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June 30, 2006

BY HAND DELIVERY

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

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Re: STB Ex Parte No. 657 (Sub-No. 1), *Major Issues In Rail Rate Cases*; Docket No. 41191, *West Texas Utilities Company v. 216919 BNSF Railway Company*; Docket No. 41191 (Sub-No.1), - 216920 *AEP Texas North Company v. BNSF Railway Company*

Dear Secretary Williams:

Enclosed please find an original and twenty (20) copies of the Rebuttal Comments of AEP Texas North Company in the above-referenced proceedings. Also enclosed is a CD containing the filing.

Finally, we have enclosed an additional copy of these Comments to be date-stamped and returned to the bearer of this letter. Thank you for your attention to this matter.

Sincerely,

Kelvin J. Dowd
An Attorney for
AEP Texas North Company

Enclosures

cc: Service List-w/enclosures

 JUN 30 2006
 RECEIVED
 Sub-No 11

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

Complainant,

Docket No. 41191

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Office of Proceedings

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~~Part of~~
~~Public Record~~

Complainant,

Docket No. 41191 (Sub-No. 1)

Defendant.

Attorneys & Practitioners

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

MAJOR ISSUES IN RAIL RATE CASES	)	Ex Parte No. 657 (Sub-No. 1)
	)	
WEST TEXAS UTILITIES COMPANY	)	
Complainant,	)	
	)	
v.	)	Docket No. 41191
	)	
BNSF RAILWAY COMPANY	)	
Defendant.	)	
	)	
AEP TEXAS NORTH COMPANY	)	
Complainant,	)	
	)	
v.	)	Docket No. 41191 (Sub-No. 1)
	)	
BNSF RAILWAY COMPANY	)	
Defendant.	)	
	)	

REBUTTAL COMMENTS OF AEP TEXAS NORTH COMPANY

Pursuant to the Decision of the Board served in the above-captioned proceedings on February 27, 2006 (“*Decision*”), AEP Texas North Company (“AEP Texas”) submits these Rebuttal Comments in response to Reply Comments filed on May 31, 2006 by BNSF Railway Company (“BNSF”) and Union Pacific Railroad Company (“UP”).

INTRODUCTION

The Coal Shippers¹ this date are filing Joint Rebuttal Comments in this proceeding. AEP Texas subscribes to the Coal Shippers' Joint Rebuttal Comments and accompanying expert witness testimony, including in particular the Verified Statements of Thomas D. Crowley and Dr. George H. Borts. AEP Texas submits these additional comments specifically to address arguments raised on reply by BNSF and UP concerning the proper rate reduction methodology to be applied when stand-alone revenues are found to exceed stand-alone costs, and their claims regarding the General Percent Reduction Methodology ("GPRM") advocated by AEP Texas for adoption and application in *Docket No. 41191 (Sub-No. 1)*.

REBUTTAL COMMENTS

In its earlier Comments, AEP Texas endorsed the Board's proposal to discontinue reliance on the Percent Reduction Methodology ("PRM") for the allocation of rate relief in SAC cases. AEP Texas also agreed with the Coal Shippers that the Maximum Contribution Methodology and the Maximum Markup Methodology, proposed by the Board as substitutes for PRM, were superior to the *status quo* from the standpoint of regulatory fairness and consistency with Ramsey pricing principles. Additionally,

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

however, AEP Texas proposed that the Board adopt GPRM, which is described in detail on the record in *Docket No. 41191 (Sub-No. 1)*, as an acceptable replacement for PRM both in the context of AEP Texas' own case and for general application in proceedings under the *Coal Rate Guidelines*.

In their Reply Comments, BNSF and UP, together with their sponsored witnesses, seek to defend the continued use of PRM.² Additionally, the carriers level various criticisms at proposed alternative methodologies, including GPRM.³ However, for the reasons set out below and in the Coal Shippers' Joint Rebuttal Comments, PRM remains fatally flawed as a methodology to determine the proper level of maximum rates on captive coal traffic, and the carriers' claims regarding GPRM are without foundation.

I. PRM Is Flawed And Should Be Discontinued

An obvious and acknowledged defect in PRM is that it determines the outcome of rate litigation largely by reference to the opening position of one of the litigants. *Decision* at 8. *See also, Coal Shippers Joint Comments* at 15-17. Regardless of whether there is evidence of a subjective intent on the part of a defendant railroad to "game" the results of the SAC analysis, it is contrary to sound regulatory policy to adhere

² *See, e.g., BNSF Reply Comments*, V.S. Kalt at 27.

³ *See BNSF Reply Comments* at 9-12; *UP Reply Comments* at 8-11.

to a formula where the rate set by a railroad in anticipation of litigation drives the result of the SAC analysis.

