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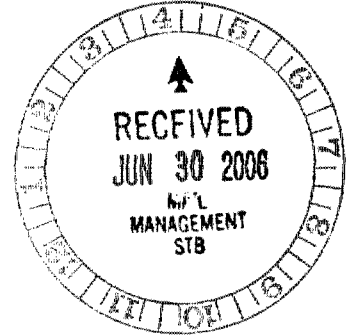
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June 30, 2006

BY HAND

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-captioned matter please find the original and twenty copies of the Rebuttal Submission of Union Pacific Railroad Company. Also enclosed is a diskette with a copy of the filing in Word format.

I have also enclosed an extra copy to be date-stamped and returned to our messenger.

Thank you for your assistance.

Sincerely,

Michael L. Rosenthal

Enclosures

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**BEFORE THE
SURFACE TRANSPORTATION BOARD**

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

MAJOR ISSUES IN RAIL RATE CASES

REBUTTAL SUBMISSION OF UNION PACIFIC RAILROAD COMPANY

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June 30, 2006

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VERIFIED STATEMENT OF KEVIN NEELS

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

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

MAJOR ISSUES IN RAIL RATE CASES

REBUTTAL SUBMISSION OF UNION PACIFIC RAILROAD COMPANY

Union Pacific Railroad Company (“UP”) is filing this rebuttal to address the various reply comments that have been submitted on the six issues and proposals that the Board set out in its Notice of Proposed Rulemaking in Ex Parte No. 657 (Sub-No. 1) (STB served Feb. 27, 2006) (“*NPRM*”).

I. INTRODUCTION

A. Overview

In its opening comments, UP stressed that the outcome of this proceeding is critical to whether railroads will be able to address the growing rail transportation needs, and in particular the growing coal transportation needs, of this country. As we explained in our opening comments, this proceeding comes at a time when the nation faces a transportation capacity crisis affecting all transportation modes and all commodities. Resolving this crisis will require massive new investment in transportation capacity, including rail capacity. The continued growth in coal demand, in particular, will continue to call for additional investment both to sustain the rail network and to expand capacity.

No one in this proceeding has disputed the need for more rail capacity investment, or for more investment in coal capacity in particular. Reflecting this need, the theme of our

comments in this proceeding has been consistent: the Board must ensure that rail rate regulation does not inappropriately deprive railroads of revenue that could be invested to provide much-needed capacity additions, or improperly distort market incentives for such investment. This guiding principle is as important today as when this proceeding began, and we urge the Board to consider it carefully and implement it in connection with this proceeding.

With the pressing need for additional rail capacity if this nation's economy is going to continue to flourish, we use our rebuttal to develop further the positions that we have consistently taken in our opening and our reply comments on the various proposals that have been offered for the stand-alone cost ("SAC") process.

First, we continue to believe that the percent reduction method best reflects the sound economic principles underlying the *Coal Rate Guidelines*¹ and the need for railroads to differentially price. The new arguments the Coal Shippers present in their reply do nothing to refute that position.

Second, we further demonstrate that UP's proposed avoided cost approach to revenue allocation for cross-over traffic is the only approach fully consistent with contestable market principles. We also note that the Board's proposed Average Total Cost ("ATC") method is flawed because it relies on arbitrary allocations of costs, that the other approaches that have been discussed in this proceeding are, like ATC, based on arbitrary allocations of costs, and that the Coal Shippers offer no valid criticisms of the avoided cost approach.

¹. *Coal Rate Guidelines, Nationwide*, 1 I.C.C.2d 520 (1985) ("*Guidelines*"), *aff'd sub nom. Consol. Rail Corp. v. United States*, 812 F.2d 1444 (3d Cir. 1987).

Third, we describe how the Coal Shippers still fail to provide evidence establishing that stand-alone railroads would realize the productivity gains experienced by real world railroads.

Fourth, we again explain why the Coal Shippers' position on movement specific adjustments to URCS would not improve accuracy, but would increase cost and complexity.

Fifth, we reiterate our support for the 10-year period for analysis and rate prescription.

Finally, we further discuss how the Board's proposal for reopening and vacatur of rate prescriptions is a common-sense and even-handed approach.

Taken as a whole, we believe the proposals by shippers on how the Board should determine stand-alone costs would result in a SAC process that reduces regulated rates to a level that will both discourage investment necessary to support the issue traffic and reduce the revenues available to railroads for investment needed to meet shippers' transportation demands. As the current environment of constrained capacity underscores, this would be poor policy and would thwart the clear Congressional directives to the Board to foster revenue adequacy and the support of a sound rail transportation system. Ultimately the shippers and the nation's economy would suffer as the nation's rail network becomes even more constrained.

In sum, the Board's decision in this proceeding will determine the extent to which the railroads can invest in additional needed capacity to meet customer needs going forward. If the Board acts consistently with sound market-based principles, preserves the ability of railroads to engage in differential pricing, and provides for a SAC process that does not introduce inappropriate distortions into market-based pricing, it will help to ensure that the railroads can

continue to invest in more capacity, in locations where such capacity is valued most highly. Our nation, which depends on a sound rail transportation network, cannot afford any other result.

B. No Party Has Refuted UP's Argument That This Proceeding Will Have A Profound Impact On Railroads' Ability And Incentive To Invest In Their Coal Networks.

In its opening submission, UP urged the Board to be mindful of the profound impact that this proceeding will have on its ability and incentive (and the abilities and incentives of other railroads) to invest in coal transportation. UP has invested more than \$7.0 billion over the past 10 years to renew and enhance its assets required to meet the growing demand for coal transportation. (UP Op. at 8 & Ex. 2.) Despite this substantial investment, UP's network remains under pressure to keep up with existing demand. (*Id.*, Haley V.S. at 4-6.) Moreover, demand for coal is expected to continue growing at a rapid pace. (*Id.*, Sansom V.S. at 4-6.) UP will not be able to accommodate the expected demand unless it can commit substantial additional capital to its coal business. (*Id.*, Haley V.S. at 9-12.) At the same time, however, shippers of other commodities, especially unregulated intermodal traffic, are also calling for increased investment to support their businesses. (*Id.* at 1-5, 13-14.) The demand for additional capacity exceeds the resources available. This proceeding is vitally important because flaws in the Board's current application of the SAC test are reducing the total dollars available to UP for needed capital investments and distorting the market signals to invest in coal transportation. (UP Op. at 15-19.)

No party in this proceeding has disputed UP's evidence that UP has invested billions of dollars in response to the growing demand for coal transportation and that its returns to date have fallen below the cost of capital invested. Nor has anyone disputed that UP's network capacity is strained; that it faces growing demand from customers for more coal transportation; that it will need to make significant new investments to accommodate the demand

for coal transportation; and that other commodities are competing for limited investment dollars. The Coal Shippers and AECC are the only parties that have attempted to address any of these points.

The Coal Shippers say that the Board need not worry about UP's ability to invest in the capacity needed to handle coal. (Coal Shippers Reply at 3.) They claim that a Western Coal Traffic League ("WCTL") study shows that railroads are earning returns on coal that exceed the full cost of service by a wide margin; that a rail infrastructure study prepared by the American Association of State Highway and Transportation Officials (the "AASHTO Study") also shows that profits are adequate to support continued investment in PRB coal; that UP's energy group generates more contribution than any other UP commodity group; and that UP's energy group ranks second among UP commodity groups in terms of revenue-to-variable cost ("R/VC") ratios. (*Id.* at 3-7.) AECC argues that UP's discussion of revenue adequacy and capacity concerns, as well as concerns about PRB rates being set at the jurisdictional threshold, reflect UP's attempts to have coal traffic cross-subsidize other traffic or lower-density portions of UP's network. (AECC Reply at 1-4.)

As discussed below, the Coal Shippers' and AECC's assertions are incorrect. More important, they do not address the primary issue UP raised – the fact that flaws in the current application of the SAC test are distorting UP's ability and incentive to invest in coal transportation.

1. UP's Investments In Coal Are Generating Returns Significantly Below The Cost Of Capital.

To support their claim that railroads collectively receive revenues from coal transportation that substantially exceed their fully allocated costs, the Coal Shippers cite an

analysis that WCTL submitted to the Board in 2004 and a two-sentence excerpt from the AASHTO Study. (Coal Shippers Reply at 4, 7.) Neither supports their claims.

UP thoroughly refuted WCTL's analysis in a prior submission to the Board, which is attached hereto as an exhibit. As UP explained in that prior submission, WCTL's analysis incorrectly assumed that coal should bear only a proportionate share of fixed costs; it used URCS costs, which are based on historical, depreciated costs, rather than the forward-looking costs that are relevant to decisions about future investment; it used system-average costs, which do not reflect the substantial investments UP has recently made in its coal routes; it used waybill revenues, which are distorted because UP masks the revenues to safeguard the confidentiality of contract rates; and it combined results for multiple railroads and thus did not accurately reflect UP's experience.

The AASHTO Study is a significant analysis of the expected growth in demand for rail transportation and the infrastructure investments required to accommodate that growth. The study concludes that if rail investment levels are not increased significantly, the freight rail network will experience an extreme investment shortfall just in its attempt to handle existing traffic growth. The study does not, however, purport to analyze whether railroad returns are sufficient to support the needed infrastructure investments.

The Coal Shippers quote a two-sentence excerpt from one of the AASHTO Study's appendices that demonstrates the study's limitations: based on the fact that railroads have continually upgraded the Joint Line, the study asserts that PRB coal is profitable enough such that "there are no significant rail capacity constraints" in the PRB. (Coal Shippers Reply at 7, quoting AASHTO Study at 117.) It is true that UP has invested and continues to invest substantial resources in its coal business. In fact, UP recently committed to spend approximately

\$100 million to pay for capacity expansion projects identified in a CANAC PRB study that UP and BNSF jointly commissioned.² However, as UP explained in its opening submission, such investment is a gamble on the future. UP's coal business is not providing adequate returns on investment, and if UP cannot count on higher returns in the future, the level of investment must decrease. (UP Op. at 15.)

UP's opening submission contained an analysis of UP's returns on investment in the coal business, focusing on UP's recent, actual investments in its coal business rather than historical, system-average investments. The analysis showed that UP stands to earn a return on its recent investments in its coal business of less than 4 percent – far below the 12.2 percent cost of capital in 2005. (UP Op., Haley V.S. at 7-8.) It also refutes AECC's claim that UP's concern in this proceeding is to allow coal to cross-subsidize other commodities. No party has refuted UP's analysis – neither the Coal Shippers nor AECC even mention this analysis in their replies. UP's analysis is a far more accurate assessment of UP's return on investment generated by coal than the WCTL analysis that UP previously refuted or the two-sentence, conclusory assertion in the AASHTO Study cited by the Coal Shippers.

2. The Coal Shippers' Arguments About Coal Contribution Amounts And Revenue-To-Variable Cost Ratios Are Flawed And Irrelevant.

The Coal Shippers' claims that coal generates more total contribution and has a higher R/VC ratio than other commodities are based on calculations performed by their witness Crowley. (Coal Shippers Reply at 5-6.) Crowley's calculations do not respond to the issues UP raised. Even if they were the least bit relevant, they are based on an improper manipulation of

² See Press Release, UP, BNSF Announce Southern Powder River Basin Joint Line \$100 Million Capacity Expansion Plan (May 8, 2006), *available at* http://www.uprr.com/newsinfo/releases/capital_investment/2006/0508_sprb.shtml.

UP cost data and are thus incorrect: Crowley's claims that coal provides more contribution and has a higher R/VC ratio than all other commodity groups handled by UP are wrong.

a) The Coal Shippers' Contribution and R/VC Calculations Do Not Respond to UP's Concern About the Effects of Flaws in the Current Application of the SAC Test.

Neither of Crowley's calculations addresses UP's warning that flaws in the current application of the SAC methodology are distorting UP's ability and incentive to invest in coal transportation. UP's primary concern about the current application of the SAC test does not involve whether coal generates more contribution than other commodities or whether coal has a higher R/VC ratio than other commodities. UP's concern is that it has many competing demands for its limited capital and that any artificial constraint on returns from investments in coal will distort investment decisions and direct relatively less investment to coal. (UP Op. at 19.) For coal to obtain the level of investment dollars the market is demanding, UP's return on coal investments must reflect the market demand. If faulty SAC methodology reduces returns for coal, then, regardless of the rankings of commodities in terms of contribution or R/VC ratios, a smaller share of investment dollars will be directed towards coal than market demand would otherwise dictate. (*Id.*)

b) The Coal Shippers' Contribution Calculations Are Irrelevant and Flawed.

