3); § 10704(a)(2).²

As the D.C. Circuit has observed, “[t]he whole thrust of ratemaking under the [Interstate Commerce] Act is *balancing*” these competing statutory policies. *Pub. Serv. Co. of Ind., Inc. v. ICC*, 749 F.2d 753, 765 (D.C. Cir. 1984). Balancing these statutory goals is difficult, and the ICC struggled for years to craft an approach that did so in an economically sound and rational manner that would withstand judicial review.³ The end result, the *Coal Rate Guidelines*, are the product of a lengthy and arduous process notice-and-commenting rulemaking and trial and error. *Potomac Elec. Power Co. v. ICC*, 744 F.2d 185, 191 (D.C. Cir. 1984).

In 1978, the ICC began a proceeding to establish rate guidelines for the movement of Western coal. See *Western Coal Investigations*, Ex Parte No. 347, 43 Fed. Reg. 22,151 (May 23, 1978). After receiving numerous public comments, the ICC closed Ex Parte 347 without issuing a final decision and instituted a new proceeding. See *Coal Rate Guidelines—Nationwide*, Ex

¹ The Board has the authority to entertain complaints that a rate is unreasonable only if it finds the carrier has market dominance over the subject traffic, under 49 U.S.C. § 10707.

² Adequate revenues are defined as revenues sufficient “to cover total operating expenses, including depreciation and obsolescence, plus a reasonable and economic profit or return (or both) on capital employed in the business.” 49 U.S.C. §10704(a)(2). Congress emphasized that adequate revenues must include revenues sufficient to allow needed capital expenditures; among other things, adequate revenues must “support prudent capital outlays” and permit rail carriers to “attract and retain capital in amounts adequate to provide a sound transportation system in the United States.” *Id.* Congress has instructed the Board to “make an adequate and continuing effort to assist [rail] carriers” to earn adequate revenues. *Id.* The Board must give “due consideration” to this revenue adequacy policy when it determines whether a rate is reasonable.

³ As then-Commissioner Strenio summarized, the ICC “struggl[ed] for years to develop an analytically sound and legally defensible approach to maximum rate reasonableness—an approach that properly balances protection for shippers subject to the potential abuse of market power with the needs of carriers for income sufficient to attract adequate capital.” *Guidelines*, 1 I.C.C.2d at 551 (Strenio, Comm’r, concurring).

Parte No. 347 (Sub-No. 1), 364 I.C.C. 360, 361 (1980). The ICC also expanded the new proceeding to encompass uniform guidelines for all coal rate cases. *See id.* In its 1980 notice, the Commission proposed several changes to the rate methodology it had used in prior cases, including a shift from the “ratio” to the “ton/ton-mile” method of allocating system constant costs. The ratio method, which the ICC had used before 1980, allocated variable costs among movements in proportion to the revenue generated by those movements. *See id.* at 365, n.4. The ton/ton-mile method proposed by the ICC would have allocated costs in proportion to tons originated and terminated. *See id.* At the time, the Commission believed that the ton/ton-mile method would reflect the relative demand for, and cost of providing, services in a way that would permit carriers to recover the fully allocated cost of transportation. *See Guidelines*, 1 I.C.C.2d at 523.

Following the receipt of comments from interested parties, the ICC rejected the ton/ton-mile method, concluding that any meaningful maximum rate policy could not be based upon a strictly cost-based approach. *See Coal Rate Guidelines—Nationwide*, 46 Fed. Reg. 62,958 (Dec. 21, 1981). Based upon comments concerning the ton/ton-mile method, the ICC determined that competitive factors required rail carriers to price their services differently based upon demand. *See id.* Indeed, rail carriers could never earn adequate revenues if they were not permitted to price their services differentially in response to shippers’ varying demand elasticities. *See id.* But that decision did not reach any conclusions about “the methodology for prescribing maximum rates.” *Id.* To that end, the ICC issued yet another request for comments on “the use of the Ramsey principle for establishing differential pricing.” *Id.*

After considering multiple rounds of further comments, the ICC next proposed that maximum coal rates be governed by “constrained market pricing.” *See Notice of Proposed*

Policy, *Coal Rate Guidelines—Nationwide*, 48 Fed. Reg. 8,362 (Feb. 18, 1983). Under constrained market pricing, rates for market dominant coal traffic would be subject to four constraints. *See id.* Parties then submitted additional comments on this proposal.

Finally, on August 8, 1985 the ICC adopted a revised and refined version of constrained market pricing in the *Guidelines*. After seven years of hard effort, the ICC had fashioned a maximum rate reasonableness regime (CMP) that was “a practical and economically sound method of applying competitive pricing principles to a regulatory framework.” *Guidelines*, 1 I.C.C. 2d at 523. The *Guidelines* were specifically designed to balance the statutory goals of “provid[ing] the necessary protection for captive shippers” and “providing railroads the opportunity to earn adequate revenues.” *Id.* at 521.

Several parties sought judicial review of the *Guidelines*, leveling various criticisms and complaints. The Third Circuit rejected those challenges, and approved the *Guidelines* and the balance of the statutory factors they embodied. *See Consolidated Rail Corp. v. United States*, 812 F.2d 1444 (3d Cir. 1987). In the intervening two decades, the principles of constrained market pricing have stood the test of time, and have generally served the public interest well by maintaining an appropriate balance between the important interests of carriers and shippers.

As the Notice instituting this rulemaking makes clear, the purpose of this proceeding is to refine and improve the sound and well-established SAC test, not to reconsider the statutory balance or the fundamental principles of Ramsey pricing and constrained market pricing that the ICC developed through years of effort. *See NPRM* at 2 (“These proposals are designed to ensure that both the SAC test and the jurisdictional floor for rate relief are applied fairly and in conformity with our statutory responsibilities.”). As such, the goals of this proceeding should be twofold. The first is to refine the SAC test to better reflect the economic theories upon which it

is founded – contestable markets and demand-based differential pricing based on Ramsey principles. The Board has not indicated that it intends, in this proceeding, to depart from the economic principles on which the *Guidelines* are based, and CSXT/NS assume that the Board does not intend to do so.

The second goal should be to reduce the cost and complexity of SAC proceedings to the extent such reductions can be achieved without sacrificing necessary accuracy. CSXT/NS fully appreciate that SAC cases are complex and expensive, and we commend the Board for its efforts to simplify cases. But simplification at the expense of accurate results is no virtue. These are large cases involving many millions of dollars. The Board must ensure that any simplifications it adopts do not sacrifice essential accuracy or otherwise undermine the important policy of permitting rail carriers to engage in differential pricing that is essential to allow them to achieve adequate revenues and make essential capital investments.

Viewed in the proper context, many of the comments submitted in the proceeding are misguided, irrelevant, or both. While many commenters have provided helpful insight on the Board's proposals, others offer nothing more than result-oriented alternatives. A number of comments have been filed by parties who are disappointed by the outcome of particular cases, offering proposals and arguments that are not founded upon the statute, the *Guidelines*, or sound economics. Those comments demonstrate a lack of understanding of the SAC test and the sound economic principles and policies on which it rests.⁴ The Board should adhere to the *Guidelines'* fundamental principles, and adopt only those proposals that are faithful to those principles and

⁴ For example, the Board should disregard statements like (1) PPL's long statement concerning the appropriateness of the STB's revenue adequacy methodology – revenue adequacy is not at issue in this rulemaking; (2) the arguments that SAC has been proven useless by *PPL* and *Otter Tail*, which seems more an expression of the shippers' belief that SAC must always demonstrate that a rate is unreasonable; and (3) *Western Fuels'* arguments as to how large an increase it faced or what R/VC ratio results from the rate, which, even if true, would be irrelevant to the SAC test.

advance the interests of fair and efficient application of the SAC test and the statutory commands it implements.