PRM also is inconsistent with Ramsey principles. It is well-recognized that the essence of Ramsey pricing is that rates are set differentially across markets to allow for the recovery of fixed costs, while minimizing the deviation from optimal prices, *i.e.*, prices set at the level of marginal costs. Ramsey pricing functions by setting prices in such a way that the markup of price over marginal cost is inversely related to a customer's elasticity of demand. *See* Reb. V.S. Crowley at 5-6. A Ramsey-based rate reduction method, then, would focus on the relative markups over marginal cost experienced by the members of a SARR traffic group. PRM fails this test, because PRM focuses on the maintenance of absolute price relationships, and essentially ignores relative markups over marginal costs. This departure from Ramsey principles compounds the problem that results from using the defendant's price as a determinant of outcome, and the end product of the SAC analysis bears no reliable resemblance to a Ramsey optimal price.

BNSF's witness Kalt contends that PRM is preferable to all other alternatives because by retaining existing price relationships it avoids distorting or "compressing" rate structures. *See* R.V.S. Kalt at 28. However, witness Kalt ignores the fact that by focusing solely on prices without regard to marginal costs, PRM actually distorts results. The core purpose of Ramsey pricing is to allow the recovery of unattributable costs while minimizing deviation from marginal cost pricing. Under PRM,

however, all rates are deemed reduced by the same percentage without regard to margin. *Inter alia*, this means that SARR traffic which already is priced at or slightly above (or below) marginal cost easily could be pushed well under the optimal price “floor,” a result plainly at odds with the lodestar Ramsey principle. *See* Reb. V.S. Borts at 2.

The Board is quite correct that the time has come to discard PRM in favor of an approach that is more consistent with the principles underlying CMP, and avoids the anomaly of having the outcome of litigation determined by one litigant’s tactics.⁴ *See* AEP Texas’ *Reply Comments* at 2-7. AEP Texas submits that GPRM is such an approach.

II. The Railroads’ Criticisms of GPRM Are Without Merit

AEP Texas has proposed that the Board approve GPRM – the methodology developed and presented by AEP Texas in *Docket No. 41191 (Sub-No. 1)* – for general application in cases brought under the *Coal Rate Guidelines* as a preferred replacement for PRM. In their comments, BNSF and UP collectively level three basic criticisms

⁴ *See* Docket No. 42072, *Carolina Power & Light Co. v. Norfolk Southern Railway Co.*, Decision served December 23, 2003 at 32.

against GPRM.⁵ However, none of these claims is meritorious, and GPRM remains an approach that is far more consistent with governing Ramsey principles than PRM.

First, it is argued that GPRM is invalid because it infers relative demand elasticities among members of the SARR traffic group using markups over marginal cost that are based on the SARR's division of revenues on cross-over traffic. *See BNSF Reply Comments* at 10-11; R.V.S. Kalt at 11-12. According to the railroads, demand elasticities can only be inferred from total prices on complete through movements. *Id.*

There is no foundation for the notion that demand elasticities differ on discrete segments of a through movement. Indeed, as witness Crowley explains, the opposite is true. Demand elasticity is movement-specific, since a shipper's degree of captivity to a particular carrier is the same over the entire movement.⁶ Similarly, the rate that the shipper pays reflects demand considerations applicable over the entire movement,

⁵ BNSF also falsely charges that AEP Texas has advanced multiple versions of GPRM. *BNSF Reply Comments* at 10. As AEP Texas clearly explained in its June 9, 2005 Brief in *Docket No. 41191 (Sub-No. 1)* (at 20-21), following the close of the evidentiary record the Board issued its decision in *Docket No. 42057, Public Serv. Co. of Colo. d/b/a/ Xcel Energy v. The Burlington No. and Santa Fe Rwy. Co.*, Decision served June 8, 2004 ("*PSCo/Xcel*"). That decision appeared to question the validity of one aspect of GPRM as it could be applied in a particular case. While AEP Texas did not and does not agree with the Board's observation in *PSCo/Xcel*, the matter was easily addressed and resolved through a technical adjustment to the GPRM model, which AEP Texas explained and illustrated in its Brief. As proposed for adoption in this proceeding, the GPRM model likewise incorporates these technical adjustments.

⁶ The Board has recognized this concept, as it is the essence of the "one lump" theory that is applied in evaluating the competitive impacts of proposed railroad mergers. *See Burlington Northern, Inc. et al., – Merger – Santa Fe Pacific Corp., et al.*, 10 I.C.C. 2d 661, 747-48 (1995).

not its individual segments. Under the Board's current, reasonable methodology for determining revenue divisions on cross-over traffic (the MSP formula), revenues are allocated relatively evenly over the entire through movement, thereby accurately reflecting the demand elasticity for the entire routing in the portion replicated by the SARR. *See* Reb. V.S. Crowley at 8-9, 27-28. BNSF witness Kalt's related argument that GPRM fails to account for changes in demand elasticities resulting from rate reductions likewise fails. It rests on the premise that post-entry rate responses by the incumbent should be incorporated into the SAC analysis, a premise that was considered and rejected in *Nevada Power II*.⁷ The same result is called for here. *See* Reb.V.S. Crowley at 28-31.