UP is concerned about how much contribution coal generates, to be sure, but it is not concerned with which commodity generates the most total contribution. Rather, UP looks to how contribution from coal compares to the investments required to sustain coal transportation. Crowley's contribution calculation does not address that issue. UP, however, did address that issue in its opening submission. As discussed above, UP showed that returns on coal were falling far short of what was required to support its recent investment in its coal network and yet

significantly more investment will be needed in the near future. In other words, even if Crowley's contribution calculation were correct and coal were generating more total contribution than any other commodity, UP has shown that returns on coal are falling short of what is needed to support continued investment in UP's coal network, such as track capacity on the PRB Joint Line, in eastern Nebraska, across Iowa, toward Kansas City, and between Kansas City and St. Louis; capacity at run-through terminals in North Platte, Fremont, Clinton, and Jefferson City; and capacity at interchange points in St. Louis and Chicago. (UP Op., Haley V.S. at 7-8, 11 & Ex. TCH-3.)

In fact, however, Crowley's calculation is incorrect. His initial calculation shows that UP's energy group ranks behind both the chemical and intermodal groups in terms of total contribution. (Coal Shippers Reply, Crowley R.V.S., Att. No. 1 at 2 & table 1.) Crowley reports a different result in the text of his statement based on an "adjustment" to UP's actual data that is buried in an attachment to his statement. His "adjustment," however, is based on the illegitimate assumption that UP's URCS system-average variable costs for coal overstate UP's actual variable costs by 11%, and that the "excess" variable costs should be reallocated to other commodity groups. (*Id.* at 3.) In other words, Crowley's "adjustment" skews his calculation of contribution – *i.e.*, revenue less variable costs – by reducing variable costs for coal and increasing variable costs for all other commodity groups.

Crowley attempts to justify his reallocation as an extrapolation of the results in *Wisconsin Power & Light v. Union Pacific Railroad* ("WPL"),³ but he never explains the basis for his assumption that URCS system-average variable costs for coal systematically overstate

³ 5 S.T.B. 955 (2001), *modified*, STB Docket No. 42051 (STB served May 14, 2002) ("*WPL II*").

actual variable costs. Crowley says that the movement-specific variable costs that the Board calculated in *WPL* were 11% below variable costs calculated using “movement characteristics” from that case as input for the URCS Phase III model. (*Id.*) However, the Board has recognized that its conclusions about movement-specific costs in one case cannot be readily transferred to other cases. In *WPL* itself, for example, the Board rejected the shipper’s attempt to use a fuel consumption rate and locomotive maintenance costs that had been accepted in an earlier case, because there was no evidence that the transportation characteristics of the two movements were the same.⁴ Moreover, even if Crowley’s calculations are correct with respect to *WPL*,⁵ there are at least two likely explanations for any actual difference between the Board’s variable cost calculations in *WPL* and those using the Phase III model, neither of which would support a reallocation of variable costs from coal to other commodities.

First, the Board understated UP’s “movement-specific” variable costs in *WPL*. For example, to calculate variable maintenance-of-way costs, the Board used the speed-factored gross ton method advocated by the shipper – a methodology it subsequently rejected as outdated and unreliable.⁶ The Board also accepted the shipper’s evidence of locomotive lease costs, even though it acknowledged that the evidence was flawed.⁷ In addition, the Board used system-average fuel costs after rejecting UP’s movement-specific evidence, which showed substantially

⁴ *WPL*, 5 S.T.B. at 1002-03.

⁵ Crowley provides no workpapers that would allow his claim to be tested. He does not even state which “movement characteristics” he analyzed, which is a potentially significant issue, because *WPL* involved movements from two mines – Antelope and Black Thunder – and the Board’s R/VC calculations for movements from the two mines differed by more than 8 percentage points although the difference in loaded miles was only 2%. *See WPL II* at 8-11.

⁶ *Texas Mun. Power Agency v. Burlington N. & Santa Fe Ry.*, (“*TMPA*”), 6 S.T.B. 573, 632-33 (2003).

⁷ *WPL*, 5 S.T.B. at 1004-05.

higher fuel consumption.⁸ Finally, the Board rejected UP's proposal to adjust the URCS model to exclude expenses recorded in UP's Account 80 and Account 76 and to include the expenses recorded in Account 90 – an adjustment it subsequently accepted in other cases.⁹

Second, WPL involved a relatively long-haul, low-cost coal movement. As one example, the average locomotive consist size was 2.16 for movements from one of the origin mines and 2.29 for the other, compared with a system-average unit-train consist size of 2.90 locomotives.¹⁰ If the Board's variable costing approach in *WPL* were applied to many other coal movements, even with the errors described above, it would produce costs higher than those that would be obtained using the Phase III model.¹¹ In other words, significant differences between movement-specific and system-average variable costs will appear within the universe of coal movements. There is thus no justification for assuming that a difference identified in one coal case reflects anything more than movement-to-movement variation. There is certainly no justification for Crowley's extreme assumption that it reflects a systematic flaw in URCS costing for coal that justifies a redistribution of coal costs to other commodities.

There is simply no basis for accepting Crowley's "adjustment" for coal traffic. The Board should reject it as both incorrect and irrelevant.

⁸ *Id.* at 1002-03.

⁹ *TMPA*, 6 S.T.B. at 616-17.

¹⁰ *WPL*, 5 S.T.B. at 991.

¹¹ As evidence of the variation in costs for transporting coal, even in seemingly similar circumstances, see note 5, above.

c) The Coal Shippers' R/VC Calculations Are Irrelevant and Flawed.

UP's investment decisions depend not merely on how much revenue a movement will contribute to fixed costs, but on the amount of fixed costs associated with the movement, including in particular the costs of expanding capacity to accommodate that movement, and whether the movement will generate sufficient revenue to cover those fixed costs. UP's evidence that coal generates far less contribution per revenue ton-mile than any other commodity group speaks to those critical issues. (UP Op., Haley V.S at 12 & Ex. TCH-6.) Crowley's R/VC calculations ratios do not. Crowley's R/VC calculations fail to convey the point that coal involves movements of immensely large volumes in very heavy trains over very long distances and requires massive investments to expand and sustain a coal network of double and triple track, concrete ties, premium rail, intensive maintenance, and modern AC locomotives equipped with distributed power. In other words, they fail to convey the point that coal must generate significant contribution in relation to other traffic in order to justify new investment in capacity.

Moreover, Crowley's R/VC ratio calculations suffer from the same flaws as his contribution calculations.¹² Crowley's R/VC calculations actually show that R/VC ratios for coal rank below R/VC ratios for the chemical and intermodal groups, and just barely ahead of the agricultural group. (Coal Shippers Reply, Crowley R.V.S., Att. No. 1 at 2 & table 1.) That coal ranks below intermodal traffic is notable in light of UP's evidence that the single most important competitor to coal for investment dollars is unregulated intermodal traffic moving over the Sunset Corridor. (UP Op., Haley V.S. at 5, 13-14.)

¹² As discussed above, the figures in the text of Crowley's statement differ from Crowley's actual calculations because of an illegitimate adjustment to variable costs.

3. The Coal Shippers And AECC Never Respond To UP's Evidence That The Current Application Of The SAC Test Departs From Reality.

In its opening submission, UP showed how the Board's application of the SAC test in *WPL* demonstrated the extent to which the current SAC methodology has departed from reality. As UP explained, the Board's application of the SAC test in *WPL* implied that UP earned nearly \$1.47 billion in excess revenues between 2000 and 2005, while UP in fact experienced a revenue shortfall of almost \$4.5 billion during that period. (UP Op. at 16-17 & Ex. 4.) UP also explained that for it to generate a return on its recent investments in coal that is just equal to its cost of capital, its coal traffic would have to produce more than \$3.2 billion of revenue each year; in fact, UP coal traffic produced only \$2.5 billion in 2005, and the result in *WPL* says that UP needs far less than that. (*Id.* at 17.)

AECC argues that the *WPL* result reflects the economies of density associated with transportation of coal from the PRB and that the result does not reflect flaws in the SAC test but rather low returns on non-coal commodities and the lower-density portions of UP's network. (AECC Reply at 3-4.) However, AECC's argument misses the point. The SAC test in *WPL* did not involve non-coal commodities. The SAC result in *WPL* implies that UP was overcharging its coal customers by 20 to 25 percent and still not generating a return on its investments in coal that approaches its cost of capital. (UP Op. at 16-17.) That SAC result cannot be correct.

AECC also argues that UP has no cause to complain if PRB coal rates are set at the jurisdictional threshold because PRB coal transportation is very efficient and higher rates on PRB coal would merely cross-subsidize other traffic. (AECC Reply at 4.) AECC's argument fails to recognize that UP's PRB coal traffic does not all terminate on high density lines – the traffic moves to power plants that are scattered around the country. The high traffic densities that exist in the PRB and on UP's primary coal lines are possible only because those lines are

supported by an extensive rail network that does not have the same high density. Thus, contrary to AECC's claims, both the SAC calculation and the prescription of a rate set at the jurisdictional threshold in *WPL* demonstrate that the Board's current application of the SAC test is disconnected from reality.

The Coal Shippers make no attempt to refute UP's arguments about the implications of the SAC result in *WPL*. Instead, they observe that the Board's Chairman at the time of the decision represents UP in this proceeding and that the Board "successfully defended its decision on appeal." (Coal Shippers Reply at 7 n.9.) UP urged the Board to embark on a rulemaking because the rulemaking process is different from the process involved in deciding a specific case. Decision of a specific case requires the Board to decide hundreds of disputed factual issues, based on the evidentiary record developed in that case, and based largely on existing precedent, in order to evaluate a specific challenged rate. The case-by-case process has resulted in a SAC test that has drifted away from the principles of constrained market pricing that animate the *Guidelines*. This rulemaking gives the Board an opportunity to step back and gain perspective on the current application of the SAC test, particularly the troubling results of the case-by-case accumulation of decisions, and make a necessary course correction.

The ICC recognized when it adopted the SAC methodology as the primary test of rate reasonableness that "the workability of the guidelines is most appropriately evaluated in light of experience," and that "modifications [may be] needed to make this approach . . . fully workable."¹³ UP's evidence demonstrates the need for both this rulemaking and changes to the Board's current application of the SAC test.

¹³ *Guidelines*, 1 I.C.C.2d at 525.

II. MAXIMUM RATE DETERMINATION

In the *NPRM*, the Board proposed to replace the percent reduction method of maximum rate determination because it was concerned about the possibility of “gaming” – *i.e.*, “that a railroad could manipulate the outcome of the Board’s regulatory process.” *NPRM* at 7. The submissions in this proceeding have demonstrated, however, that concern about possible gaming is not a sufficient reason to abandon the percent reduction method, and no party has offered any other persuasive reason for replacing the percent reduction method with any of the alternatives proposed by the Board.

The Coal Shippers’ filings initially echoed the Board’s concern about gaming. In their opening submission, the Coal Shippers described the “manipulation issue” as “a key flaw in the percentage reduction method.” (Coal Shippers Op. at 15.) Other parties, however, argued that there was no evidence that gaming was a problem that required the abandonment of the percent reduction method, and that any concerns about gaming could be addressed without replacing that fundamentally sound approach. (BNSF Op. at 44-45 & Kalt V.S. at 25-34, Gaskins V.S. at 4-8; NS/CSX Op. at 3-4.) The Coal Shippers appear to have recognized the strength of those arguments. On reply, they shift position and say that concern about gaming “misses the true mark.” (Coal Shippers Reply at 9.) Instead, they say, “[t]he problem simply is that, by applying a method in which the rate chosen by the monopolist dictates the maximum rate level, the Board effectively has ceded its core responsibility . . . to engage in meaningful rate regulation.” (*Id.*, internal quotation omitted.)

The Coal Shippers’ position is a constantly moving target. The Coal Shippers now say that the Board “has ceded its core responsibility” by applying the percent reduction method because it uses the rate level chosen by the defendant as the starting point for rate reductions, but they have also urged the Board to endorse the generalized percent reduction

method (“GPRM”) and the reduced markup method (“RMM”), which share that same essential feature. (Coal Shippers Op. at 24.)¹⁴ The Coal Shippers’ only consistent position appears to be that they want the freedom to use whatever method produces the lowest rate in any given case. That may be attractive as a litigation strategy, but it does not make for sound regulatory policy. (UP Reply at 6 n.4; BNSF Reply, Kalt R.V.S. at 6-7.)