**THE BOARD MAY NOT ADOPT PROPOSALS THAT WERE NOT
NOTICED IN THE NPRM OR PROPOSALS FOR WHICH THERE IS
NO SUPPORT IN THE RECORD.**

In addition to commenting on the Board's proposals, many commenters have put forward their own novel and divergent suggestions for changing the SAC test. For example, some parties have suggested that the Board revisit the cross-subsidy test enunciated in *PPL Montana* and applied in *Otter Tail*. Others propose various different mechanisms for calculating maximum reasonable rates. Perhaps the only common strand shared by all of these new proposals is that they were not noticed for comment in the *NPRM*, and therefore are not at issue – and may not be adopted – in this proceeding. CSXT/NS have not undertaken a thorough review of these extra-*NPRM* proposals, and have generally refrained from commenting on them, because they are not properly at issue in this proceeding.

It is fundamental administrative law that proposals that were not included in a notice of proposed rulemaking may not be adopted as a final rule. See, e.g., 5 U.S.C. § 553; *National Mining Ass'n v. Mine Safety & Health Admin.*, 116 F.3d 520, 531-32 (D.C. Cir. 1997). In *National Mining*, for example, the D.C. Circuit held that an agency did not provide sufficient notice of a final rule where that rule was based on a proposal raised by a commenter. *Id.* The scope of the present proceeding is defined by the Notice, and therefore the only proposals at issue are the ones the Board has made. The only options properly available in this proceeding are either to adopt or to reject each of the six proposals set forth in the *NPRM*. The Board is certainly free to (as CSXT/NS urge) adopt some of the proposals it made in the *NPRM* and abandon others. But the Board may not adopt proposals that were not included in the *NPRM*.

This is not to say that all of the other issues and proposals raised by the parties in their comments are unworthy of further consideration—some are. For example, there appears to be merit in the proposal that the Board give further consideration to whether regulations implementing the Board’s directive to ensure that rates are reasonable can better accommodate railroads’ needs to make extraordinary investments in infrastructure to meet current and projected demand. Indeed, some new policy addressing this issue may be critical to meeting the ICA’s directive that the Board ensure rail carriers generate revenues adequate “to support prudent capital outlays,” at a time when shippers, transportation companies, and policymakers are all concerned about capacity constraints in the transportation system.⁵ But no new proposal may be adopted without the Board giving notice that it was considering that proposal and offering adequate opportunity for parties to comment.

In addition, no commenter has submitted facts or evidence to support the adoption of two of the Board’s proposals. In those instances, the proposal is without support in the record, and may not be adopted. *See, e.g., McGregor Printing Corp. v. Kemp*, 20 F.3d 1188, 1193-94 (D.C. Cir. 1994) (agency regulation held arbitrary and capricious because there were no facts in rulemaking record to support the rule); *National Treasury Employees Union v. Horner*, 854 F.2d 490, 499 (D.C. Cir. 1988) (rule held arbitrary and capricious where agency’s judgments were not supported by evidence in the record). Therefore, application of general principles of administrative law preclude the adoption of the operating expense indexing proposal (NPRM item III) and the proposal to disallow all movement-specific adjustments to URCS system average costs (NPRM item IV). *See American Public Gas Ass’n v. Fed. Power Comm’n*, 567

⁵ *See* 49 U.S.C. § 10704(a)(2).

F.2d 1016, 1029 (D.C. Cir. 1977); *see also Engine Manufacturers Ass'n v. EPA*, 88 F.3d 1075, 1084 (D.C. Cir. 1996); *McGregor Printing* 20 F.3d at 1193-94; *Horner*, 854 F.2d at 499.

I. MAXIMUM RATE DETERMINATION

The Board should not adopt either of its proposed alternatives to the Percentage Reduction Method (“PRM”). As CSXT/NS and other commenters have established, MCM and MMM cannot be reconciled with the *Guidelines* and the economic theory and statutory and regulatory policies they implement. Therefore, adoption of either of the proposed alternative rate reduction approaches would be arbitrary and capricious, and would create an internally inconsistent rate regulatory regime. Moreover, the Board need not adopt MCM or MMM to address the hypothetical problem of gaming because it retains the power to address such a problem should gaming ever arise.

A. Rail Carriers Have the Legal Right to Set Common Carrier Rates, and CSXT and NS Set Their Rates Based Upon Market Demand.

Contrary to the suggestion by some commenters, rail carriers have the statutory right and responsibility to set common carrier rates. *Compare* 49 U.S.C. § 10701(c) (rail carrier may establish “any rate” for transportation or other service subject to the Board’s jurisdiction) *with* Coal Shippers Reply at 9-10. In the 4R Act and the Staggers Act, Congress granted rail carriers broad ratemaking initiative, thereby precluding the ICC from engaging in rate equalization practices of the past. *See, e.g., Arizona Public Service Co. v. BNSF Railway Co.*, STB Doc. No. 42077. 2003 WL 22338623, at *5 (served Oct. 14, 2003) (Staggers Act gave railroads “the right to set their own rates at levels of their own choosing.”); *MidAmerican Energy Company v. Surface Transportation Board*, 169 F.3d 1099, 1104-05 (8th Cir. 1999); *Rulemaking Concerning Traffic Protective Conditions in Railroad Consolidation Proceedings*, 366 I.C.C. 112, 119 (1982). As the Board has explained, ICCTA “further facilitated the railroads’ rate-making

initiative by repealing the rate suspension procedures under which rate adjustments were sometimes prohibited from taking effect without first being investigated.” *Arizona Public Service* at *5.

For some traffic, the rate set by a carrier is subject to regulatory challenge and reasonableness review by the Board. *See* 49 U.S.C. § 10707(c) (upon a finding of market dominance over the transportation to which a rate applies, the Board may determine whether that rate exceeds a maximum reasonable level). And, if the Board finds that a rate subject to its jurisdiction exceeds a maximum reasonable level, the Board may prescribe the maximum reasonable rate. *See* 49 U.S.C. § 10704(a). However, the fundamental right of rail carriers to establish, in the first instance, any common carrier rate they deem appropriate – notwithstanding the Board’s authority to conduct a subsequent review of the reasonableness of rates for traffic over which a carrier has market dominance – is beyond dispute. *See AEP Texas North Company v. BNSF Railway Co.*, STB Dkt. No. 41191. 2004 WL 542863 at *2 (served March 19, 2004) (“[U]nder 49 U.S.C. 10701(c), a rail carrier is free to establish any common carrier rate it chooses and has the rate freedom to increase its rates without precondition, except for [the requirement that the carrier provide notice of the rate]”) (emphasis added).

Both CSXT and NS set common carrier rates based upon market demand, business conditions, and other commercial considerations.⁶ When developing common carrier rates for traffic that potentially is subject to the Board’s regulation, both carriers also take rate reasonableness requirements into account by limiting their rates to levels consistent with what

⁶ The Coal Shippers’ claim that CSXT or NS asserted that their rates of return on coal traffic were so “anemic” that they could not invest in the infrastructure needed to serve that traffic are patently false. *See* Coal Shippers Reply at 4 (citing rail carriers’ letters responding to Chairman Nober’s 2004 “Fall Peak” inquiry). Review of the referenced Fall Peak response letters shows that neither NS nor CSXT made any such claim. *See* D. Goode Letter to Director M. Clemens, Jr. at 2 (July 16, 2004); M. Ward Letter to Chairman R. Nober at 3 (Aug. 3, 2004).

they believe would be found reasonable under SAC and other CMP constraints. The ways that CSXT and NS set their prices are fully consistent with governing statutes, the *Guidelines*, and the sound regulatory and economic policies that support them. The Board's recent decisions finding the challenged rates reasonable in three separate eastern rate cases – in the face of complainants' repeated, vociferous claims that the challenged rates were "outrageous," "confiscatory" and the product of improper "gaming" – is strong testament that the rate setting practices of NS and CSXT are sound, appropriate, and well within regulatory limits. *See Duke Energy Corporation et al v. Norfolk Southern Railway Co. et al*, STB Dkt. No. 42069 (served Oct. 20, 2004) (consolidated final decision issued for three separate cases, STB Dkt. Nos. 42069, 42070, and 42072).

