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**BEFORE THE
SURFACE TRANSPORTATION BOARD**

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

MAJOR ISSUES IN RAIL RATE CASES

**SUPPLEMENTAL COMMENTS OF
BNSF RAILWAY COMPANY**

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BNSF Railway Company ("BNSF") hereby submits these supplemental comments in STB Ex Parte No. 657 (Sub-No.1), *Major Issues in Rail Rate Cases* ("EP 657 NPRM"), to address an issue that arose after the end of the comment period set out in the Board's February 27, 2006 Order initiating this proceeding. BNSF previously submitted opening, reply and rebuttal comments in this proceeding on May 1, 2006, May 31, 2006 and June 30, 2006, respectively.

The new issue to which these supplemental comments are addressed involves the Board's decision served July 28, 2006, in STB Ex Parte No. 646 (Sub-No. 1), *Simplified Standards for Rail Rate Cases* ("EP 646 NPRM"), where the Board proposed to adopt a simplified SAC methodology ("SSAC") for use in medium-size rail rate disputes. The SSAC methodology proposed by the Board in Ex Parte No. 646 follows closely the basic methodology used in a full SAC case with modifications designed to reduce the costs and burdens associated with the development and presentation of a full SAC case. On two critical issues of SAC methodology – the allocation of revenue on cross-over traffic between on-SARR and off-SARR portions of a through movement and the setting of a maximum reasonable rate if SAC revenues exceed SAC costs – the Board announced that it would apply the same methodology in SSAC cases that it

adopts in the pending Ex Parte No. 657 proceeding. *See EP 646 NPRM*, slip op. at 13, notes 21 and 24.

BNSF believes that the validity of the Board's proposals in Ex Parte No. 657 in these two areas can be further assessed by considering how the proposed methodologies would affect SSAC cases. For example, as discussed further below, the serious flaws in the Board's proposal to apply a rate reduction methodology that drives rates for high margin traffic to a uniform cost-per-ton-mile or R/VC level are highlighted when such a methodology might be applied in a SSAC case involving many different types of traffic with highly divergent demand characteristics. BNSF believes that its views on the application of the Board's proposed methodologies in SSAC cases can assist the Board in reaching a decision in Ex Parte No. 657 on the proper methodologies to adopt for both full SAC and SSAC cases.

Under the comment schedule originally set by the Board in Ex Parte No. 646, the Board would have had the benefit of BNSF's comments on the application of its proposed methodologies in Ex Parte No. 657 to SSAC cases before reaching a decision in Ex Parte No. 657. The original comment schedule in Ex Parte No. 646 called for opening comments on the Board's SSAC proposal on September 29, 2006. The Board's February 27, 2006 decision in Ex Parte No. 657 indicated that the Board intends to issue a decision in that proceeding by the end of October, thus providing time under the original comment schedule in Ex Parte No. 646 for the Board to consider BNSF's comments before reaching a decision in Ex Parte No. 657. However, in a September 15, 2006, decision in Ex Parte No. 646, the Board extended the date for filing opening comments in that proceeding to October 24, 2006. Under the current schedule, the Board will not be able to consider BNSF's comments in Ex Parte No. 646 in reaching a decision on the proper methodologies to adopt in Ex Parte No. 657. To ensure that the Board has the

benefit of BNSF's views on this important issue, BNSF is submitting these supplemental comments. BNSF also intends to develop a full record on these issues in its comments in Ex Parte No. 646.

I. Rate Reduction Methodologies

A. BNSF's Prior Comments Explained The Defects In The Board's MCM and MMM Proposals

BNSF explained in its prior comments that the Board's proposed rate reduction methodologies, if adopted, would turn back the regulatory clock and revive discredited regulatory approaches that have been shown not to work in the railroad industry. The Board's proposed rate reduction methodologies are based on the view, long abandoned by policymakers and economists, that a railroad's shippers should pay uniform, cost-based rates to the maximum extent possible. *See EP 657 NPRM*, slip op. at 11. The Board's proposed MCM methodology would cap rates at a uniform rate per ton-mile; its MMM methodology would cap rates at a uniform R/VC ratio. But the ICC and Congress recognized more than 20 years ago that such an approach to the regulation of rail rates was inimical to the financial health of the railroad industry. The *Coal Rate Guidelines*, and the statutory provisions that the *Guidelines* implement, are based on the widespread recognition that railroads must be permitted to charge demand-based rates – not uniform cost-based rates – to the maximum extent possible. For more than two decades, it has been understood that differential pricing is critical to the financial viability of the railroad industry.