The Coal Shippers’ most recent position is also ill founded. As we discuss below, the Board plainly does not cede its responsibility to regulate rates by using the percent reduction method, which has been used in every rate case since *Coal Trading*.¹⁵ Moreover, the Coal Shippers are wrong to criticize the percent reduction method on the ground that it uses the defendant’s existing rate structure to help establish the measure of relief, because the *Guidelines* require that approach. The Coal Shippers are also wrong when they say that the Board’s proposed Maximum Contribution Methodology (“MCM”) and Maximum Markup Methodology (“MMM”) actually reflect demand-based differential pricing and are thus consistent with the *Guidelines*. In fact, those methods do not maintain market-based rate structures – instead, they would set maximum rates based on the premise that a railroad should set rates by allocating costs uniformly among its shippers.

A. The Board Does Not Cede Its Responsibility To Regulate Rates By Applying The Percent Reduction Method.

The Coal Shippers are clearly incorrect when they equate use of the percent reduction method to no regulation at all. The issue of maximum rate determination does not even arise unless the Board has first established that a rate exceeds a reasonable maximum. In

¹⁴ See AEP Texas Op. at 13-14 (describing the application of GPRM); Western Fuels Op. at 16-17 (describing the application of RMM).

¹⁵ *Coal Trading Corp. v. Baltimore & Ohio R.R.*, 6 I.C.C.2d 361 (1990).

other words, by the time a case reaches the maximum rate determination stage, the Board has already decided to grant relief and is considering how much relief to grant.

In making their argument, the Coal Shippers confuse two separate issues. They argue that courts have rejected the position that rates are reasonable under the statute so long as they are “commercially sustainable” – *i.e.*, they do not force shippers to reduce production, or, as the Coal Shippers put it, they are no more than “what traffic will bear.” (Coal Shippers Reply at 10-13.) But no party in this proceeding is seeking to revive that standard of rate reasonableness. BNSF suggested that the Board should consider whether rates were commercially sustainable in order to test for “gaming.” (BNSF Op., Gaskins V.S. at 2-6.) But BNSF’s suggested test asks only whether there is a reason to depart from the percent reduction method; it does not describe the operation of the percent reduction method. In other words, contrary to the Coal Shippers’ claim, no party has “advocate[ed] a rate standard predicated on ‘what traffic will bear.’” (Coal Shippers Reply at 10.)

The Board and its predecessor have applied the percent reduction method in every rate case since *Coal Trading*. We are unaware of any case in which the use of the percent reduction method was equivalent to no regulation at all. Application of the percent reduction method has resulted in substantial rate reductions for UP. In *FMC*, UP’s rates were reduced by 15 to 25 percent.¹⁶ In *WPL II*, application of the percent reduction method would have reduced rates by 14 to 25 percent but for the jurisdictional threshold.¹⁷ UP has also prevailed in several rate cases, but it was not because of the percent reduction method – it was because stand-alone

¹⁶ *FMC Wyo. Corp. v. Union Pac. R.R.*, 4 S.T.B. 699, 851-65 (2000).

¹⁷ *WPL II* at 12-13.

costs exceeded stand-alone revenues,¹⁸ or because the complainant did not make a valid stand-alone cost presentation.¹⁹ Our review of the case law demonstrates that UP's experience is not unique.²⁰

B. The Principles Underlying The *Guidelines* Require The Board To Consider The Defendant's Existing Rate Structure When Fashioning Rate Relief.

The Coal Shippers' complaint that rate relief under the percent reduction method depends on rates initially set by defendants is nothing less than an assault on the statutory framework for rate regulation and the basic principles underlying the *Guidelines*. Consistent with the national Rail Transportation Policy favoring market-based rates,²¹ and the agency's recognition that railroads must engage in differential pricing in order to recover their fixed costs,²² the *Guidelines* established the principle that existing railroad pricing structures should be maintained to the maximum extent possible when imposing rate relief.²³ The percent reduction method comports with that principle because it "preserves the rate structure . . . by maintaining existing rate relationships, albeit at reduced levels, and thereby implicitly recognizes varying demand elasticities."²⁴

¹⁸ *Bituminous Coal – Hiawatha, UT, to Moapa, NV*, 10 I.C.C.2d 259 (1994).

¹⁹ *Arizona Elec. Power Coop., Inc. v. BNSF Ry.*, Docket No. 42058 (STB served Mar. 15, 2005).

²⁰ See, e.g., *W. Tex. Utils. Co. v. Burlington N.R.R.*, 1 S.T.B. 638, 711 (1996) (reduction of rates by up to 33% but for the jurisdictional threshold); *Arizona Pub. Serv. Co. v. Atchison, Topeka & Santa Fe Ry.*, 3 S.T.B. 70, 85 (1998) (reduction of rates by up to 44%).

²¹ 49 U.S.C. § 10101(1).

²² *Guidelines*, 1 I.C.C.2d at 526-27.

²³ *Id.* at 548 ("In considering a rate prescription and/or reparations, we will attempt to provide an effective remedy for the complaining shipper, but in a manner that would not introduce further distortions into the carrier's pricing structure." (footnote omitted).)

²⁴ *Coal Trading*, 6 I.C.C.2d at 380.

The Coal Shippers' complaint that a defendant's rates will affect the measure of relief is very different from the Board's concern about "gaming." If a defendant has "gamed" its rates, then its rate structure will not reflect market-based differential pricing, and it would make no sense to preserve that artificial structure when fashioning rate relief. If the Board were to find that gaming occurred in a particular case, it might reasonably consider applying some other methodology as a remedial measure. The Board, however, should not adopt a method of maximum rate determination that would fail to preserve the existing rate structure in all cases just because gaming is a theoretical possibility, particularly where it can examine allegations of gaming on a case-by-case basis. (UP Reply at 6; BNSF Op. at 44-45 & Kalt V.S. at 24-34, Gaskins V.S. at 4-8.)

In the *Guidelines*, the agency recognized that a meaningful maximum rate policy must be founded on the demand-based differential pricing structures that reflect marketplace forces. The *Guidelines* do not prescribe a formula for fashioning relief, but they recognize that the appropriate reference point is the "carrier's pricing structure," which reflects the "demand elasticities" that should, in theory, be used to allocate the "unattributable costs of the SAC system."²⁵ The ICC applied those principles in *Coal Trading* when it adopted the percent reduction method, explaining that "[t]he rate structure exhibited by the defendants over the complaint period is the necessary consequence of differential pricing and cost of service," and thus, "[a]ny revision to rates due to the imposition of rate prescriptions should, to the extent possible, retain the underlying relationships," unless there is evidence that the existing pattern of

²⁵ *Guidelines*, 1 I.C.C.2d at 548.

differential pricing is “seriously flawed.”²⁶ The Coal Shippers’ claim that a complainant’s relief should not depend on the defendant’s rate structure even in the absence of any gaming is thus inconsistent with the CMP and SAC principles underlying the *Guidelines*.

C. MCM and MMM Do Not Reflect The Defendant’s Existing Rate Structure.

After attacking the percent reduction method on the ground that it allows the rates chosen by the defendant to affect the amount of relief, the Coal Shippers reverse themselves and try to defend MCM and MMM on the ground that those methods allocate rate relief “within the context of the defendant’s existing rate structure” and develop the appropriate measure of relief “using the defendant’s rate structure as a measuring tool.” (Coal Shippers Reply at 16.) They also contradict their argument on opening that rate relief should not be structured to “continu[e] to maintain” the defendant’s “differential pricing profile” (Coal Shippers Op. at 17), by arguing that MCM and MMM reflect varying market demand for service “at least to the same extent that the defendant’s rate structure does.” (Coal Shippers Reply at 17.)

The railroad parties’ opening submissions exhaustively demonstrated that MCM and MMM are inconsistent with the demand-based differential pricing that is reflected in railroad rate structures. We do not repeat those arguments here. In fact, the illustrations in the *NPRM* demonstrate that MCM and MMM are based on the premise that a railroad should set rates by allocating costs uniformly among its shippers. *See NPRM* at 10-15. These methods may reflect a degree of differential pricing in some situations by leaving low rates unchanged, but they disregard differential pricing for high-rated traffic in all cases. Thus, it is simply false to claim, as Coal Shippers do, that they reflect differential pricing “at least to the same extent that the

²⁶ *Coal Trading*, 6 I.C.C.2d at 435.

defendant's rate structure does." (Coal Shippers Reply at 17.) Moreover, the railroad parties have shown that MCM and MMM do not, in fact, reflect a correct application of differential pricing principles even for low-rated traffic.²⁷ They have also shown that there is no justification for disregarding demand-based pricing differences with respect to high-rated traffic – a point reinforced by the *Guidelines*.²⁸

The Coal Shippers also claim that MCM and MMM are different from the rejected "ton/ton-mile" and "ratio" methods of allocating fixed costs because MCM and MMM allocate the SARR's costs rather than the defendant's costs. (Coal Shippers Reply at 15-16.) As the *Guidelines* make clear, however, that is not a meaningful distinction. The ICC did not reject the "ton/ton-mile" and "ratio" methods because they focused on the defendant's costs rather than the SARR's; the agency rejected them because they were based on the flawed premise that fixed costs could be allocated using uniform markups rather than demand-based differential pricing – the same flaw that infects MCM and MMM.²⁹

²⁷ As railroad parties have observed in their submissions, leaving lower rates unchanged while reducing higher rates for movements included in the traffic group is not consistent with Ramsey pricing principles. (UP Reply at 8; BNSF Op., Willig V.S. at 22-24.)

²⁸ *Guidelines*, 1 I.C.C.2d at 533 ("[W]e cannot . . . ignore[] the varying degrees of elasticity (or inelasticity) among 'captive' shippers Setting all captive rates in the same proportion to marginal costs would be contrary to the principle of differential pricing, and could prevent a railroad from covering its total costs.").

On reply, the Coal Shippers repeat the claim in their opening submission that differential pricing is not required on high-rated traffic because a "SARR by definition is revenue adequate." (Coal Shippers Reply at 18 n.25.) As UP explained in its reply submission, however, differential pricing principles would apply even if MCM or MMM were used to establish rates for a revenue adequate railroad. (UP Reply, Koraleski R.V.S. at 4-5 & Neels R.V.S. at 14-15.)

²⁹ *Guidelines*, 1 I.C.C.2d at 522-23, 523 n.6.

The percent reduction method is easy to apply,³⁰ and it is the only maximum rate determination method discussed in this proceeding that maintains, to the extent possible, the defendant's demand-based differential pricing structure. The Board should not abandon this well-established and theoretically sound maximum rate determination method in favor of any of the flawed alternatives proposed in this proceeding.

III. REVENUE ALLOCATION FOR CROSS-OVER TRAFFIC

In its opening submission, UP urged the Board not to adopt the proposed Average Total Cost ("ATC") method of revenue allocation for cross-over traffic and to reject other equally arbitrary methods of setting divisions, including mileage-based prorate methods. It urged the Board to adopt instead a method that would set SARR divisions equal to the incumbent carrier's avoided costs of providing the service replicated by the SARR. (UP Op. at 29-31 & Neels V.S at 14-17.)³¹

The parties to this proceeding broadly agree that the ATC method is flawed because it requires an arbitrary allocation of a carrier's fixed costs, and thus is not properly

³⁰ The Coal Shippers assert that "nothing is less conducive to negotiated settlements than percent reduction," because a shipper cannot "calculate a SAC-based rate until litigation begins." (Coal Shippers Reply at 14-15.) However, MCM and MMM also do not permit calculation of a SAC-based rate until after litigation begins. Just like the percent reduction method, MCM and MMM require the shipper to engage in discovery to develop a traffic group and then calculate the SARR revenues and costs associated with the traffic group. Moreover, MMM would add a complicating factor: the shipper would need to calculate URCS variable costs for all of the shipments in the traffic group – a task not required under the percentage reduction method.

³¹ If the Board believes that it cannot adopt UP's proposed avoided cost approach because the approach was not included in the *NPRM*, UP urges the Board not to adopt ATC as the exclusive approach of revenue allocation for cross-over traffic, but instead to leave the issue of open for further development on a case-by-case basis. However, UP believes that all interested parties have had a fair opportunity to address the avoided cost approach, and no potential opponent of the approach has responded to UP's proposal by claiming that it was unable to address it because it was not included in the *NPRM*.

rooted in the contestability principles underlying the *Guidelines*. (UP Op. at 23-25; Coal Shippers Op. at 53; AECC Op. at 9; BNSF Op., *Kalt V.S.* at 39.)