Second, the railroads contend that GPRM's use of Phase III URCS data to estimate average marginal costs for purposes of determining Ramsey markups introduces an unacceptable degree of imprecision into the process, and fails to reflect the different "risk profiles" of individual movements. *See* R.V.S. Klick at 9-10. *See also BNSF Reply Comments* at 12; R.V.S. Kalt at 14-21; *UP Reply Comments* at 10-11; R.V.S. Neels at 15-17. The railroads' insistence on empirical perfection is at odds with common sense and reasonable regulatory policy.

The fact that it may be impractical to allocate rate relief using a method that requires precise, movement-specific calculations of marginal costs for each member of a SARR traffic group does not mean that the Board should abandon the Ramsey markup

⁷ *Bituminous Coal – Hiawatha, Utah to Moapa, Nevada*, 10 I.C.C. 2d 259 (1994).

principle altogether. The Board often tempers precision with practicality when it comes to calculating regulatory costs,⁸ and the *Coal Rate Guidelines* themselves approve system average costs of the type used in GPRM as a useful indicator of economic costs.⁹

Similarly, the fact that GPRM may not yield precise Ramsey *prices* does not mean that it is not truer to core Ramsey *principles* than the obviously flawed PRM. And while the railroads' witnesses make colorful claims concerning alleged disparities among the service conditions and "risk profiles" of individual shipper movements,¹⁰ they provide no evidentiary support for the breadth of the disparity that they assume. *See* Reb.V.S. Crowley at 36-38.

Finally, the railroads argue that GPRM's use of system average marginal costs fails to account properly for differences in individual shippers' movement costs.¹¹ Here again, however, the railroads overstate the potential for error arising from the use of system averages as a proxy, and ignore altogether the fact that GPRM's (and Ramsey's)

⁸ *See, e.g., PSCo/Xcel* at 16.

⁹ *Coal Rate Guidelines, Nationwide*, 1 I.C.C. 2d 520, 532 n. 31, 544 (1985). *See also Rate Guidelines – Non-Coal Proceedings*, 1 S.T.B. 1004, 1027 (1996).

¹⁰ The railroads' witnesses also spend considerable time speculating about how system congestion, demand fluctuations and other "real world" conditions should influence the marginal cost calculation. *See, e.g., R.V.S. Kalt* at 14; *R.V.S. Willig* at 13; *R.V.S. Klick* at 8. As witness Crowley explains, however, under CMP a SARR does not operate in the real world. It exists in a hypothetical world of optimal efficiency, where capacity matches peak demand and operating systems are designed to avoid congestion (at considerable added cost). *Reb. V.S. Crowley* at 34-36. The marginal costs used in GPRM are the SARR's costs, not the defendant's.

¹¹ *See R.V.S. Kalt* at 21; *V.S. Neels* at 17.

focus is on the relationship between markups, not the absolute level of the markups themselves. Reb. V.S. Crowley at 41-43. As witness Crowley explains, the fact that virtually all cases brought under CMP involve SARRs dominated by unit train coal traffic supports a presumption of cost similarity that makes the movements quite compatible with a system average approach to marginal costs. Reb. V.S. Crowley at 39-41. *See also Omaha Public Power Dist. v. Burlington N. R.R. Co.*, 3 I.C.C. 2d 123, 139 (1986). And it bears repeating that the railroads' objections in this regard rest largely on the erroneous premise that it is the defendant's marginal costs that are in issue. As Mr. Crowley illustrates, when one correctly views the question from the perspective of the SARR's costs, the results of GPRM are insensitive to the kinds of changes and differentials highlighted by the railroads' witnesses. Reb. V.S. Crowley at 44.

In sum, GPRM represents an approach to the determination of SAC-based rate reductions which is far more consistent with Ramsey principles than PRM, and avoids the manipulation risk inherent in PRM. The railroads' objections are all keyed to a standard of perfection that is neither required nor reasonable as a matter of regulatory fairness. AEP Texas has demonstrated that GPRM is superior both to the current methodology and to the alternatives proposed by the Board in this proceeding. Its application in *Docket No. 4119 (Sub-No. 1)*, and in CMP cases generally, should be endorsed.

CONCLUSION

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

Respectfully submitted,

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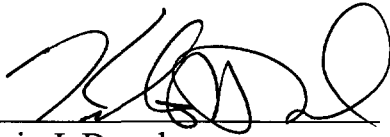


Dated: June 30, 2006

Attorneys & Practitioners

CERTIFICATE OF SERVICE

I hereby certify that on this 30th day of June, 2006, I caused a copy of the foregoing Rebuttal Comments of AEP Texas North Company to be served upon all parties of record in this proceeding.



Kelvin J. Dowd