BNSF showed the dramatic impact that the Board's proposed rate reduction methodologies would have on the ability of railroads to charge demand-based prices. In the area of coal transportation, the wide divergence of demand by individual shippers for transportation service is reflected in a wide divergence in railroad rates when measured on a per ton-mile or

R/VC basis. *See Gaskins V.S.*, attached to BNSF's May 1, 2006 Comments. On rebuttal, BNSF's witness Mr. Klick showed graphically the impact of the Board's MCM and MMM methodologies on BNSF's demand-based rate structure. Diagrams 2 and 3 from Mr. Klick's Verified Statement, filed as an attachment to BNSF's June 30, 2006 Rebuttal Comments, show that both MCM and MMM effectively obliterate the railroad's preexisting rate structure, creating a flat rate structure that has virtually no remnant of differential pricing. The obvious consequence of applying either rate reduction approach would be to substantially reduce the revenue available to the railroad from its most demand-inelastic traffic, precisely the same group of traffic to which the railroad needs to charge higher rates if it is to achieve revenue adequacy.

The Board's MCM and MMM methodologies therefore embody a significant and unjustified departure from the principles of demand-based pricing that have been the standard for rail rate regulation since the Staggers Act. The ICC stated in the *Coal Rate Guidelines* that: "[a]ny means of allocating [unattributable] costs among shippers other than actual market demand is arbitrary and may not permit a carrier to cover all of its costs." *Coal Rate Guidelines – Nationwide*, 1 I.C.C. 2d 520, 526 (1985). The ICC specifically rejected approaches, like MMM, that would establish uniform rates for shippers with different demand characteristics, even where the only shippers affected by the uniform rates were so-called 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." *Id.* at 533. The U.S. Court of Appeals for the D.C. Circuit struck down an attempt to set rates by reference to average R/VC levels, an approach similar to the Board's proposed MMM methodology, noting the "lack of any visible intellectual coherence in the R/VC method."

Burlington Northern Railroad Co. v. United States, 985 F.2d 589 (D.C. Cir. 1993)(“*Burlington Northern*”).

B. Application of MCM or MMM in a Simplified SAC Context Highlights Their Manifest Defects

The flaws in the Board’s proposed MCM and MMM approaches are even more apparent when those approaches are considered in the context of a SSAC case. In a SSAC case, the complainant would identify a SARR configuration based on the lines of the defendant actually used to provide the issue traffic service. The SARR is assumed to handle all of the traffic that traveled over those lines in the Test Year. *See EP 657 NPRM*, slip op. at 12-13. Therefore, the SARR in a SSAC case will normally handle the full mix of traffic handled by the defendant railroad over a given line segment.

As noted above, the Board indicated in the *EP 646 NPRM* that it intends to apply the same rate reduction approach that it adopts in Ex Parte No. 657 in SSAC cases. *EP 646 NPRM*, slip op. at 13. But the Board itself has stated that where the SARR in a SAC case involves a broad range of traffic with different characteristics, the proposed MCM methodology would not be appropriate. When the Board initially proposed MCM in Ex Parte No. 657, it stated that MCM

is less-well suited to cases where the traffic group is diverse, such as where it is comprised of both short-haul and long-haul traffic, or both unit-train and manifest traffic. In those cases, the traffic in the group could have differing cost structures per ton-mile. Yet MCM would treat these movements similarly for purposes of their contribution towards the total SAC costs.

EP 657 NPRM, slip op. at 13. The Board gave an example of differing costs per ton mile for transporting coal, on the one hand, and chemicals, on the other, which brings this point home quite forcefully. The Board explained that “[m]ore trains, crews, and rail capacity would be needed to haul a million tons of the lighter” chemicals while the heavier unit coal trains would

result in more ton miles. *EP 657 NPRM*, slip op. at 16. As the Board recognized, a ton-mile based rate prescription approach would therefore allocate responsibility for more costs to the heavier traffic without any sound basis for doing so.

MMM has similar characteristics to MCM when applied to a mixed traffic group. As BNSF demonstrated in its prior comments in this docket, MMM starts from the same premise as MCM – that all traffic should pay a uniform allocation of SAC costs – and operates by reducing all but the lowest rated traffic in a particular traffic group to a common average R/VC value. As BNSF pointed out, capping rates at a common average R/VC for a group of coal shippers in unit-train service ignores the widely varying demand that exists among even sole-served coal shippers. *See, e.g., Gaskins V.S.* attached to BNSF’s Opening Comments. The use of MMM to set maximum reasonable rates would therefore prevent railroads from engaging in necessary differential pricing. This problem would be magnified in a SSAC case which included all of the traffic moving across a segment of a defendant railroad. Variations in demand among the many traffic types would likely be greater than the variations among sole-served coal shippers, but MMM would reduce rates for all such traffic to an average R/VC ratio.

Public data concerning variations in R/VC ratios (and hence demand as observed by railroads) for different types of traffic indicate that the variation is significant. For example, one set of estimates published by Escalation Consultants, a firm that offers rate analysis and negotiation support to rail shippers, shows average R/VC ratios by commodity that vary from a low of 76.8% for “Forest Products” to a high of 217.2% for “Ordinance of Accessories.”¹ There is wide variation by product between these two bounds, with estimated R/VCs of 146.5% for “Farm Products,” 160.3% for “Coal,” and 180.5% for “Chemical,” just to list a few. Even if the

¹ See “STB Rate Data Provides Valuable Rate Comparison,” in *Rail Business* (May 20, 2002).

accuracy of these estimates is subject to dispute, there should be no question that wide variations in demand exist across shippers of various commodities. The effect of applying MMM would be to ignore that varying demand and to cap rates at a single average R/VC ratio regardless of commodity, let alone demand characteristics for individual movements.