The Coal Shippers and their allies, however, advocate the continued use of mileage-based prorate methods – specifically, the Modified Straight Mileage Prorate (“MSP”) method or the Modified Mileage Prorate (“MMP”) method. The Coal Shippers’ defense of the status quo is not based on the merits of the current approach; instead, it is based on the erroneous claim that no party has proposed a superior approach. (Coal Shippers Reply at 20-22.) They do not reply to UP’s evidence that MSP and MMP are subject to the same criticism that they have leveled against ATC – *i.e.*, that those methods are also based on arbitrary allocations of costs. (UP Op. at 24 & *Neels V.S.* at 3-4.) Nor do they reply to UP’s evidence that MSP and MMP produce results biased toward the over-assignment of revenue to the on-SARR segments, thus allowing complainants to demonstrate “unreasonableness” – and demand rate reductions – when no such unreasonableness exists. (UP Op. at 25-27 & *Neels V.S.* at 10-14.)

UP’s proposed avoided cost approach to revenue allocation for cross-over traffic is the only approach that is fully consistent with contestable market principles. The Coal Shippers and their allies offer no valid criticisms of UP’s approach. Instead, the Coal Shippers recycle the flawed rationales the ICC offered when it rejected a similar avoided cost approach in *Nevada Power II*,³² the first case to permit the use of cross-over traffic and one of the earliest cases decided under the *Guidelines*. (Coal Shippers Reply at 24-28.) This rulemaking is an opportunity for the Board to correct the ICC’s misstep and adopt an economically sound solution

³² *Bituminous Coal – Hiawatha, Utah, to Moapa, Nevada*, 10 I.C.C.2d 259 (1994).

to the acknowledged problems created by complainants' extensive reliance on cross-over traffic in SAC cases. *See NPRM* at 17.

A. MSP And MMP Are Based On Arbitrary Cost Allocations And Produce Demonstrably Flawed Results.

UP observed in its opening submission that mileage-based prorate methods of revenue allocation for cross-over traffic are, like the proposed ATC method, based on arbitrary allocations of costs. (UP Op. at 24 & Neels V.S. at 3-4.) In its reply submission, UP observed that the Coal Shippers had properly criticized ATC on the ground that it was based on arbitrary allocations of costs, but that they were blind to the same failing in MSP and MMP. (UP Reply at 18.)

In their own reply, the Coal Shippers ignore UP's observation that their criticisms of ATC apply equally to MSP and MMP. They simply repeat their criticisms and observe that UP agreed with them. (Coal Shippers Reply at 22-23.) They never acknowledge that MSP and MMP also rely on arbitrary cost allocations to establish divisions for cross-over traffic – that “revenues from a movement are allocated to the SARR based . . . upon the assumption that ‘average costs are a continuous function of distance (holding other factors constant).’”³³ The Coal Shippers thus ignore the fact that they refute their own position when they argue “[t]he ATC method – or any other strictly ‘cost-based’ divisions methodology – reinserts into the SAC process the very problem that the ICC was attempting to eliminate – the use of arbitrary cost formulas to allocate constant costs.” (Coal Shippers Reply at 22; *see also* Neels Reb. V.S. at 3.)

³³ *BNSF Ry. v. STB*, No. 05-1030 (D.C. Cir. June 16, 2006), slip op. at 16-17 (quoting *Pub. Serv. Co. of Colo. d/b/a Xcel Energy v. Burlington N. & Santa Fe Ry.*, STB Docket No. 42057 (STB served Jan. 19, 2005) at 8.)

UP's opening submission demonstrated the practical as well as the theoretical failings of mileage-based prorate methods of revenue allocation for cross-over traffic. UP provided a detailed illustration based on a simplified version of UP's coal network that demonstrated how mileage-based prorates were biased toward allowing complainants to posit SARRs that would make reasonable rates appear "unreasonable." (UP Op. at 27 & Neels V.S. at 9-15.) As UP explained, spreading a pool of revenue across a network of varying densities solely based on a ratio of the costs of carrying the traffic on different segments will wrongly suggest that the dense segments are earning too much while the less dense segments lose money. (UP Op. at 27 & Neels V.S. at 9-10.)

The flaws in any approach to revenue allocation for cross-over traffic that relies on arbitrary cost allocations will almost invariably produce results that are biased in favor of the complainant. A complainant can readily use cross-over traffic to configure its SARR to replicate the densest segments of UP's network, while leaving the incumbent the responsibility for handling cross-over traffic on relatively less dense portions of the network. (UP Op. at 27 & Neels V.S. at 9; Neels Reb. V.S. at 3-4.) No one has challenged UP's evidence that mileage-based prorate methods of revenue allocation for cross-over traffic will yield systematically biased outcomes in favor of complainants.

B. UP's Avoided Cost Approach Is Vastly Superior To Methods That Rely On Arbitrary Cost Allocations And The Only One That Is Fully Consistent With Contestability Theory.

In its opening submission, UP proposed an alternative to ATC and other similarly arbitrary methods of revenue allocation for cross-over traffic that is the only economically valid method for apportioning revenue between the SARR and the incumbent. UP's approach would, for each cross-over movement, allocate to the SARR that portion of the incumbent's total

revenue equal to the incumbent's costs avoided as a result of the SARR's operations. (UP Op. at 29-31.) BNSF proposed the same approach. (BNSF Op. at 50-53 & Kalt V.S. at 37-46.)

UP's approach assigns to the SARR the division of revenues that would be observed in a contestable market. It asks how a SARR and an incumbent would react in a contestable scenario to the situation in which the SARR wanted to replace the incumbent for a portion of a movement that the incumbent handled end-to-end. UP explained that, under those circumstances, the incumbent will interchange the movement with the SARR if and only if the amount of the total end-to-end revenue that it pays to the SARR is less than the cost it would incur were it to carry the traffic itself. (UP Op., Neels V.S. at 16.) The SARR could not demand more revenue, because in a contestable market there would be nothing to prevent the incumbent from offering its own end-to-end service. (*Id.*) Thus, in a truly contestable marketplace, the SARR could not obtain more revenue than the incumbent's avoided costs. (*Id.* at 16-17.)

UP and BNSF acknowledged that the ICC had rejected the same basic approach in *Nevada Power II*, and they urged the Board to use this rulemaking to reconsider and correct that decision. (UP Op. at 30-31; BNSF Op. at 52-53.)

The Coal Shippers and their witness, Dr. Borts, argue that UP's avoided cost approach inappropriately assumes a competitive response by the incumbent; that it wrongly assumes that the SARR does not replace the incumbent; that it leads to rates that are too low to support entry by the SARR and allow complaining shippers the benefit of grouping traffic; that it creates impermissible barriers to entry; and that it wrongly applies the results of contestability to the world of sunk costs. (Coal Shippers Reply at 24-28 & Borts Reb. V.S. at 5-11.) UP already addressed most of these points in its reply and demonstrated that the Coal Shippers' arguments

are wrong in all respects. (UP Reply at 19-22 & Neels R.V.S. at 8-11.) We address those arguments and the few new arguments that the Coal Shippers raise on reply below.³⁴

First, contrary to the Coal Shippers' claims, UP's avoided cost approach is not predicated on a theory of "competitive response" or "price retaliation" or alteration of "pre-entry prices" by the incumbent. (Coal Shippers Reply at 24-25 & Borts R.V.S. at 6-7.) UP agrees that contestability theory provides that a potential entrant should evaluate the profitability of entry at the incumbent's pre-entry prices. Under the avoided cost approach, the incumbent's end-to-end price for a movement – the only "pre-entry price" that exists – never changes. When the SARR replaces the incumbent for an entire end-to-end movement, it obtains the incumbent's full pre-entry price. When the SARR replaces the incumbent for a portion of an end-to-end movement, there is also no change in the pre-entry price. The avoided cost approach simply addresses a special problem that arises when a complainant chooses to use cross-over traffic rather than replicate the incumbent's end-to-end service – how the incumbent and the SARR should divide the pre-entry price. (Neels Reb. V.S. at 5.)

UP's avoided cost approach does, in a some sense, reflect "competition" between the incumbent and the SARR: under contestability principles, the SARR and incumbent could each offer service along those routes on which they possess a cost advantage, and divisions measured by avoided costs would result if the SARR had to contend with the incumbent's ability to handle the cross-over portions of movements. (*Id.* at 5-6). However, UP's approach does not

³⁴ AECC also criticizes UP's proposal, but its criticisms seem to be based on a fundamental misunderstanding. AECC argues that the use of an avoided cost approach would not impose any constraint on rates because it would allow railroads to retain any monopolistic profits. (AECC Reply at 8.) UP, however, is not proposing to use the avoided cost approach as a test of rate reasonableness. UP is proposing to use the avoided cost approach only to establish appropriate divisions for cross-over traffic.

involve an impermissible “competitive response” or “price retaliation” by the incumbent, and the Coal Shippers are wrong when they suggest that it does. (Coal Shippers Reply at 28.)

Economists understand the terms “competitive response” and “price retaliation” to describe the situation in which an incumbent, faced with entry, drops pre-entry prices to non-remunerative levels in order to drive the entrant from the market. (Neels Reb. V.S. at 6.) The terms do not even apply to setting SARR divisions using the avoided cost approach because there are no pre-entry divisions with which the resulting divisions can be compared. (*Id.*) Moreover, as discussed above, the avoided cost approach leaves all existing pre-entry prices unchanged – the incumbent is not undercutting the SARR and competing away traffic and revenue. The imagined “competition” is simply a way to think about how divisions of pre-entry prices between two carriers would be established under conditions of contestability.

Second, contrary to the Coal Shippers’ claims, UP’s avoided cost approach does in fact assume that the SARR replaces the incumbent for purposes of conducting the SAC test. (Coal Shippers Reply at 25-26 & Borts R.V.S. at 7-8.) The avoided cost approach never leads to an outcome in which the incumbent retains cross-over traffic as a result of a competition with the SARR. As discussed above, it allows the SARR to replace the incumbent and handle all the traffic the complainant selects for the SARR’s traffic group and simply addresses the separate question of how much revenue from that traffic is appropriately credited to the SARR. (Neels Reb. V.S. at 6 n.15.)³⁵

³⁵ Of course, as discussed above, UP’s approach does not assume that the SARR replaces the incumbent in the sense that the incumbent permanently withdraws from the market and exerts no influence on the prices charged by the SARR. To the contrary, the incumbent remains free in a contestable market to reenter at any time, and the possibility of reentry will by itself constrain the prices charged by the SARR. (*See also* UP Reply, Neels R.V.S. at 10.)

Third, contrary to the Coal Shippers' claims, UP's avoided cost approach would not produce divisions that are too low to support entry by a SARR and allow the complaining shipper the benefits of grouping. (Coal Shippers Reply at 25-26 & Borts R.V.S. at 7.) As UP has already explained, divisions based on avoided costs would leave an efficient SARR with sufficient revenue to continue to provide the service and benefit from the economies of grouping traffic, and a substantial margin of contribution as well. (UP Op., Neels V.S. at 15; UP Reply at 22.) As Dr. Neels further explains, an avoided cost approach does no more than correctly calculate the revenues that the SARR postulated by the complainant can expect to earn in a contestable market. (Neels Reb. V.S. at 6-7.)

The Coal Shippers also cite the ICC's concern in *Nevada Power II* that low divisions based on avoided costs would lead a SARR to "shun [the] market" out of fear that "price retaliation by the incumbent [will] reduce[] revenues before the entrant has a chance to recoup its costs." (Coal Shippers Reply at 25, quoting *Nevada Power II*, 10 I.C.C.2d at 266.) As discussed above, however, divisions based on avoided costs do not reflect the incumbent's "retaliation." Moreover, an incumbent would never try to drive a SARR out of the market by establishing below-cost rates because it would be futile: in a contestable market, the SARR could exit costlessly in the face of any retaliation and then reenter costlessly as soon as the incumbent returned rates to the initial level. The only party to suffer losses would be the incumbent that established below-cost rates. (UP Reply at 22 & Neels R.V.S. at 10-11; Neels Reb. V.S. at 7.)

Fourth, contrary to the Coal Shippers' claims, UP's avoided cost approach does not create any "barrier to entry." (Coal Shippers Reply, Borts R.V.S. at 9.) The Coal Shippers define the term "barrier to entry" to mean a cost "not actually incurred by the defendant carrier."