B. The Board Should Not Adopt its Rate Reduction Proposals Because They Would Contravene Well-Established Regulatory Policies and Decisions, and Eviscerate the *Coal Rate Guidelines*.

The Board has applied the PRM to preserve demand-based differential pricing that is at the heart of the regulatory regime established by the *Coal Rate Guidelines*. As the Board recently explained, the PRM "preserve[s] the rate structure for the traffic group by maintaining existing rate relationships, albeit at reduced levels, thereby implicitly preserving the carrier's demand-based differential pricing that recognizes the traffic's varying demand elasticities." *Public Service of Colorado d/b/a/ Xcel Energy v. BNSF Railway Co.*, STB Dkt. No. 42057 at 37 (served June 8, 2004) ("*Xcel*"), *aff'd sub nom BNSF Railway Co. v. Surface Transportation Board*, D.C. Cir. No. 05-1030 (June 16, 2006).

In contrast, the two rate reduction approaches proposed in the *NPRM* are in direct conflict with the economic and regulatory principles at the heart of the *Coal Rate Guidelines*. *See* CSXT/NS Reply at 5-8; CSXT/NS Op. at 6-7; BNSF Op. at 18-45; UP Op. at 20-21. Both proposals would violate core differential pricing principles by imposing uniform average rates on

all higher-rated traffic, an approach that the ICC expressly considered and rejected as arbitrary when it adopted the *Guidelines*. See CSXT/NS Reply at 5-6; *Guidelines*, 1 I.C.C.2d at 533, 559.⁷ The Board has repeatedly affirmed the bedrock principle that the *Guidelines* and differential pricing policy necessitate demand-based differential pricing for all traffic, and preclude any rate regulatory approach based on a single uniform mark-up for all higher rated traffic. See CXST/NS Reply at 5-7. Accordingly, adoption of MCM or MMM would require the Board to abandon demand-based differential pricing principles that form the foundation of the *Guidelines* – and hence abandon the *Guidelines* themselves – the only rate regulatory regime upheld on judicial review in the last quarter century. There is no evidence in this proceeding that remotely justifies the *NPRM*'s proposal for such a radical rejection of established policies and principles of rate regulation that have served the public interest well since the passage of the Staggers Act. Carriers' comments in this proceeding have demonstrated that the established PRM is far more consistent with differential pricing principles, the *Guidelines*, and the Board's statutory mandates than MCM or MMM. See, e.g., CSXT/NS Reply at 3-8; CSXT/NS Op at 4-7; BNSF Op. at 28-45, V.S. Kalt at 13-24; UP Reply at 12-16.

C. Neither The Board's Concern About The Theoretical Prospect Of "Gaming" In Some Future Case, Nor The Record In This Proceeding Supports The Proposal To Replace The PRM With Either MCM Or MMM.

The concern that motivated the *NPRM*'s unsound rate reduction proposals was the theoretical possibility that a party could engage in "gaming" of the Board's established PRM approach. The *NPRM* made clear its proposals were designed to address the concern that a party's litigation *tactics*, rather than the evidence and the law, might unduly influence a rate

⁷ One likely consequence of application of either proposal would be significant rate compression, a result about which courts have expressed concern in other contexts. See *Burlington Northern R.R. Co. v. ICC*, 985 F.2d 589 (D.C. Cir. 1993).

reasonableness determination. Summarizing the issue MMM and MCM were proposed to address, the Board stated,

the maximum reasonable rate that can be charged to a complaining captive shipper should be determined by the Board based upon evidence and applicable precedent, not by the parties' litigation tactics.

NPRM at 9 (emphasis added). It has been suggested that, in some future case, a carrier might set an extremely high rate without regard for market conditions or demand elasticities. *See NPRM* at 7-8 (expressing concern regarding possibility that either a carrier or a shipper *could* act in manner that might manipulate the regulatory process).

The concern about gaming is entirely hypothetical, because the Board has never found that either a carrier or a shipper has manipulated the rate reduction methodology. Indeed, in the case in which the complainant was the most insistent that a carrier had engaged in gaming (an allegation the carrier strongly denied) – *CP&L v. NS* – the Board held that the challenged rate was not unreasonable, thereby precluding the possibility of a finding of gaming (because PRM is employed only where the Board finds the challenged rate to be unreasonable). *See Carolina Power & Light v. Norfolk Southern Railway Co.*, STB Dkt. No. 42070 (served Oct. 20, 2004), at 22.

Shipper comments do not demonstrate that gaming ever has, or ever will, occur. Even those commenters who state they “are not opposed” to the proposed rate reduction methods offer no evidence that gaming actually has occurred in any case, or that there is a real risk that a party will engage in such conduct in the future. *See, e.g.*, Coal Shipper Op. Comments at 15 (two sentences citing the *NPRM*’s statement about the possibility of gaming, without elaboration).

Moreover, the Coal Shippers themselves contend that the Board’s proposals would not “solve” the hypothetical gaming problem, because they would not eliminate “the risk that the

carrier could manipulate the outcome of the rate analysis.” Coal Shipper Op. at 18, V.S. Borts at 7, 9-10.⁸ Thus, even shippers’ tepid support for the *NPRM*’s two proposals fails to demonstrate the existence of the predicate “problem,” or that the proposals would eliminate that non-existent problem.

Instead of addressing the Board’s concern regarding the potential for shippers or carriers to manipulate the PRM – the issue the Board promulgated its proposals to address – the main shipper comments argue that PRM should be rejected because it respects carriers’ statutory right to set rates, and allows carriers to engage in differential pricing. In their opening comments, the Coal Shippers quickly skipped over the “gaming” issue, and instead urged the Board to jettison the PRM because it allows rail carriers to price differentially, an economic necessity that lies at the very heart of the *Guidelines*. See, e.g., Coal Shipper Op. at 16. On reply, they express dissatisfaction with carriers’ statutory right to set common carrier rates and its purported effect on the evaluation of the reasonableness of rates for traffic over which a carrier has market dominance. See Coal Shippers Reply at 9. Eliminating or impeding carriers’ right to establish rates, however, is not at issue in this proceeding.

The Coal Shippers also attempt to undermine the PRM by raising another issue the Board’s proposals are not designed to address, the use of prices to infer elasticities. See, e.g., Coal Shippers Op. at 16, 18, 20-24. Unlike their prior claim, this argument at least appears to concede that prescribed rates must reflect differential pricing. This argument is fatally flawed, however, because prices are the only practicable and administratively feasible way to

⁸ MMM and MCM are also susceptible to other types of manipulation and bias, particularly where the SARR makes extensive use of cross-over traffic. See, e.g., BNSF Op. Comments, V.S. Klick at 13-23. Thus, not only would the proposals fail to eliminate the possibility of the types of gaming identified in the *NPRM*, they would also introduce new opportunities for gaming, distortion, and irrational results.

approximate demand elasticities. *See Guidelines*, 1 I.C.C.2d at 527-28. While a carrier's real world rates are an imperfect proxy for demand elasticities, they are a far more accurate measure of such elasticities than that proposed by Coal Shippers and others, which would start with the untenable assumption that a carrier's URCS costs are equal to marginal costs (as that term is used in economic theory) for all movements handled by the SARR. *See, e.g., Coal Shipper Op.* at 23-25; *AEP Texas Op.* at 8-11; *cf. BNSF Reply Comments*, V.S. Kalt at 10-22.

Importantly, while the rationale for MCM and MMM is the concern that parties might be able to manipulate the PRM in some instances, the Board's proposals would apply to all rate reductions in SAC cases, without regard to whether a party had endeavored to "game" the regulatory process. Thus, the proposals would undermine carriers' ability to engage in differential pricing, and thereby adversely affect carriers' ability to earn adequate revenues necessary to respond to growing demand for additional rail capacity, all in order to address the hypothetical possibility that, in some isolated future case, a carrier might attempt to manipulate the PRM. Plainly, these proposals represent a cure (or, more accurately, an inoculation) far worse than the prospective disease.