(Coal Shippers Op. at 39.) As UP has explained, however, the need to address cross-over traffic arises only when a SARR does not replicate the incumbent's entire network, and thus the SARR is avoiding costs that the defendant carrier actually incurred in building its network. (UP Reply at 19 n.25 & Neels R.V.S. at 6-7.)

The Coal Shippers also claim that the avoided cost approach saddles the SARR with "an artificial division requirement not faced by the incumbent." (Coal Shippers Reply, Borts R.V.S. at 9.) However, any division established to account for the SARR's ability to use cross-over traffic will necessary be "artificial" because there are no "real world" divisions for the traffic in question – the incumbent has by definition made the investment necessary to provide end-to-end service for the traffic. (Neels Reb. V.S. at 8.)

Finally, the Coal Shippers claim that the avoided cost approach prevents SARRs from using the "same productive techniques" as the incumbent. (Coal Shippers Reply, Borts R.V.S. at 9.) That claim is false: SARRs always remain free to provide end-to-end service for the traffic in question – the "same productive technique" used by the incumbent. (Neels Reb. V.S. at 8-9.)

Fifth, contrary to the Coal Shippers' claims, UP's avoided cost approach does not improperly "apply the results of contestability to the world of sunk costs." (Coal Shippers Reply, Borts R.V.S. at 9.) Of course, the avoided cost approach, like the entire SAC test, uses contestability principles to develop results that are ultimately applied to real-world rates to determine whether they exceed a reasonable maximum. But the approach itself consistently uses contestability principles to determine appropriate divisions. (Neels Reb. V.S. at 9.)

The Coal Shippers, in fact, are the ones that fail to maintain a proper distinction between the contestable world and the real world. This is most apparent when they argue that

the Board should use real-world divisions as the “best evidence on the division of revenues on cross-over traffic.” (Coal Shippers Reply, Borts R.V.S at 11.) As UP has explained, the Coal Shippers approach the issue of revenue divisions with the assumption that the SARR and the incumbent would be negotiating divisions in a world *with* sunk costs and barriers to entry. (UP Reply at 18-19.) The Coal Shippers thus improperly shift between a contestable world – one in which the SARR faces no barriers to entry when it replaces the incumbent – and the real world – in which the incumbent lacks the same barrier-free ability to reenter and thus must negotiate with the SARR just like connecting carriers facing sunk costs and barriers to entry must negotiate with each other in the real world. (*Id.* at 19 & n.24; Neels Reb. V.S. at 9-10.)

UP consistently applies contestability principles to the question of revenue allocation for cross-over traffic. The avoided cost approach assigns the SARR the division that would be observed in a contestable market. (UP Reply at 21; UP Op. at 29-30 & Neels V.S. at 14-17.)

C. UP’s Avoided Cost Approach Provides Fair And Practical Solutions To The Challenges That Arise When Complainants Use Cross-Over Traffic.

The Coal Shippers assert that the “norm of regularity” requires “any party proposing to calculate cross-over traffic divisions using new methods . . . to prove that the new methods were superior to MSP.” (Coal Shippers Reply at 21.) The “norm of regularity” concept creates a presumption in favor of an agency’s decision to “stay[] on the course it had long ago adopted,” when the agency is defending the settled rule in a judicial proceeding. *See BNSF Ry. v. STB*, slip op. at 17-18. The concept does not apply to a rulemaking such as this one, in which the agency has proposed to depart from its past course. But even if such a standard applied here, UP has met that standard with its proposed avoided cost approach.

The Board has recognized that the use of cross-over traffic involves a compromise between accuracy and manageability of the SAC analysis. *NPRM* at 17. UP's evidence in this proceeding – which no party has rebutted – shows not only that cross-over revenue allocation methods that rely on arbitrary cost allocations such as ATC, MSP, and MMP are inconsistent with contestability principles, but also that the bias resulting from the use of such methods can be severe and will invariably harm defendant carriers. (UP Op. at 27 & Neels V.S. at 9-15.)

UP's avoided cost approach is manageable. The parties and the Board can easily calculate the incumbent's URCS variable costs for the on-SARR portion of the movement and allocate that amount of revenue to the SARR. (UP Op. at 30.)

UP's approach is also fully consistent with the contestability principles underlying the *Guidelines*. It assigns the SARR the division that would be observed in a contestable market. It also allows the SARR to achieve efficient traffic densities by adding cross-over traffic to its network. In addition, UP's approach helps ensure that any division will leave the incumbent with sufficient revenues to support the off-SARR portions of the network required by cross-over traffic. (UP Reply at 22 & n.30; Neels Reb. V.S. at 10-11.)

UP's approach will be more accurate than methods that rely on arbitrary cost allocations because it has no systematic bias against incumbent railroads and provides a built-in opportunity to correct any perceived bias against a complainant. If a complainant perceives the result of the avoided cost method as depriving it of revenue from a movement that it regards as particularly attractive, it can obtain for the SARR the full amount of revenue available from that movement by replicating the incumbent's end-to-end service. (UP Op. at 30; Neels Reb. V.S. at 11.) Under the Board's current approach, by contrast, incumbents have no ability to correct

for bias – they must live with the consequences of whatever network configuration the complainant posits. (Neels Reb. V.S. at 11.)

The Board should reject ATC, MSP, MMP and all other methods of revenue allocation for cross-over traffic that rely on arbitrary cost allocations and adopt UP's avoided cost method.

IV. INDEXING OPERATING EXPENSES

Despite the fact that a SARR is unlike real world railroads in many respects, the Coal Shippers continue to insist that SARR operating expenses should be indexed to reflect productivity gains experienced by real world railroads. As before, however, they fail to offer evidence establishing that SARRs would in fact realize such gains (either in their initial years or at any point during the SAC analysis period); that complainants will build into SAC analysis the cost of new technology or other improvements needed to realize such gains; or that any gain a SARR might realize would match RCAF-A or some predetermined percentage of RCAF-A.

Because there is no sound basis for routinely applying RCAF-A to the operating expenses of a SARR, the Board should use RCAF-U to index those expenses. The Board should apply a productivity adjustment only if a complainant in a particular case presents persuasive evidence that its SARR will realize a productivity gain at some point after its start-up, evidence of the timing and amount of that gain, and evidence that the costs of realizing the gain are included in the SAC analysis.

A. The Assumption Of A Highly Efficient SARR Makes Productivity Gains Unlikely.

As UP and others have explained, the fact that a SARR is designed to operate with maximum efficiency makes it unlikely that the SARR will experience a productivity gain in the period after start-up. When a SARR has the most modern equipment and facilities on day

one, an optimal design, and operations that incorporate all current best practices throughout, there is little opportunity for improvement. And with a homogenous traffic group and/or a simple operating plan for the select traffic group, a SARR has limited potential to increase efficiency over time.

In response to these arguments, the Coal Shippers again complain that the railroads have not addressed the “Board-mandated disparity between cost indexing and revenue forecasting.” (Coal Shippers Reply at 33.) This supposed “disparity” hardly seems worth comment. As Mr. Baranowski has explained, there is no necessary relationship between the factors applied to operating costs and revenues; they are independent elements of the SAC analysis, just as they are independent for real railroads. (BNSF Reply, Baranowski R.V.S. at 3-5.) Moreover, contrary to the Coal Shippers’ argument, there is no reason to equalize cost and revenue factors in order to preserve the financial viability of the SARR. The whole point of the SAC analysis is to test the relation of SARR revenues and costs. The right of shippers to submit evidence of an optimally efficient railroad means that the SARR starts out with far more favorable operating costs than actual railroads. Nor does the use of RCAF-U doom the viability of a SARR. Half the SAC cases decided by the Board have found that the SARR’s revenues exceeded its costs during the projected life of the SARR.³⁶

The Coal Shippers complain that the assumption of a highly efficient SARR is incorrect and that the Board has accepted inefficient operating plans proposed by railroad defendants in several cases. (Coal Shippers Reply at 34-38.) Such decisions arose from the

³⁶ See Hearing on Economics, Service and Capacity in the Freight Railroad Industry, Before the Subcommittee on Surface Transportation and Merchant Marine of the Senate Committee on Commerce, Science and Merchant Marine, 109th Cong., 2d Sess. (June 21, 2006) (statement of W. Douglas Buttrey, pp. 6, 15-16).

Board's conclusion that the complainants in those cases failed to present a workable operating plan. In *FMC*, the one case cited in which UP was the defendant, the Board correctly noted that FMC used "unsupported operating assumptions to estimate the number of trains, locomotives, cars, and operating personnel that would be required."³⁷ Had FMC offered realistic assumptions and proper documentation in support of its proposed operating plan, the Board might have adopted that plan. As suggested by the passages from other cases quoted by the Coal Shippers, it is unclear whether a more efficient design would have been feasible in those cases in view of the traffic the complainant selected or the rail facilities it elected to construct. Moreover, the Coal Shippers do not provide concrete suggestions about how operations of the SARRs in these cases could have increased productivity over time, *e.g.*, how they could have operated with a smaller staff to produce the same output. They say nothing about whether costs of achieving productivity gains were included in the SAC analysis in those cases.

The Coal Shippers also argue that, contrary to evidence submitted by UP and BNSF, there is room for unit train operations to improve. (Coal Shippers Reply at 39.) Unit trains have already achieved a high degree of productivity, and a SARR would enjoy this productivity from the outset. (UP Op., *Haley V.S.* at 15.) UP has explained why many of the improvements the Coal Shippers predict either are unlikely to be realized in the foreseeable future, or will be quite costly to implement. (UP Reply, *Rebensdorf R.V.S.* at 2-8.)

³⁷ *FMC*, 4 S.T.B. at 736; *see also FMC Corp. v. Union Pac. R.R.*, Docket No. 42022, Union Pacific's Reply Evidence, filed March 31, 1999, Verified Statement of Avery Grimes, at 6-13 (statistical analysis demonstrated that FMC's operating plan produced efficiencies far beyond those achieved by the average Class I railroad and that the level of efficiency reflected in FMC's operating plan was so far beyond what any Class I railroad had ever achieved that it was not credible).

The UP document that the Coal Shippers cite and that the Board referenced in its *WPL* decision does not support the Coal Shippers' claim that unit train productivity will improve for a SARR. (Coal Shippers Reply at 38-39.) Contrary to the Coal Shippers' characterization, this document was not a "study of productivity gains for unit train service." (*Id.*) Rather, the document was a sensitivity analysis that incorporated a forecast of RCAF that was not specific to unit trains, produced in response to a discovery request that asked for any forecast. This particular 1998 forecast assumed that overall UP operations would gain efficiency at a faster rate than the rest of the industry early on – an assumption that has not been borne out by experience since 1998. This forecast certainly has no relevance to a SARR that starts out with highly efficient operations.

The Coal Shippers argue that a SARR will have excess capacity in its early years and that this will give it the flexibility to improve its operations in the early period. (Coal Shippers Reply at 39-40.) They add nothing new in their reply comments, simply quoting passages from their opening comments. Mr. Baranowski has previously responded to these arguments. As he explained there, under SAC methodology, complainants enjoy the benefit of a perfect match between traffic and capacity in the peak year, and the resulting economies are prorated to all years of the SAC analysis, including the initial years. Thus, a SARR enjoys full economies of density even in years when its traffic density is lower. (BNSF Reply, Baranowski R.V.S. at 8.) Even if this were not the case, common sense suggests that excess capacity at the outset of the analysis period will not yield any productivity gain over time for a SARR. Because excess capacity declines as traffic increases, SARR congestion will increase during the forecast period, and, if anything, productivity should decrease as a result.

B. Complainants Must Account For The Costs Associated With Any Productivity Gains They Claim For A SARR.

UP and other railroads have explained that realization of most or all of the potential productivity gains shippers have identified will require substantial expenditures (if they materialize at all). The Coal Shippers respond that any costs required to produce productivity gains are already factored into the RCAF-A. (Coal Shippers Reply at 41.) This is wrong. The RCAF-A reflects the effect of greater output relative to changes in the unit costs of inputs, but it does not address whether enough of the necessary resources are included in a SARR's budget to achieve the productivity gains reflected in RCAF-A, *e.g.*, the actual costs of salaries for a process improvement team or the capital cost of constructing longer sidings to accommodate longer trains.