Thus, even apart from the demonstrated inconsistency of MCM and MMM with fundamental economic and regulatory principles adopted by the *Guidelines* (which were affirmed by a court of appeals, and re-affirmed by subsequent decisions of the Board), the record is devoid of evidence to support a conclusion that the proposals would adequately address the theoretical problem – should it ever arise – to which they are directed. Indeed, the Board's proposals would create new problems that would be far more profound and far-reaching than the hypothetical problem they are intended to address.

D. The Board Has the Authority and the Tools to Address Any Attempted Manipulation of the Rate Reduction Process That Might Arise.

If, in some future case, the Board were to determine that a party to a rate case had engaged in tactics designed to manipulate the application of the PRM, it has the power to take appropriate remedial steps. When a sound SAC analysis finds that a rate established by a market dominant carrier exceeds a reasonable maximum level, the Board's statutory responsibility is to prescribe a maximum reasonable rate the carrier may charge, and to award reparations to a shipper that has been charged a rate in excess of that maximum reasonable rate. *See* 49 U.S.C. §§ 10704, 10705, 10707. If a party demonstrates in a particular case that, because a shipper or carrier has engaged in tactical gaming in a specific case, application of the PRM to the challenged common carrier rate would not produce a reasonable maximum rate prescription in accordance with statutory requirements, the Board could devise a remedy to eliminate the effects of whatever gaming it found.⁹ CSXT/NS therefore urge the Board to continue to apply the sound, established, and economically valid PRM, while retaining discretion to apply a different rate reduction approach should it ever find a party has engaged in conduct that would prevent the PRM from prescribing a maximum reasonable rate that is consistent with the Board's statutory and regulatory mandates.

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⁹ CSXT/NS believe the Board has the expertise and experience to make a determination founded in the evidence in a specific case, whether gaming has occurred. If such a case were ever presented, the Board presumably would have significant evidence in the record upon which to base a determination of an appropriate maximum rate for the issue traffic. Such evidence might, for example, allow the Board to approximate what the initial common carrier rate might have been in the absence of gaming, and to use such an inferred rate to calculate an appropriate rate prescription using the PRM.

In sum, adoption of either of the *NPRM*'s rate reduction proposals would undermine the *Guidelines*, destroy the delicate and economically sound balance they struck between competing statutory and regulatory policies, and dramatically reduce rail carriers' ability to generate returns necessary to make important investments in capacity improvement, all in order to address a theoretical problem that the Board has never found to exist in an actual case. If the Board declines to adopt the unsound proposals set forth in the *NPRM* – as it should – it will retain the authority and responsibility to address such potential “gaming” should it ever arise in the context of a specific case. Therefore, the Board should not adopt either of the two alternative rate reduction approaches proposed in the *NPRM* and should continue to apply the tried-and-tested PRM as its standard rate prescription methodology.¹⁰

II. CROSS-OVER TRAFFIC REVENUE ALLOCATION

The Board should adopt its proposal to use an Average Total Cost (“ATC”) approach for allocating the revenues generated by cross-over traffic. As CSXT/NS's comments in this proceeding have consistently indicated, ATC represents an improvement over MSP and the Board's previous approaches to allocating cross-over traffic revenue between the SARR and the residual incumbent. *See* CSXT/NS Op. at 8; CSXT/NS Reply at 11-13.¹¹

Because complainants often rely heavily on the use of cross-over traffic in SAC cases, it is important that the Board's methods for analyzing cross-over traffic approximate as closely as

¹⁰ As CSXT/NS have made clear in their prior comments, the only rate reduction approaches properly at issue in this proceeding are the two proposed in the *NPRM* (MCM and MMM) and the Board's existing approach (PRM). The new and different methodologies proposed by various commenters are beyond the scope of this rulemaking, and may not be adopted in this proceeding. *See, e.g., National Mining Ass'n*, 116 F.3d 520, 531-32 (D.C. Cir. 1997). With respect to rate reduction methodology, the only question in this proceeding is whether to “replac[e] the percent reduction approach with either a Maximum Contribution Methodology (MCM) or Maximum Markup Methodology (MMM).” *NPRM* at 9.

¹¹ Contrary to some commenters' suggestion, CSXT/NS have not opposed ATC or stated that it is “arbitrary” or bad policy.

possible the results that would be generated by a full end-to-end SAC analysis. *See NPRM* at 17 (aim of cross-over traffic revenue allocation is to ensure “that a simplified SAC analysis using cross-over traffic will approximate a full SAC analysis” without cross-over traffic); *Otter Tail Power Co. v. BNSF Railway Co.*, STB Dkt. No. 42071 (Jan. 27, 2006), at 15. The Board has allowed cross-over traffic as a simplifying device to reduce the burden that complainants would face if they were required to perform a full SAC analysis of origin-to-destination service for the entire SARR traffic group. The goal of allowing cross-over traffic is to “make the analysis more manageable without introducing bias.” *See NPRM* at 17. In order to avoid introduction of such bias, the Board must “ensur[e] that a SAC analysis using cross-over traffic will approximate a full SAC analysis,” and will not distort the SAC analysis and results. *See id.* As demonstrated, ATC would introduce less bias and distortion to the SAC analysis than MSP, and its application would more closely approximate a full SAC analysis than the approaches the Board has previously applied. *See, e.g., CSXT/NS Op.* at 8; *CSXT/NS Reply* at 11-13.

Accurate cross-over traffic revenue allocation has assumed even greater importance in recent years, as complainants have increasingly relied on crossover movements for the overwhelming majority of non-issue SARR traffic. Complainants’ increasing reliance on cross-over traffic is part of an effort to use the MSP to achieve results that are different from those that a full SAC analysis would produce. ATC would result in more accurate revenue allocations, and thereby reduce the propensity of cross-over traffic to distort the SAC analysis. More accurate cross-over traffic revenue allocation would also have the salutary effect of reducing the incidence of the residual incumbent subsidizing the on-SARR segments of crossover traffic.

Because ATC more closely approximates the results of a full SAC analysis – and hence introduces less bias and distortion than MSP – the Board should adopt ATC.¹²

In addition to its greater precision, ATC is also superior to MSP because it better accounts for economies of density. As the Board has acknowledged, MSP does not take into account economies of density. *See NPRM* at 18; *see also Otter Tail*, slip op at 15-16 and decisions cited therein. ATC, in contrast, does account for the relative densities of on-SARR and off-SARR lines, and the effects of economies of density. *See NPRM* at 19-20; BNSF Reply at 29-31. Addressing this very issue earlier this month, the D.C. Circuit Court of Appeals indicated that an accurate and appropriate method for allocating cross-over traffic revenue should take economies of density into account (unlike MSP, which does not account for economies of density). *See BNSF Railway Co. v. STB*, D.C. Circuit No. 05-1030, slip op. at 18 (D.C. Cir. June 16, 2006), ___ F.3d ___. Because ATC accounts for economies of density, it is clearly superior to MSP.

For these and other reasons described in their previous comments, CSXT/NS, as well as BNSF, believe that ATC represents an improvement over MSP. *See, e.g., BNSF Op* at 53; BNSF Reply at 17, 29-31.¹³ Because the only alternatives available in this proceeding are ATC and MSP, the Board should adopt ATC as a replacement for the flawed MSP approach.

¹² Some commenters have advocated an alternative cross-over traffic revenue allocation approach, which is sometimes referred to as "Efficient Component Pricing." CSXT/NS are familiar with the general concept of ECP, which is founded in sound economics and is an appropriate analytical tool in a number of circumstances, including the evaluation of "bottlenecks" and related issues. Because CSXT/NS have focused only on the Board's proposals, CSXT/NS have not evaluated whether ECP, or some variation thereon, might be an even more appropriate method than ATC for the allocation of cross-over traffic revenues.