The possibility that “productivity-based cost savings will exceed any implicit costs of accelerating asset replacement” (Coal Shippers Reply at 42) does not prove anything about whether the relevant cost has been included in the SAC analysis. Assuming a SARR would conclude that early asset replacement is worthwhile because it would produce a net gain, it is still essential that the cost of the new asset (along with any training or other costs associated with implementation of the new asset and costs and revenues associated with retirement of the old asset) be included in the SAC analysis. The complainant must prove that it has included this cost before it can claim the benefit of any amount of productivity gain alleged to result from the new asset.

C. Complainants Should Bear The Burden Of Establishing The Existence And Amount Of Any SARR Productivity Gains.

The Coal Shippers complain that the railroads want to place “insurmountable evidentiary burdens” on complainants. (Coal Shippers Reply at 42.) But there is no injustice in requiring a complainant to produce evidence of any productivity improvements it wishes to

claim. UP has explained previously that, in view of the fact that a SARR operates with maximum efficiency at the outset and ordinarily has a simple operating plan, it is inappropriate to assume that the SARR will experience productivity gains measured by RCAF-A or some arbitrary percentage tied to RCAF-A. (*See, e.g.*, UP Reply at 35-38.) Because the circumstances of a highly efficient SARR make it so unlikely that the SARR would experience productivity gains following start-up, routine application of RCAF-A (or a percentage of RCAF-A) to adjust SARR operating expenses is likely to result in double counting of efficiency benefits. If any complainant believes that there are special reasons why its SARR would improve productivity after start-up, it should bear the burden of showing how and when this will occur, how it has incorporated in the SAC analysis the cost associated with the improvement, and how much gain is likely to result.

Even if a complainant is able to show that the SARR will enjoy some productivity gain during the forecast period, this is not a basis for using RCAF-A (or a predetermined percentage of RCAF-A) as the measure of any gain. In view of the many differences between a SARR and a real railroad, a SARR's improvement is unlikely to bear any relation to the experience of real railroads. It makes more sense to require a complainant to identify specific developments that would result in productivity gains for a SARR and to show which cost categories would be affected by a particular development.³⁸

If an important new technology is implemented in the middle of the forecast period, the Board should permit the complainant to seek reopening in order to present evidence

³⁸ AECC's suggestion that analysis of individual productivity developments in a rate proceeding will discourage innovation is frivolous. (*See* AECC Reply at 7.) It is difficult to imagine that any railroad would forgo a technological development expected to yield significant economic benefit based on the possibility that evidence concerning that development might someday be used as part of a SAC calculation.

of the cost of implementing the technology and the effect it will have on operating costs. Requiring that complainants seek reopening after a new technology has actually been developed and tested will remove the need to speculate at the outset about the nature, timing, and impact of that development. Because a SARR presumably incorporates from the outset all technologies that are currently cost-effective for its operations, the complainant can claim productivity gain only from as yet unproven technologies. Some of these technologies may never prove viable, and the timing of others is unpredictable. For example, AECC cites one-man crews and electronically controlled pneumatic (“ECP”) brakes as initiatives that are “in the queue.” (AECC Reply at 6.) However, neither of these potential developments is imminent; it is currently unclear whether and when they will actually be implemented. For example, use of ECP brakes requires that all cars on a train be equipped with electronic brakes. Because PRB coal transportation customers generally provide their own equipment, the SARR could not install ECP brakes until its customers replaced their equipment. (And because it will take even longer for railroads to convert the hundreds of thousands of cars in their fleets, it is highly unlikely that RCAF-A will reflect improvements due to ECP brakes any time soon.) Moreover, installation of ECP brakes or other technological developments that are not available to the SARR when it begins operations will require large expenditures, and these costs would need to be included in the SAC analysis. It makes more sense to wait until such potential changes are ready for deployment and to allow the complainant to seek reopening to present evidence once it becomes clear when the new technology will be available, how much it will cost, and how much gain it will actually produce.

Of course, where a complainant seeks reopening to present evidence of a new technology that has become available during the forecast period, there may be no need to apply

any index to reflect the productivity gain. This is because the timing of introduction of the new technology may differ for a SARR and a real railroad. Take Positive Train Control (“PTC”) as an example. The limited scale of a SARR and its hypothetical nature allow the complainant to assume that the SARR would be an earlier adopter and that it could deploy the technology throughout its system all at one time, achieving 100% of the benefit immediately. Real railroads, with real dollars sunk in signal systems spanning tens of thousands of track-miles and facing constraints on buying and installing such advanced technology all at once, will be much slower to implement PTC.³⁹ The SARR has the opportunity with a modest reopening to recognize the costs and claim all of the benefits immediately, whereas the benefits would accrue to real railroads gradually. If a complainant chose to realize all benefits and costs of the new technology immediately, it would achieve the full productivity gain at one time. Any attempt to apply some portion of RCAF-A to SARR operating expenses after reopening would result in a double recovery of that gain.

D. If The Board Makes Adjustments For Productivity Gains, It Should Also Include Offsetting Adjustments.

As UP pointed out in its reply comments, if the Board permits an adjustment to a SARR’s operating expenses to reflect productivity gain, it should also recognize other adjustments that could offset the effect of the productivity gain. The Coal Shippers argue that one such adjustment – to the inflation of capital assets in the DCF model – is inappropriate. (Coal Shippers Reply at 45-46.) In lieu of an adjustment to capital inflation, they introduce a new proposal (adjustment of SARR asset lives) that is not within the scope of this rulemaking.

³⁹ For this reason, AECC is wrong in surmising that an incumbent will have fully implemented all proven methods of cost reduction in its current operations. (See AECC Reply at 6.)

Moreover, it appears that the Coal Shippers are trying to gain a one-sided benefit, by adjusting one set of costs, but declining to apply a similar adjustment to a different set of costs in the same analysis.

V. MOVEMENT-SPECIFIC ADJUSTMENTS TO URCS

UP's comments on the Board's proposal to simplify variable cost calculations addressed two concerns. *First*, UP asked the Board to make clear that it did not intend to depart from its precedent by excluding from variable cost calculations defendants' costs associated with payments to third parties or to shippers that are not reflected in URCS unit costs. (UP Op. at 37-40.) *Second*, UP asked the Board to allow parties to substitute a limited number of movement-specific inputs for values calculated by the URCS Phase III model. (*Id.* at 40-44.) No party to this proceeding has disagreed with UP's core concerns.

No one has taken issue with UP's position that the Board should follow existing precedent with respect to the treatment of railroad payments to third parties or to shippers. The Coal Shippers say that UP advocated "a blanket rule that would categorize any payment made to another carrier as a variable cost to the payor." (Coal Shippers Reply at 53.)⁴⁰ In fact, UP asked the Board only to "clarify that it does not intend to change its treatment of these payments." (UP Op. at 37.) On that point, there appears to be complete agreement: the Coal Shippers state that

⁴⁰ The Coal Shippers take issue with the example UP offered to illustrate its concern – UP's payment to the Missouri & Northern Arkansas Railroad ("MNA"). (Coal Shippers Reply at 53-54.) They make several assertions about UP's relationship with MNA that are incorrect. UP believes the MNA payment should be treated as a variable cost under Board precedent, but it also believes that the issue should be addressed in the KCPL case. UP used the MNA example simply to illustrate the need to clarify that the Board's proposal would not foreclose UP from presenting evidence on the specific dispute in the KCPL case. (UP Op. at 39-40.)

the Board “should continue to approach the issue of ‘third party payments’ on a case-by-case basis.” (Coal Shippers Reply at 55.)⁴¹

Similarly, no party has disagreed with UP’s position that the Board should allow parties in rate cases to substitute certain additional movement-specific operating statistics for the default values that would be supplied by the URCS Phase III model. In fact, most parties have argued that the Board should abandon its proposal to simplify the variable cost component of rate cases. We continue to believe that UP’s proposal strikes an appropriate balance between accuracy and simplicity.

The Coal Shippers claim that UP’s proposal “would restrict the categories of movement-specific evidence that could be submitted . . . to those issues that are likely to benefit the carrier,” pointing to our statements that our road property, maintenance-of-way, and locomotive ownership costs are above system-average costs. (Coal Shippers Reply at 57.) However, UP did not propose to allow movement-specific evidence of those costs. Instead, UP’s proposal focused on basic operating characteristics for which actual data are readily available – *e.g.*, empty miles, number of locomotives, and tare weight of cars. (UP Op. at 41.) This proposal was a genuine effort to fashion a constructive modification that would improve the accuracy of variable cost calculations while remaining consistent with the Board’s goals as

⁴¹ The Coal Shippers argue that a “line-haul division” that a Class I railroad pays to a shortline “warrants different treatment” from a “*bona fide* subcontract arrangement” and should be treated as an “offset to revenue.” (Coal Shippers Reply at 55.) UP submits that relationships between Class I railroads and shortlines should be assessed on a case-by-case basis, but that there will never be a situation in which a Class I’s payment to a shortline would appropriately be treated as an “offset to revenue.” The payment will be either a cost to the Class I or a division between the Class I and the shortline. If the payment is a division, there is no reason to consider the amount of the division separately from the through rate – the shortline should be a defendant in a case that challenges the through rate. *See Cent. Power & Light Co. v. S. Pac. Transp. Co.*, 1 S.T.B. 1059, 1072 (1996) (“[T]he shipper’s only interest is that the charge shall be reasonable as a whole.”) (quoting *Great N. Ry. v. Sullivan*, 294 U.S. 458, 463 (1935)).

expressed in the *NPRM*. Litigation costs are a concern for UP as well as for the Board. For that reason, UP continues to urge the Board to give serious consideration to its proposal.⁴²

VI. STAND-ALONE COST ANALYSIS PERIOD

After reviewing the opening comments and reply comments regarding the SAC analysis period, UP continues to support a change to a 10-year SAC analysis period, with a maximum rate prescription period of 10 years. Our reasons appear in UP's reply comments.

VII. STANDARDS FOR REOPENING

UP continues to adhere to the positions stated in its reply comments with respect to the reopening or vacating of rate prescriptions, for the reasons stated in those reply comments. Among other things, we demonstrated there why the Board's proposal on this subject is consistent with *Arizona Grocery Co. v. Atchison, Topeka & Santa Fe Ry.*, 284 U.S. 370 (1932).

The Coal Shippers continue to complain that the Board's multi-tier approach will favor railroads over shippers. (Coal Shippers Reply at 62.) It is far from clear that this will necessarily be the result of implementing the Board's proposals.⁴³ Moreover, there is no reason to refrain from making simple changes quickly in order to correct mistakes the Board identifies when it grants rehearing, just because of a concern that such corrections will tend to benefit railroad defendants. The Coal Shippers' preferred approach would sacrifice accuracy (and common sense) for whatever undeserved advantage they might gain through unnecessary delay. Contrary to the Coal Shippers' objection, the Board's approach to the reopening/vacating

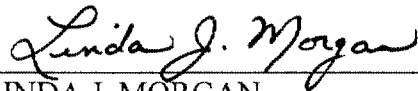
⁴² The Coal Shippers, who frequently complain about the cost of litigating rate cases, also had the opportunity to offer constructive suggestions to reduce complexity and costs, but they chose to offer none.

⁴³ The Board is not hesitant to reopen decisions and correct them in the shipper's favor. See, e.g., *Otter Tail Power Co. v. BNSF Ry.*, STB Docket No. 42071 (STB served May 26, 2006) (reopening proceeding on Board's own initiative to correct prior decision to use BNSF's unit costs for locomotives).

procedures is a common-sense, even-handed approach that takes into account the nature of the issues and seeks to avoid irreparable injury to either party where possible.

Respectfully submitted,

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A handwritten signature in cursive script that reads "Linda J. Morgan". The signature is written in dark ink and is positioned above a horizontal line.

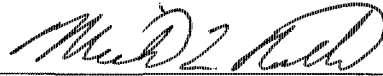
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*Attorneys for Union Pacific
Railroad Company*

June 30, 2006

CERTIFICATE OF SERVICE

I, Michael L. Rosenthal, hereby certify that on this 30th day of June, 2006, I caused a copy of the Rebuttal Submission of Union Pacific Railroad Company to be served by first-class mail or a more expeditious method of delivery upon all persons who have filed a notice of intent to participate in STB Ex Parte No. 657 (Sub-No. 1).

A handwritten signature in black ink, appearing to read "Michael L. Rosenthal", written over a horizontal line.