¹³ In each of the first two rounds of comments, BNSF stated that ATC is superior to MSP, and that if the Board does not adopt BNSF's contestability proposal, then BNSF would support the adoption of ATC. *See BNSF Op.* at 53; BNSF Reply at 29-31 ("BNSF endorses the Board's

III. INDEXING OPERATING EXPENSES

The Board should not adopt the “hybrid” index for adjusting a SARR’s operating costs proposed in the *NPRM*. The record compiled in this proceeding provides no evidentiary support for a rule under which the RCAF-A mechanically would be applied to the SARR’s operating expenses in equal 5% increments throughout the DCF period (much less the Coal Shippers’ proposal to credit the SARR, which is assumed to be optimally efficient at its inception, with 50% of the productivity reflected in the RCAF-A from the very outset). See CSXT/NS Op. at 8-11; CSXT/NS Reply at 14, 17. The proposed “hybrid” index is inconsistent with both the Board’s pronouncements regarding the unsuitability of the RCAF-A as a barometer of a SARR’s likely productivity, and with its practice of evaluating the issue of SARR productivity on a case-by-case basis. Nothing in the present record supports a departure from the Board’s established approach. Therefore, the Board should decline to adopt the proposed “hybrid” index for SARR operating costs. Instead, it should continue to evaluate whether to deviate from the RCAF-U on a case-by-case basis.

A. Because There Is No Evidentiary Support For The Board’s Proposal Or For Any Of The Other Proposals Raised By Commenters, Adoption Of Any Of Those Proposals Would Be Arbitrary And Capricious.

The record contains no support for the indexing methodology proposed in the *NPRM*. CSXT/NS and other railroad commenters unanimously oppose the proposed rule, primarily on two grounds: *First*, a SARR, as the hypothetical “least cost, most efficient” railroad from its inception, could not garner the types of productivity that are reflected in the RCAF-A, particularly during the early years of its existence. See, e.g., CSXT/NS Op. at 9-11; Reply at 14-15; CPR Op. 4-5; Reply at 2-3; BNSF Op. Comments at 14 and V.S. Baranowski; BNSF Reply

proposed ATC approach in the event the Board decides not to use contestability principles in establishing revenues on cross-over traffic.”).

at 33-40; UP Op. at 31-35; Reply at 24-33. For the most recently published five year period (1999-2004), for example, there were only a handful of primary drivers of productivity gains. A typical SARR would not see these gains because:

- As a unit train operation that is optimized from the outset, the SARR would not see improvement in car utilization, which drives gains associated with car ownership;¹⁴
- Train and road operations gains will not occur unless and until the industry has one-man crews;
- SARRS typically do not handle intermodal traffic, which drives the gains associated with other equipment (a category that encompasses equipment other than cars and locomotives);
- SARRs rarely have any yard operations or a diverse traffic mix that requires switching (changes in which drive gains in yard operations);
- A SARR begins with the leanest possible level of administrative support thereby precluding gains associated with such support; and
- The SARR would not realize the benefits of refinancing debt at lower interest rates that real-world carriers obtained during that period. Moreover, the future course of interest rates over a significant period of time could not be projected with any accuracy.

Second, there is no basis in the record for the specific hybrid approach proposed in the *NPRM*. The record is devoid of support for the proposition that a mechanical phase-in of the RCAF-A – in 5% increments or otherwise—would produce a rational result, particularly in the early years of the DCF period.¹⁵ Some shipper commenters agree with this analysis, and similarly oppose a rule that would automatically apply the RCAF-A in 5% increments in every case. *See, e.g.,* Albemarle Corp. Op. at 6; Arkansas Electric Cooperative Corporation (“AECC”) Op. at 17-19. Adoption of such a pre-determined, uniform productivity credit in all cases –

¹⁴ The remainder is from car ownership, which does not change during the life of the SARR.

¹⁵ *Cf. San Antonio v. United States*, 631 F.2d 831, 850-53 (D.C. Cir. 1980) (rejecting ICC’s “seven percent solution” because it lacked justification or basis in the record), *partially rev’d on other ground*, 459 U.S. 131 (1982) (holding mandate procedure on remand was erroneous).

without any evidence that such a credit reflects the specific productivity improvements a SARR might achieve – would be arbitrary, capricious, and unsupported by evidence in the record of this proceeding.¹⁶

The fundamental flaw in the *NPRM*'s proposal (and the proposal raised by the Coal Shippers) is that it pre-judges the issue of SARR productivity by woodenly applying a uniform, linear productivity adjustment in every case, regardless of the traffic selected for movement by the SARR, the specific operations posited by the complainant, or the facilities and equipment employed by the SARR at the outset. Thus, the proposed hybrid index embodies “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.” Albemarle Corp. Op. Comments at 6. CSXT/NS agree with shipper Albemarle Corporation that “[i]t 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.” *Id.* Rather than adopting an inflexible “one-size-fits-all” rule that preordains the level of productivity improvements automatically attributed to diverse SARRs in every case, the Board should not deviate from the RCAF-U index in the absence of specific evidence demonstrating that a specific productivity adjustment is appropriate. *See Otter Tail* at 21-22; *Xcel* at 33-34.

¹⁶ The Coal Shippers assert that the Board’s proposal “does not go far enough” and offer a new proposal under which the RCAF-A and the RCAF-U would be applied on a 50/50 basis in the very first year of the DCF period, with application of the RCAF-A increasing in 5 percent annual increments thereafter. Coal Shippers Op. at 69-70, 84-86; Coal Shippers Reply at 33. However, the Coal Shippers have completely failed to demonstrate *any* correlation between their new proposed index and the level of productivity likely to be achieved by a SARR at any point during the DCF period. *See generally* Coal Shippers Op. at 69-70, 84-86.

B. The Proposed Approach is Inconsistent with Sound, Established Board Precedents Regarding SARR Productivity

The proposed hybrid index also represents a marked departure from the Board's approach to the issue of SARR productivity in SAC cases. In its prior decisions, the Board has not (as the comments of certain shippers appear to suggest) adopted *any* presumption regarding the level of future productivity that the SARR might achieve. Rather, the Board has entertained – indeed, it has encouraged – evidence regarding the most appropriate measure of the SARR's likely productivity for purposes of indexing operating costs, and it has applied the index that was best supported by the record evidence. *See, e.g.*, STB Dkt No. 42071, *Otter Tail* at 22 (applying RCAF-U because record did not support proposed use of RCAF-A); STB Dkt. Nos. 42069, 42070, 42072, *Duke Energy Corp. et al v. Norfolk Southern Railway et al*, slip op at 15-19 (served Oct., 20, 2004); STB Dkt No. 42057, *Xcel v. BNSF* (served June 8, 2004) at 34 (applying RCAF-U as “the best index on record”). The record in this proceeding provides no basis for departing from that sound practice in future SAC cases.

The Board's recent SAC decisions also demonstrate why the RCAF-A in particular is not a suitable benchmark for SARR productivity. The Board has consistently held that “the potential impact of [productivity] improvements [for the SARR] would be far less than for existing railroads, which make changes incrementally as older-technology assets wear out or become obsolete.” *Xcel* at 33; STB Dkt No. 42070; *see Duke Energy Corp. v. CSX Transportation, Inc.* (served February 4, 2004) (“*Duke/CSXT*”) at 30; STB Dkt No. 42069, *Duke Energy Corp. v. Norfolk Southern Railway Co.* (served Nov. 6, 2003) (“*Duke/NS*”) at 36-37. As the Board explained in *Xcel* (at 34):

those productivity improvements [reflected in the RCAF-A] are driven in part by railroads shifting from older assets to newer technologies – technologies that, for the most part, the [SARR] would start out with – or by railroads abandoning unneeded or

antiquated facilities – actions that would be unnecessary for the [SARR] as its system would be optimally designed from the outset for its needs for the SAC analysis period.

For those reasons, the Board has consistently rejected the notion that a SARR would experience the same types of productivity as the rail industry generally, particularly in the early years of the DCF period. Rather, the Board has found that a typical SARR could achieve meaningful productivity benefits (if at all) only in the “outward years” of the SAC analysis period. *Otter Tail* at 22. *See also NPRM* at 20 (“use of RCAF-U is imperfect, particularly in the more distant years of the DCF analysis”) (emphasis added); *Duke/CSXT* at 29-30; *Duke/NS* at 37. Nothing in the record in this proceeding casts doubt upon the correctness of these Board findings with respect to SARR productivity. The hybrid indexing method proposed in the *NPRM* – which would apply the RCAF-A in inflexible 5 percent increments starting in the first years of the SARR’s existence – is inconsistent with the Board’s findings in actual, decided SAC cases.

Moreover, as CSXT/NS and other commenters have demonstrated, other factors mitigate concerns that application of the RCAF-U may exaggerate SARR operating expenses. First, the Board’s concern that the RCAF-U may overstate operating costs in the later, “outward” years of the 20-year SAC analysis period can be addressed by adoption of the Board’s proposal to reduce that period from 20 to 10 years. CSXT/NS and most other commenters support the proposal to reduce the length of the SAC analysis period. As several commenters have demonstrated, virtually all potential productivity gains available to the SARR would accrue after 10 years. *See, e.g., CSXT/NS Op.* at 9-11; *CSXT/NS Reply* at 17; *BNSF Op* at 55-59. As a general matter, therefore, adoption of a 10-year DCF period would eliminate any need to make productivity adjustments to SARR operating expenses. Accordingly, CSXT/NS urge the Board to adopt a ten year SAC analysis period while continuing its practice of determining the appropriate adjustment (if any) to SARR operating costs to reflect future productivity on a case-by-case basis.

Second, a SARR is already credited with hidden productivity benefits. In particular, the SARR is allowed to add and subtract crews, locomotives, and other equipment each year of the SAC analysis period as necessary to meet SARR traffic levels, without incurring the costs that the incumbent would incur to do the same thing. A real-world railroad is either unable to reduce or increase assets to perfectly match the traffic it will handle each year, or it incurs a substantial cost when it attempts to do so. Such costs are not an entry barrier – they are costs incurred any time a railroad buys (leases) or sells (cancels leases) cars and locomotives. It takes time and money to train crews. Given the unpredictable shifts in traffic patterns due to changing needs of rail customers and other uncertainties faced by real world railroads, crews simply cannot be adjusted to perfectly match changes in the traffic a real world railroad handles from year-to-year.

C. The Board Should Make SARR Productivity Adjustments in Specific Cases in Which the Complainant Satisfies its Burden of Proving the SARR Would Achieve Quantifiable Productivity Improvements During the SAC Analysis Period.

The Coal Shippers attempt to support their alternative productivity index on the ground that they believe that future rail industry research and development efforts will produce innovations – such as Positive Train Control, GPS tracking software, one-man crews, or improved train operations and maintenance systems – that would generate (unquantified) productivity savings for SARRs. Coal Shippers Op. at 74-82; Coal Shippers Reply at 32, 42-44. The Coal Shippers argue that it would be unfair to require complainants to present evidence supporting projected productivity gains from future innovations because “demonstrat[ing] future events regarding productivity improvements [is] a virtually impossible task.” Coal Shippers Reply at 43. It may indeed be difficult to predict future innovations. The appropriate response to such difficulty, however, is not to eliminate complainants’ burden of proof or to pre-emptively

award the SARR unforeseen productivity without even considering the costs necessary to achieve such improvements.¹⁷

The appropriate response is to account for productivity improvements when the facts and evidence in a specific case demonstrate they will occur. If a particular cost-saving measure is demonstrable at the time a rate case is being litigated, the complainant may incorporate it in its SARR design, and garner the full benefit of that innovation throughout the SAC analysis period. Where a major innovation becomes available to the rail industry in a subsequent year, the complainant should be allowed to seek reopening of the record to consider the effects of that development on the SARR's costs. However, the Board's analysis of such innovations must take into account the additional costs that the SARR would necessarily incur in implementing new technologies or replacing its assets. Such an approach properly balances a complainant's right to benefit from demonstrable productivity improvement with the right of carriers to have their rates evaluated based upon facts and evidence, and not speculation.

¹⁷ Moreover, it would be at least equally unjust – and certainly arbitrary – automatically to credit a SARR with 50% or more of forecast rail industry productivity improvement embodied in projections of the RCAF-A (as the Coal Shippers suggest), without requiring the submission of any case-specific evidence, on the basis of unsupported speculation in this rulemaking regarding hypothetical future technologies or other cost-saving measures. A technological change that is under study today may or may not ever be implemented or generate actual productivity improvements. Even if new technologies become available, each real world railroad must weigh the benefits and costs associated with those technologies, and decide whether, and on what schedule, it might implement them. An economically rational SARR, like a real railroad, would subject new technology to the same cost-benefit analysis it applies to decisions regarding whether to double-track a line segment or make other road property investments. For example, the degree to which a SARR might benefit from Positive Train Control or GPS-based tracking programs would depend upon its traffic mix, and the geographic scope and complexity of its operations. Likewise, even if a more efficient locomotive type were assumed to become available at some point during the SAC analysis period, a rational SARR might very well conclude that the prospective benefits of such locomotives would not justify their acquisition cost.

The Coal Shippers object to the common-sense requirement that a proper analysis of future SARR productivity must consider the cost of acquiring productivity-enhancing assets. According to them, such an inquiry is unnecessary because the costs incurred by railroads to acquire and deploy such assets “already are factored into the calculation of the RCAF-A.” Coal Shippers Reply at 41. This argument is disingenuous. While the RCAF-A does, indeed, reflect the “net” productivity gains achieved by the rail industry, the productivity-related costs that are factored into the index are based upon the actual expenditures made by real-world carriers to acquire more productive assets and systems. By contrast, the initial cost of a SARR does not take account of the additional expenditures that would be required for the SARR to achieve the same productivity-enhancement in future years. Thus, adjusting a SARR’s operating costs based on the RCAF-A, without also requiring the SARR to recognize the accompanying costs real world railroads must incur to generate the level of productivity reflected in that index, would result in a significant understatement of SARR operating expenses.

D. The SARR Could Not Achieve the Same Productivity Improvements Available to Real World Railroads, Because the SARR is Assumed to Attain Optimal Efficiency Providing the Services at Issue, Given the Evidence Submitted by the Parties and Feasibility Limitations.

The Coal Shippers take issue with the proposition that a SARR, which is assumed to be optimally efficient from the outset, could not achieve the same level of productivity as real world railroads because, they claim, the SARRs adopted in recent SAC cases have not been “least cost, most efficient” railroads. Coal Shippers Reply at 34-40. This novel contention confuses the methodology applied by the Board with the results of the Board’s evaluation of the evidence submitted by the parties in each case. In its SAC decisions, the Board consistently seeks to determine “the lowest cost at which a hypothetical, optimally efficient carrier could provide the service at issue.” *Xcel* at 10. *See also Otter Tail* at 6-7; *Duke/NS* at 11; *Duke/CSXT* at 11.

However, proper application of the SAC methodology does not require that the Board blindly accept every claim made by a complainant regarding SARR operations or efficiency. Where the complainant's operating plan is credible, adequately supported, and represents "the best evidence of record," the Board will accept that plan. *See Otter Tail* at 18-19. However, where (as in the cases cited by the Coal Shippers) the complainant's SARR design and operating plan are demonstrably infeasible, or fail to provide the service required by the selected traffic group, the Board properly rejects that evidence.

The SARR design and operating plans submitted by complainants frequently reflect a tactical decision to forgo investment in infrastructure and other road property investment. This is complainants' prerogative, and it benefits them by reducing SARR capital investment. Such decisions, however, generally result in increased SARR operating expenses. In the recent Eastern cases, for example, complainants declined to make the capital investments necessary to construct gathering yards and other facilities used by the incumbent carriers to serve the numerous small mine origins in the Central Appalachian coalfields. As a result, SARR operating expenses were substantially higher than they would have been if complainants had chosen to make additional infrastructure investments. SARR operating expenses (or their rate of increase) may, in some cases, be reduced by implementing new technology or other productivity enhancing measures, but such productivity improvements are available only if the SARR incurs the costs necessary to achieve them.