Michael L. Rosenthal



September 20, 2004

The Honorable Roger Nober
Chairman
Surface Transportation Board
1925 K Street, N.W., Suite 810
Washington, D.C. 20423-0001

Re: Ex Parte No. 655, Powder River Basin Site Visit

Dear Chairman Nober:

I write in response to a letter you received from the Western Coal Traffic League ("WCTL") that was placed into the public record in the above-referenced proceeding on September 8, 2004. The letter attached a calculation purporting to demonstrate that The Burlington Northern and Santa Fe, CSXT, Norfolk Southern, and Union Pacific collectively receive revenues from coal transportation services that substantially exceed the railroads' fully allocated costs.

WCTL's calculation does not reflect Union Pacific's experience. As we explained during the Board's recent site visit to the Powder River Basin, Union Pacific has seen a steady erosion in the revenue we receive in relation to the costs we incur for transporting coal. If that erosion continues, Union Pacific will find it even more difficult to fund the investments necessary to meet projected demands for transportation of coal and all the other commodities that move over our shared network.

WCTL's suggestion that Union Pacific and other railroads are nonetheless earning excessive revenues on their coal traffic is incorrect for two reasons. First, WCTL's calculation does not address whether the railroads are earning revenues from coal sufficient to support investment in their networks. Second, WCTL's calculation is itself flawed in several respects.

WCTL's calculation does not address whether railroads are earning disproportionate revenues from coal traffic. Coal traffic should make a significant contribution to cover the total fixed costs of the portion of Union Pacific's network that it shares, given the increasing demand for western coal and its dependence on rail transportation. WCTL's approach, which assigns a proportionate share of the Union Pacific network's fixed costs to a coal based on URCS variable costs of handling coal, is not a valid method for determining whether coal is being asked to contribute more than its fair share to the network.

J. Michael Hemmer
Sr. Vice President - Law and General Counsel

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Even if it were correct to ignore the contribution that coal must make to a network it shares with other traffic, WCTL's calculation does not address whether railroad returns are sufficient to support future new investments and re-investment in the portions of the network that carry coal traffic. It uses URCS costs, which are based on historical, depreciated costs of assets, rather than the type of forward-looking costs that are relevant to future investment decisions. It assumes that coal should bear only a proportionate share of fixed costs. It also uses system-average costs, which do not reflect the substantial investments that Union Pacific has recently made in its coal routes. And it does not reflect the high maintenance costs that we are discovering arise from transporting heavy wheel load coal traffic, including bridge damage, rail wear, fouling of subgrades, signal insulation problems, and incident recovery. We described these emerging costs during the site visit.

Moreover, to the extent that WCTL's approach has any value, when the calculations are performed correctly, they reinforce the concerns we raised during the site visit.

We have reproduced WCTL's approach, focusing on data for Union Pacific. As shown in the attached exhibit, Union Pacific's revenue/cost ratio is not in the 1.20 range suggested by WCTL. Instead, it has declined from 1.03 in 2001 to 1.00 in 2003. In other words, even applying WCTL's inapposite approach, Union Pacific's revenue/cost ratio indicates that coal revenues are sufficient only to cover the sum of variable and an arbitrary allocation of fixed costs (even based on historic costs), and the coverage ratio is declining below the level that would support reinvestment.

WCTL asserts that its calculations are based on data from the STB Costed Waybill Sample. We have been unable to replicate those calculations precisely. We note, though, that many railroads, including Union Pacific, "mask" revenue data to safeguard the confidentiality of contract rates when submitting revenue data for the waybill sample. When the Board releases these data, it warns recipients that the "masked revenue figures are typically larger than actual contract revenues," and thus that use of "revenue data from the Carload Waybill Sample in any type of comparison could lead to wrong or misleading results."¹ We thus replicated WCTL's approach using actual, publicly reported revenue data.

As we explained during the site visit, Union Pacific's coal revenues are by no measure excessive, and they have been falling relative to costs. If this trend continues, investments in some of the

¹ See, e.g., Letter from Leland L. Gardner, Director, Office of Economics, Environmental Analysis, and Administration, to Michael L. Rosenthal, Esq., dated Dec. 22, 2003.

facilities necessary to meet projected future demand will not be justified. If that happens, customers who depend on Union Pacific for coal transportation will inevitably face capacity constraints. Union Pacific does not want to find itself in that position.

Sincerely,

A handwritten signature in black ink, appearing to read "Mike Hemmer". The signature is fluid and cursive, with a large loop at the end.

Enclosure

cc: Hon. Francis P. Mulvey
Hon. Douglas Buttrey
Hon. Vernon A. Williams
Mr. Matthew K. Rose
Mr. Mark W. Schwartz

Comparison of Revenues to Fully-Allocated Costs (including Cost of Capital) for Coal Traffic
Handled by the Union Pacific Railroad

<u>Description</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>
Coal Traffic Revenue ¹	\$2,353,598,139	\$2,287,765,412	\$2,355,138,785
Coal Total Variable Costs ²	\$1,702,479,780	\$1,638,131,007	\$1,752,853,595
Constant Cost Markup Ratio ⁴	1.34	1.34	1.34
Coal Fully-Allocated Costs (including Cost of Capital) ⁵	\$2,276,913,483	\$2,191,766,525	\$2,345,283,053
Revenue to Fully-Allocated Costs (including Cost of Capital) ⁶	1.03	1.04	1.00

Notes

Data source: 2001 and 2002 Carload Waybill Sample and 2001, 2002, and 2003 Union Pacific Railroad Annual Reports.

1. Coal Traffic Revenue for 2001 and 2002 calculated as total revenue from Energy Commodities (coal and coke) revenue figures from Union Pacific's 2001, 2002, and 2003 Annual Reports, multiplied by the ratio of coal revenue to coal + coke revenue in the 2001 and 2002 Carload Waybill Samples. The 2002 coal ratio is used in 2003 calculation because the 2003 Carload Waybill Sample is not yet available.

2. Total Variable Costs for UP for 2001 and 2002 from 2001 and 2002 Carload Waybill Samples. 2003 Total Variable Cost adjusted from 2002 figure using unadjusted RCAF because the 2003 Carload Waybill Sample is not yet available. 2003 costs are also adjusted for changes in total energy ton-miles from 2002 to 2003, based on the 2003 Union Pacific Annual Report.

3. Calculated as Coal Traffic Revenue / Total Variable Cost.

4. UP Constant Cost Markup Ratio from URCS WT D&L627C1. Value for 2003 estimated by assuming no change from 2002 to 2003.

5. Calculated as Total Variable Cost for coal multiplied by the Constant Cost Markup Ratio.

6. Calculated as Coal Traffic Revenue / Fully-Allocated Costs (including Cost of Capital).

REBUTTAL VERIFIED STATEMENT

OF

KEVIN NEELS

I. Introduction

My name is Kevin Neels. I previously filed verified statements in this proceeding that were included in the opening and reply submissions of Union Pacific Railroad Company (UP).¹ A summary of my qualifications is contained in my opening verified statement.

UP has asked me to address the reply comments filed in this proceeding that have criticized UP's proposal to set divisions for cross-over traffic based on avoided costs and urged the Board to retain its current mileage-based prorate method of setting cross-over divisions – primarily the reply comments filed by the Coal Shippers.²

The contentious problem of revenue allocation for cross-over traffic arises because the use of cross-over traffic involves a departure from the ideal of a full stand-alone cost (SAC) test. As I have previously explained, in a full SAC test, the stand-alone railroad (SARR) truly stands alone.³ This does not mean that the SARR must handle all movements included in the SARR's traffic group all the way from origin to destination, but it must replicate all portions of the incumbent's route over which the traffic moves.⁴

¹ Opening Submission of Union Pacific Railroad Company (UP Op.), Verified Statement of Kevin Neels (Neels VS) & Reply Submission of Union Pacific Railroad Company (UP Reply), Reply Verified Statement of Kevin Neels (Neels RVS).

² Joint Reply Comments of Western Coal Traffic League, Concerned Captive Coal Shippers, Western Fuels Association, Inc., Edison Electric Institute, National Rural Electric Cooperative Association, and American Public Power Association (Coal Shippers Reply).

³ Neels VS, pp. 4-7.

⁴ To correct the analogy used by Dr. Borts, a witness for the Coal Shippers, a full SAC test is not comparable to requiring Wal-Mart to grow its own food. Rather, it is comparable to (continued...)

In a full SAC test, the SARR would entirely supplant the incumbent with respect to all movements included in the SARR's traffic group, and it thus would plainly be entitled to whatever revenue the incumbent would have earned from those movements at pre-entry prices.

When a SARR is allowed to handle cross-over traffic, however, a new and different problem arises. The cross-over traffic continues to move at pre-entry prices, but the revenue generated by those pre-entry prices must somehow be divided between the incumbent and the SARR. The question of how to establish the necessary division arises in the context of a contestable world, and contestability theory provides an answer to the question – namely, allocate revenues based on the incumbent's avoided costs of providing the service replicated by the SARR.

II. The MSP Method Is Fundamentally Flawed.

In their reply comments, the Coal Shippers note that the railroads oppose the Board's proposed ATC method for allocating cross-over traffic revenues for precisely the same reasons that they themselves oppose it – that is, because it requires an arbitrary allocation of a carrier's fixed costs.⁵ At the same time, however, they fail to acknowledge that their preferred alternative – the Board's current Modified Straight-Mileage Prorate method (MSP) – suffers from precisely the same defect. Moreover, they fail to respond to the evidence that I and others have submitted in this proceeding that demonstrates the problems and biases that are inherent in MSP.

requiring Walmart to build all four walls of its store, or to build aisles that run all the way from the shelves to the checkout. *See Coal Shippers Reply, Reply Verified Statement of George H. Borts (Borts RVS), p. 10.*

⁵ Coal Shippers Reply, p. 22.

A. *MSP Requires an Arbitrary Allocation of Fixed Costs.*

MSP, like the Board's proposed ATC method, relies upon arbitrary allocations of a carrier's fixed cost. Despite the Coal Shippers' efforts to depict MSP as an appropriate surrogate for market-based revenue divisions⁶ and as a practice that has been validated by long usage,⁷ the fact remains that MSP allocates cross-over revenues to the SARR based "upon the assumption that average costs are a continuous function of distance."⁸ In other words, MSP, like the Board's proposed ATC method, relies on the incumbent carrier's costs to assign a portion of the contribution associated with cross-over traffic movements to the SARR and a portion to the incumbent. As UP observed in its opening submission in this proceeding, "there is no principled basis for allocating *contribution* from a movement among different segments."⁹ The Coal Shippers rely on this statement to support their argument that the ATC method should be rejected.¹⁰ However, they ignore that the criticism is equally applicable to MSP as it is to ATC, and thus that it also condemns MSP.

B. *MSP Will Produce Systematically Flawed and Biased Results.*

In my verified statement that was included in UP's opening submission, I presented and discussed a numerical example based upon the configuration of UP's coal network that showed how MSP produced flawed results that were biased, allowing complainants to

⁶ Joint Opening Comments of Western Coal Traffic League, Concerned Captive Coal Shippers, Western Fuels Association, Inc., Edison Electric Institute, National Rural Electric Cooperative Association, and American Public Power Association (Coal Shippers Op.), Verified Statement of George H. Borts (Borts VS), pp. 16-17.

⁷ Coal Shippers Reply, p. 21.

⁸ *Pub. Serv. Co. of Colorado d/b/a XcelEnergy v. Burlington N. & Santa Fe Ry.*, STB Docket No. 42057 (STB served Jan. 19, 2005) at 8.

⁹ UP Op., p. 23.

¹⁰ Coal Shippers Reply, p. 23.

configure SARRs and present truncated SAC analyses indicating that rate relief is warranted, even though a full SAC analysis would demonstrate conclusively that no customer or group of customers was paying more than stand-alone costs.¹¹ My example illustrated how a systematic bias can arise when MSP is applied to networks that, like UP's network, contain a mixture of high and low density lines, and in particular, when it is applied to truncated SARRs that replicate only the high density portions of such networks.¹² Shippers seeking to reduce the rates they pay for coal transportation, who have substantial freedom to configure their SARR presentations in whatever way they choose, have a powerful incentive to seek out instances in which the potential for bias that is inherent in the MSP method will skew SAC test results in their favor.

None of the reply submissions in this proceeding address or discuss these results.

My conclusion that MSP will produce systematically biased outcomes is thus unchallenged.

III. Allocating Cross-Over Revenue Based On An Avoided Cost Approach Is A Proper Application Of Contestability Principles.

As I have previously explained, basing revenue allocation for cross-over traffic on the incumbent's avoided cost is the only approach that is fully consistent with contestable market principles.¹³ None of the objections raised by the Coal Shippers in their reply submission has any merit.

¹¹ Neels VS, pp. 9-15.

¹² AECC's reply comments actually reinforce this point. AECC's witness argues that only modest rates are needed to support high density lines such as the PRB Joint Line and other high density portions of UP's coal network. *See* Arkansas Electric Cooperative Corporation Reply Comments, pp. 3-4. By that logic, the rates required to support the portions of PRB coal movements moving across lower density lines must be substantially higher. However, MSP does not divide revenues in a way that reflects these economic realities. Instead, it apportions revenue uniformly on the basis of mileage, thus treating high density and low density lines in precisely the same manner.

¹³ Neels VS, pp. 14-17.

A. ***UP's Avoided Cost Approach Is Based on Pre-Entry Prices and Does Not Permit a "Competitive Response" or "Price Retaliation" in Response to Entry by a SARR.***

The Coal Shippers are wrong when they assert that UP's avoided cost approach involves an impermissible "competitive response" or "price retaliation" or alteration of "pre-entry prices" by the incumbent.¹⁴

The Coal Shippers are correct when they say that contestability theory provides that the profitability of entry be evaluated at the incumbent's pre-entry prices. That is, however, exactly what the avoided cost approach does. Under the avoided cost approach, the end-to-end prices charged by the incumbent – which are the *only* pre-entry prices that exist – are unaffected by the SARR's entry. The potential for confusion arises because the use of cross-over traffic involves a special situation in which the SARR is not proposing to offer end-to-end service and thus is not entitled to the full end-to-end price. When cross-over traffic is used in a SAC analysis, there must be a way to determine the appropriate division for the SARR. The SARR's division, however, will always be a portion of the *pre-entry price*. In other words, the question addressed by the avoided cost approach is how those unchanged pre-entry prices are to be divided between the incumbent and the SARR.

An avoided cost approach does, in a limited sense, reflect "competition" between the incumbent and the SARR. Under contestability principles, the SARR and incumbent could each offer service along those routes on which they possess a cost advantage, and divisions

¹⁴ Coal Shippers Reply, pp. 24-25 & Borts RVS, pp. 6-7.

measured by avoided costs would result if the SARR had to contend with the incumbent's ability to handle the cross-over portions of movements.¹⁵

However, basing cross-over traffic revenue allocations on avoided costs does not in any way involve an impermissible "competitive response" or "retaliation" on the part of the incumbent. A "competitive response" or "retaliation" in the face of entry is generally understood to occur in situations in which an incumbent, faced with entry, drops its prices to non-remunerative levels in order to drive the entrant from the market. Basing cross-over divisions on the incumbent's avoided costs cannot be viewed as a competitive response or retaliation in this sense if only for the simple reason that there are no pre-entry revenue divisions with which they can be compared. Setting cross-over divisions based upon the incumbent's avoided costs does not represent a reduction from pre-entry price levels; it involves the creation of prices when none existed before.

B. UP's Avoided Cost Approach Does Not Set Divisions Too Low to Serve the Purpose of the SAC Test.

The Coal Shippers are wrong when they assert that UP's avoided cost approach to revenue allocation for cross-over traffic sets cross-over divisions too low to support entry by the SARR or to allow the SARR to benefit from economies of density.¹⁶ As I have previously

¹⁵ This "competition" between the SARR and the incumbent does not mean that the SARR does not replace the incumbent for purposes of conducting the SAC test. The SARR will always handle all of the traffic the complainant selects for the SARR's traffic group – both the traffic the SARR handles end-to-end and cross-over traffic. The idea that the SARR and the incumbent "compete" for cross-over traffic is merely an analytical tool used to establish the revenues to which the SARR is entitled when it handles cross-over traffic. Moreover, the incumbent possesses no inherent advantage in this competition as a result of its ability to offer end-to-end service to the traffic in question. The SARR also possesses this ability, and is free to build out as much or as little of the route as it chooses.

¹⁶ Coal Shippers Reply, pp. 25-26 & Borts RVS, p. 7.

explained, divisions based on avoided costs would leave an efficient SARR with sufficient revenue to handle cross-over traffic and thus obtain the benefits of economies of density.¹⁷

There is nothing in the use of an avoided cost approach that precludes the SARR from exploiting fully any advantages of density and grouping of traffic. The complainant remains free to group the issue traffic with whatever non-issue traffic it chooses, and to replicate whatever portion of the incumbent's facilities that it chooses. An avoided cost approach does no more than correctly calculate the revenues that the SARR postulated by the complainant can expect to earn in a contestable market based upon the network that it chooses to build.

The Coal Shippers also express concern that divisions based on avoided costs would be so low that they would lead a SARR to "shun [the] market" out of fear that it would not be able to "recoup its costs" before the incumbent engages in "price retaliation."¹⁸ As I discuss above, however, the avoided cost approach does not involve "price retaliation." In addition, it would be economically irrational for an incumbent operating in a contestable market to engage in retaliation against a new entrant. Unless the incumbent enjoyed a genuine cost advantage, the only way it could drive an entrant from the market would be to charge prices so low as to prevent the incumbent from covering its costs – a strategy that the incumbent could only sustain temporarily. Even if the entrant were forced to withdraw, it would recover all of its costs. When the incumbent would eventually be forced either to raise its below-cost prices or withdraw from the market, the entrant would immediately return, preventing the incumbent from ever recouping its losses. Retaliation would thus always be a costly strategy that was doomed to fail.

¹⁷ Neels VS, p. 15.

¹⁸ Coal Shippers Reply, p. 25.

C. *UP's Avoided Cost Approach Does Not Create Any "Barriers to Entry."*

The Coal Shippers are wrong when they assert, through Dr. Borts, that adoption of an avoided cost approach to revenue allocation for cross-over traffic would create an "impermissible barrier to entry" by subjecting the SARR to "an artificial division requirement not faced by the incumbent."¹⁹ Dr. Borts has not identified any actual "barrier to entry." The Coal Shippers have previously defined the term "barrier to entry" to mean a cost "not actually incurred by the defendant carrier."²⁰ Under that meaning of the term, there is no barrier to entry associated with use of the avoided cost approach. The incumbent has cleared a far higher hurdle than any imposed on the SARR by the avoided cost approach – it has made all of the investment necessary to provide end-to-end service to the traffic in question. In other words, this is not a case in which the SARR is being asked to bear a cost that the incumbent has not borne – it is a case in which the SARR is avoiding costs the incumbent has borne.

Moreover, there is no merit to Dr. Borts' complaint that divisions based on avoided costs are "artificial." Any division of revenue established to account for the SARR's ability to use cross-over traffic will necessarily be "artificial" because there are no real-world divisions for the traffic in question – the incumbent has by definition made the investment necessary to provide end-to-end service for the traffic.

Finally, Dr. Borts complains that the avoided cost approach prevents SARRs from using the same "productive techniques" as the incumbent.²¹ Dr. Borts is plainly incorrect: the

¹⁹ Borts RVS, p. 9.

²⁰ Coal Shippers Op., p. 39.

²¹ Borts RVS, p. 9.

SARR can always use the same productive techniques as the incumbent – it remains free to provide end-to-end service for the traffic in question.

D. UP's Avoided Cost Approach Does Not Improperly Apply the Results of Contestability to the World of Sunk Costs.

The Coal Shippers are wrong when they assert, through Dr. Borts, that UP's avoided cost approach improperly "appl[ies] the results of contestability to the world of sunk costs."²² As I have previously explained, the avoided cost approach is the only approach to cross-over revenue allocation that is fully consistent with contestable market principles – it assigns to the SARR the division of revenues that would be observed in a contestable market. The avoided cost combines contestability principles and real world facts only in the same way that the SAC test necessarily does – it is an analytical tool that is used to determine whether the defendant carrier has set the challenged rate above a reasonable maximum level.

In fact, it is the Coal Shippers that fail to draw a proper distinction between the contestable and real worlds when they urge the Board to allocate cross-over revenues using real-world divisions as guideposts. In other words, the Coal Shippers urge the Board to adopt an approach to rate regulation under which a SARR would enter a market under conditions of contestability – no barriers to entry and no sunk costs – but then obtain divisions measured by the standards that apply in a world with sunk costs and barriers to entry.

The Coal Shippers' attempt to import real-world revenue divisions into SAC proceedings is entirely inappropriate. Real-world rail transportation markets are characterized by numerous rigidities, sunk costs and barriers to entry and exit. These structural characteristics strongly influence the manner in which real-world revenue divisions are determined. The Board

²² Borts RVS, p. 9.

has for many years adopted as the standard against which rates are to be judged the rates that would emerge from a hypothetical and perfectly competitive contestable railroad market in which there are no such barriers or rigidities. In order for this standard to yield meaningful results, it must be consistently applied. Importing real-world revenue divisions into a SAC analysis for purposes of establishing the revenues to be earned by the SARR on cross-over traffic cannot be reconciled with any consistent set of economic principles.

IV. Allocating Cross-Over Revenues Based On Avoided Costs Is A Sensible Solution To The Issues Raised By The Use Of Cross-Over Traffic.

As the Board has recognized, the use of cross-over traffic involves a trade-off between accuracy of results and the manageability of analyses. The question the Board must consider is how best to strike the balance. I submit that the use of revenue divisions based on avoided costs strikes that balance.

I discussed the many advantages of an avoided cost approach in my opening verified statement.²³ I review them briefly here because the Coal Shippers have asserted in their reply submission that no party has proposed an approach to allocating cross-over revenues that is superior to MSP.²⁴

First, an avoided cost approach is the only economically valid method for apportioning cross-over revenues between the SARR and the incumbent. One of the most important advantages of an avoided cost approach is that it does not suffer the inherent and fundamental problems associated with MSP and other approaches that rely on arbitrary allocations of the incumbent's costs.

²³ Neels VS, pp. 14-17.

²⁴ Coal Shippers Reply, p. 20.

Second, an avoided cost approach preserves the key objective of using cross-over traffic while eliminating problems associated with its use. It allows the SARR to take advantage of the economies of density associated with traffic grouping, and it assures that the SARR will obtain sufficient revenue to support that traffic by assigning to the SARR the incumbent's avoided costs for the service to be provided by the SARR. Because the SARR's costs will in virtually all cases be lower than those of the incumbent, the SARR will be able to earn contribution – perhaps substantial contribution – on this traffic.

Third, an avoided cost approach will be more accurate than methods that rely on arbitrary allocations of the incumbent's costs because it eliminates systematic bias against defendants and also provides a built-in opportunity to correct any perceived bias in the other direction. The complainant remains free to try to capture additional revenue from a movement by replicating more of the incumbent's network, even to the point of replicating the incumbent's entire end-to-end service. Under the Board's current approach, by contrast, incumbents are subject to a methodology that is systematically biased, and they have no ability to correct for that bias. Defendants must live with the consequences of whatever networks and traffic groups complainants posit, even when the SARR appears to have been structured to exploit the flaws in the current approach in order to overstate revenues.²⁵

Fourth, an avoided cost approach makes sense because it is the only way to ensure that incumbents are left with sufficient revenue to support the continued operation of off-SARR segments required by cross-over traffic movements. Such assurance is essential as a theoretical and a practical matter: if the incumbent could not support the off-SARR portion of

²⁵ See, e.g., *Arizona Elec. Power Coop. v. BNSF Ry.*, STB Docket No. 42058.

cross-over movements, there would be no cross-over movements for the SARR to handle and no corresponding opportunity to benefit from economies of density. As I have previously discussed, MSP and other methods that rely on arbitrary cost allocations are insufficient for this purpose because they over-assign revenue to the high-density segments that complainants tend to replicate and thus under-assign revenue to the low-density off-SARR segments.²⁶

Finally, an avoided cost approach has the potential to simplify the difficult problem of how to allocate rate relief between issue and non-issue traffic. Because an avoided cost approach allocates none of the incumbent's contribution from cross-over revenues to the SARR, if SARR revenues are shown to exceed SARR costs, then any rate relief that needs to be granted could be restricted to the traffic that is local to the SARR.

²⁶ This is one of the many reasons why the approach advocated by Mr. Nelson in his original testimony for AECC – *i.e.*, give all of the contribution generated by cross-over traffic to the SARR – is guaranteed to lead to incorrect outcomes. See Neels RVS, pp. 12-14.

VERIFICATION

I, Kevin Neels, declare under penalty of perjury that the foregoing statement is true and correct. Further, I certify that I am qualified and authorized to file this statement. Executed on June 30, 2006.

A handwritten signature in cursive script, reading "Kevin Neels".

KEVIN NEELS