The Coal Shippers' carping about the Board's decision to reject the infeasible and internally inconsistent operating plans submitted by complainants in the recent Eastern coal rate cases (Coal Shippers' Reply Comments at 34-38) is nonsense. As the Board explained in *Duke/CSXT* (at 24-28), the complainant in that case proffered an operating plan that assumed,

among other things, that all of the selected traffic would move exclusively in unit trains “regardless of historical traffic patterns or customer preferences” (*Duke/CSXT* at 24); that the SARR would not need any staging yards or gathering infrastructure to build trains (*id.*); that average train lengths would be greater than those operated by CSXT (*id.* at 25); and that particular shippers would receive and accept coal from mines other than those from which they were actually acquiring their coal (*id.*). Because of these and other fanciful assumptions, the Board correctly concluded that the complainant’s operating plan would not meet the transportation needs of the selected traffic group. *Id.* at 28. Accordingly, the Board held that “Duke’s operating plan is clearly not feasible and thus cannot be used” (*id.*), and it instead adopted the operating plan submitted by CSXT (which represented the best evidence of record with respect to operations that could meet the requirements of shippers with the physical configuration posited by complainant).¹⁸

Likewise, the complainant in *Duke/NS* posited an operating plan that was radically different from NS’ real world operations. Under the operating plan posited by Duke, all traffic would move in unit trains, even though “18% of the selected coal traffic currently moves in LTL shipments.” *Id.* The plan “would [have] require[d] some shippers to accept trains much larger or smaller than they have been receiving,” without any evidence that those shippers would be willing or able to accept such different size shipments. *Id.* at 31. To boost the efficiency of its SARR, Duke also assumed that mine origins would load, and shippers would receive, coal from different mines, and on different days, than they did in the real world. Indeed, the Board

¹⁸ Indeed, it would have been entirely appropriate for the Board to dismiss those cases outright based upon complainants’ failure to present a prima facie case. The Board’s decision to substitute the evidence submitted by defendant carriers for the defective evidence presented by complainants in those cases effectively excused failure to meet their burden of proof.

concluded that “combining traffic from different mine origins in an unworkable way is the defining characteristic of Duke’s operating plan.” *Id.* at 32 (emphases added).

As these excerpts from the *Duke/CSXT* and *Duke/NS* decisions demonstrate, the Board rejected the operating plans posited by the complainants in those cases because they were unrealistic and utterly ignored the needs, practices and preferences of the mines and customers who would be served by the SARR. It would be truly perverse to rely upon such failures of proof on the part of complainants as the basis for altering the SAC methodology to attribute to the SARR in every case a level of future productivity that could not be achieved by a “least cost, most efficient” carrier. The Coal Shippers’ proposal, which would do precisely that, should be rejected.

IV. THE BOARD SHOULD NOT ADOPT THE PROPOSAL TO DISALLOW ALL MOVEMENT-SPECIFIC ADJUSTMENTS TO URCS SYSTEM AVERAGE COSTS.

A. No Commenter Supports The *NPRM*’s Proposal, And There Is No Basis In The Rulemaking Record For Adopting That Proposal.

Significantly, no party supports the Board’s proposal to disallow all movement-specific adjustments to URCS system-average costs. Commenters are in general agreement that some adjustments to URCS system average are necessary and appropriate, although they differ as to which adjustments they support. There is thus no support in this record for the Board’s proposal to disallow all movement-specific URCS adjustments, and the Board should not adopt that proposal. Because variable costs are perhaps the single most important factor in cases evaluated under the *Simplified Guidelines*, there is even more reason to continue to allow movement-specific adjustments to URCS system average costs in cases considered in that framework. *See* Decision, *Major Issues in Rail Rate Cases*, STB Ex Parte 657 (Sub-No. 1) (served April 14, 2006), at 2 (“if our proposal to disallow movement-specific adjustments to variable costs is

adopted, that policy would apply to the calculation of the 180% jurisdictional floor in all rate reasonableness cases, whether brought under *Guidelines* or *Simplified Guidelines*"); see generally, *Rate Guidelines – Non-Coal Proceedings*, STB Ex Parte 347 (Sub-No. 2) (served Dec. 31, 1996).

B. CSXT/NS's Evidentiary and Procedural Proposals Would Reduce the Overall Expense of SAC Proceedings While Preserving Accuracy and Precision of Variable Cost Determinations Where Necessary or Appropriate.

CSXT/NS support the goal of reducing the time and expense of litigating issues concerning adjustments to URCS system average variable costs, in those instances in which reductions can be achieved without unduly sacrificing accuracy or analytical rigor. Moreover, CSXT/NS are acutely aware of the costs of variable cost adjustment litigation, because, while both parties must incur the cost and burden of submitting variable cost evidence, the substantial burden associated with variable cost discovery falls almost exclusively on defendant carriers.

Although CSXT/NS do not support the Board's proposal, they have offered constructive suggestions for procedural changes that could reduce the time and expenses associated with litigating variable cost adjustments. In contrast, shippers are unanimous in their opposition to any limitation on movement-specific adjustments to URCS variable costs in SAC cases; unanimous in their opposition to any cost-saving suggestion proffered by railroad comments; and entirely silent as to how the Board could reduce the expense of variable cost proceedings. The shippers' silence is particularly curious in light of their public complaints to Congress, to the Board, and in the press about the time and expense of litigating a rate case.

To reduce the time and expense of litigating variable cost adjustments, CSXT/NS proposed that each party be allowed to present evidence concerning a limited number of adjustments. See CSXT/NS Op. at 17. Shippers rejected this suggestion as unduly favoring carriers. See Coal Shippers Reply at 58 (relying on expense categories mentioned by CSXT/NS

as *examples* of some types of costs the Board might consider). CSXT/NS find this response disappointing – instead of suggesting a limited set of variable cost categories that shippers would propose be considered for movement-specific adjustments, they flatly refuse even to consider CSXT/NS’s cost-saving proposal. It appears that the shippers are more interested in complaining than in engaging in constructive efforts to develop effective solutions.

CSXT/NS also proposed that the Board adopt a new procedural approach that would allow parties the option to forgo the submission of variable cost evidence at the beginning of a case, at the end of a case, or both. *See* CSXT/NS Op. at 15-16. Parties exercising these options could realize substantial savings of time and expense by effectively waiving the threshold quantitative market dominance determination and/or the determination of the jurisdictional floor on any rate prescription. In those cases in which a party determines that either quantitative market dominance or the rate prescription floor is a close question, or is otherwise important, that party may insist upon presentation of variable cost evidence. *Id.*; *see* CSXT/NS Reply at 22. Significantly, this proposal would allow the parties to weigh the expense of presenting variable cost evidence against the importance of that evidence in a particular case, and afford them the flexibility to determine in each specific rate case whether presentation of variable cost evidence is worth the required time, effort, and expense.

Shippers oppose the CSXT/NS cost-saving proposal because they believe it would be “procedurally cumbersome” and would significantly increase the length of time it takes to litigate a maximum rate reasonableness case. *See* Coal Shipper Reply at 57-58. As to the first concern, the procedure CSXT/NS envision would be simple and straightforward: At the outset of a case, the defendant carrier would elect whether or not to contest quantitative market dominance. If the carrier declines to contest quantitative market dominance, variable cost

discovery would not be conducted and, after a short discovery period, complainants would file their opening SAC evidence. If the carrier contested quantitative market dominance, cases would proceed as they do under the Board's current procedures. Later, if the Board's SAC analysis determines the challenged rate is below a maximum reasonable level, there would be no need to consider variable cost evidence, and the case would conclude. If the Board determines that the challenged rate exceeds a reasonable maximum level, then either party would have the option to insist upon the submission of variable cost evidence necessary to determine the jurisdictional floor on a rate prescription.

The Coal Shippers' second concern is that CSXT/NS's approach may cause SAC cases to take longer. In two of the three possible scenarios, this concern is simply unfounded. First, in the majority of cases, parties likely will choose not to present variable cost evidence.¹⁹ This would result in substantial overall savings of time and expense for all parties, because parties in such cases would not be required to engage in variable cost discovery or to develop and present multiple rounds of variable cost evidence. In the second category of cases – those in which the carrier elects to contest quantitative market dominance at the outset of the case – the length of time to resolve a SAC case would be exactly the same as it is under the Board's current procedures.

In the third category of cases, in which a party invokes its right to require submission of variable cost evidence at the end of the SAC case, the time it would take to conduct variable cost discovery and to submit variable cost evidence at that point should be substantially offset by the time and effort saved by skipping those steps at the beginning of the case. It is also important to

¹⁹ As other commenters have explained, if SAC is properly applied, cases in which rates are prescribed at or near the 180% R/VC jurisdictional floor should be rare. *See, e.g.*, UP Op. at 18; UP Reply at 47-48. Accordingly, determination of that floor should be necessary only in the exceptional case.

clarify that CSXT/NS are not proposing that a shipper be denied the benefit of a reduced rate during the submission and consideration of variable cost evidence for the purpose of determining a jurisdictional floor on any rate prescription. Rather, CSXT/NS propose that, in such circumstances, the Board would issue a preliminary rate prescription at the conclusion of the SAC case, and direct the carrier to charge that preliminary rate until the Board determines the jurisdictional floor and makes a final rate prescription. *See CSXT/NS Op.* at 16. In those instances in which the jurisdictional floor alters the level of the final prescribed rate, the parties would be required to conduct a “true-up” to place them in the same position they would have been in had the final rate prescription been issued at the time of the Board’s SAC maximum reasonable rate determination. *Id.*

C. “Unadjusted URCS System Average” Costs Should Include Movement-Specific Operating Statistics and Service Units.

As CSXT/NS previously explained, regardless of whether the Board adopts its proposal to disallow movement-specific adjustments to URCS unit costs, it should clearly define what it means by “unadjusted URCS” costs. *See CSXT/NS Reply* at 18-22. The unadjusted URCS costs for a movement should be calculated by using the specific operating statistics (service units) that reflect the way the incumbent carrier handles the movement, and “system average” unit costs. *See id.* The use of correct service units – which are objectively verifiable and should rarely, if ever, be disputed by the parties – is essential to the accurate calculation of the baseline unadjusted URCS costs of a movement. *Id.* at 19-21.

As CSXT/NS have demonstrated, these costs clearly would include third-party payments. Shippers object to the inclusion of these third-party payments on the ground that it would allow a railroad to outsource an entire movement (i.e. to sell or lease a line traversed by a movement) to another carrier and then collect 180% of its payment to that second carrier. As the Board well

knows, however, no railroad makes business decisions regarding whether to lease or sell a line in order to influence a future rate case. Those decisions are made for day-to-day business reasons (not for rate regulation purposes), such as whether the route is more direct and whether it would be more efficient. Certainly, no shortline has ever been created on the rail network of CSXT or NS to gain an advantage in a rate reasonableness case.

Calculation of unadjusted URCS costs in the manner described in CSXT/NS' comments will establish an accurate estimate of a movement's system average URCS, which will then serve as an appropriate starting point for any movement-specific unit cost adjustments.

V. SAC ANALYSIS PERIOD

Consistent with the general consensus of commenters, the Board should adopt a 10-year SAC analysis period. As CSXT/NS previously observed, adoption of a 10-year SAC period could also obviate any further inquiry regarding adjustment of projected operating expenses, because any potential productivity gains likely would not accrue to the SARR until after the expiration of the 10-year period. *See supra* at III; CSXT/NS Reply at 17; CSXT/NS Op. at 9-11.²⁰ As CSXT/NS demonstrated in their Reply Comments, there is no basis for the Coal Shippers' request that the adoption of a ten-year SAC analysis period should be linked to a change in the Board's amortization of debt-financed capital, or to creation of a new and unprecedented presumption that a rate prescription would extend beyond the end of the SAC analysis period. *See* CSXT/NS Reply at 24-25. Most obviously, extending a rate prescription beyond the SAC analysis period would be arbitrary and capricious because it would impose a rate prescription without any evidentiary basis. Not only are these proposals without merit, they

²⁰ Of course, use of the RCAF-U to index SARR operating expenses over the 10-year SAC analysis period would simply be the default assumption. Parties should remain free to present evidence showing that the SARR would achieve productivity gains before the end of the 10-year period that would justify adjustment of the operating expense index.

are outside the scope of this rulemaking. Therefore, they should be rejected without further consideration.

VI. STANDARDS FOR VACATING RATE PRESCRIPTIONS

The Board should adopt its proposed procedures for re-opening and vacating a rate prescription. The proposal, which applies the same standard for vacating a rate prescription to all parties, is fair, balanced, and consistent with the requirements of governing statutes and caselaw. *See CSXT/NS Reply at 25-27.*

Contrary to the Coal Shippers' claim, the proposal to lift temporarily the prescriptive effect of a rate prescription does not violate the requirements of *Arizona Grocery Co. v. Atchison, Topeka & Santa Fe Rwy.*, 284 U.S. 370 (1932). That case forbade retroactive ratemaking, but did not involve the Board's authority to "suspend" or "change" a Board action pursuant to 49 U.S.C. § 722. Pursuant to that authority, the Board's proposal would simply *suspend* the Board action in question (a rate prescription), pending a full investigation of whether to permanently vacate or modify the rate prescription. *See* 49 U.S.C. § 722(b), (c). The Board's proposal protects against the possibility that either party would be unduly harmed by the suspension, by requiring that the parties keep account of the amounts paid during the pendency of the investigation, and providing for a true-up or "make whole" process at the conclusion of the investigation. *See NPRM at 37-38.*²¹

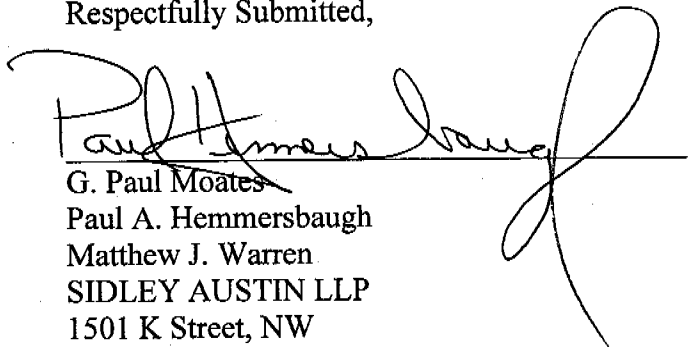
²¹ Unlike the ICC action at issue in *Arizona Grocery*, the proposed reopening and vacatur procedure – including the suspension of a previous rate prescription – would not result in a retroactive rate prescription or the retroactive payment of reparations or otherwise unduly disturb parties' justifiable repose interest. Rather, any "make whole" payments would be prospective from the date of re-opening, at which time all parties would be fully on notice that the suspended rate prescription may be vacated or modified. *See, e.g., NPRM at 36-38.*

CONCLUSION

For all of the reasons set forth in these Rebuttal Comments, in CSXT/NS' Opening and Reply Comments, and in other comments and authority cited therein, the Board should:

(1) reject its proposals regarding the rate reduction methodologies and continue to apply the PRM; (2) adopt the ATC proposal for allocating cross-over traffic revenue; (3) reject the proposal regarding indexing of SARR operating expenses; (4) reject the proposal to disallow movement-specific adjustments to URCS system average costs; (5) adopt its proposal for a 10-year SAC analysis period; and (6) adopt its proposed standards and procedures for re-opening cases and vacating rate prescriptions.

Respectfully Submitted,



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Dated: June 30, 2006

Certificate of Service

I hereby certify that on this 30th day of June 2006, I caused a copy of the foregoing "**Joint Rebuttal Comments of Norfolk Southern Railway Company and CSX Transportation, Inc.**" to be served upon all parties on the service list for this proceeding by first class mail or more expeditious method of delivery.

Catherine Lheal