Both the Board and the D.C. Circuit have recognized that the R/VC ratios on traffic handled by a railroad engaged in differential pricing reflect variations in demand for transportation services. As the D.C. Circuit explained, “if a profit-maximizing railroad charges more for the issue traffic than for the benchmark traffic, that would seem to represent a judgment – by the party with the greatest interest in making it correctly – that the issue traffic either costs more to transport or has a less elastic demand.” *Burlington Northern*, 985 F.2d at 597.² The rate structure that would emerge after application of MMM, however, would set all but the lowest rated traffic to the same average R/VC ratio. Hence, the presumption underlying the Board’s application of MMM in a SSAC case would be that all shippers of all commodities have the same demand characteristics. Such a presumption is entirely inconsistent with reality and with basic principles of demand-based differential pricing.

When the Board adopted simplified guidelines in 1996, it rejected approaches like MMM that would cap all rates at a uniform average, noting that such an approach would be fundamentally inconsistent with economic principles underlying Constrained Market Pricing, in particular the need for demand-based differential pricing. The Board acknowledged that even the need for simplification did not justify a repudiation of differential pricing. As the Board stated, “[b]y its very nature, an average number, which is produced by combining numbers that

² See also *Rate Guidelines – Non-Coal Proceedings*, 1 S.T.B. 1006, 1034 (1996) (“We are satisfied that comparison of r/vc ratios (a markup expressed in terms of variable costs), while not a refined measure, gives at least a rough indication of relative degree of captivity”) (“*Non-Coal Guidelines*”).

are both above and below that level, does not provide an appropriate regulatory ceiling.” *Non-Coal Guidelines*, 1 S.T.B. at 1022.³ The Board stated repeatedly that it did not intend “to return to an era of rate equalization among different traffic,” *id.*, and that it had no intention “to cap rates at an average level.” *Id.* at 1023. The Board specifically rejected any approach “premised on the general notion that a railroad can and should charge a single, uniform markup to all of its captive shippers. Such an approach is fundamentally inconsistent with demand-based differential pricing principles.” *Id.* at 1030. What the Board proposes to do now by applying MMM to all types of traffic, however, is exactly what it said it would not and could not do in 1996: return to an era of “rate equalization” by capping all types of traffic at an average R/VC level irrespective of demand considerations and irrespective of the need of railroads to earn adequate revenues.

Indeed, in 1996, the Board attempted to ensure that its simplified maximum rate approach would preserve at least some degree of differential pricing. The Board’s simplified guidelines set out a benchmark – R/VC_{Comp} – that is based on the average R/VC of a group of traffic comparable to the issue traffic. While the use of an average tends to ignore differences in demand, the Board nevertheless preserved some recognition of differential pricing by basing the average R/VC on a subset of traffic that has comparable demand characteristics. The Board proposes to continue to use this benchmark in establishing maximum reasonable rates for small cases. The Board recognizes that its small shipper guidelines represent a movement away from true Constrained Market Pricing, but even in small shipper cases the Board is striving to preserve some differential pricing. The application of MMM in big and medium-size SAC cases would

³ See also *id.* at 1023 (“The analysis that we envision would not presume that, simply because a rate produces an r/vc ratio above the average level, it is thereby unreasonable. The nature of an average number – which is produced by combining numbers that are both above and below that level – does not permit such a presumption”).

completely ignore differences in the demand characteristics of the SARR traffic. All traffic with an R/VC over a certain level would be driven to the same R/VC level regardless of differences in demand. Thus, if the Board chooses to apply MMM in both large and medium size cases, the perverse and completely irrational result would be that more differential pricing is preserved under the most simplified approach than under either of the more complicated and supposedly more precise approaches. Such an outcome would not be supportable.

II. The Board's Proposed ATC Methodology Is An Appropriate and Workable Revenue Allocation Methodology For Medium-Sized Rate Disputes

In the *EP 646 NPRM*, the Board also stated that it intends to use the "revenue allocation methodology used in Full-SAC proceedings" to apportion revenue from cross-over traffic between the on-SARR and off-SARR portions of the movement in medium-sized rate disputes. *EP 646 NPRM*, slip op. at 13. In Ex Parte No. 657, the Board proposed using an "Average Total Cost" ("ATC") approach for allocating cross-over traffic revenues in lieu of the Modified Straight-Mileage Prorate ("MSP") approach that had been applied in some recent SAC cases. *EP 657 NPRM*, slip op. at 19-20.

BNSF explained in its opening, reply, and rebuttal comments in this proceeding that the Board's proposed ATC approach is a proper methodology for allocating revenues from cross-over traffic in Full SAC cases that is far superior to the MSP approach in at least two respects. First, by taking account of the relative density of on-SARR and off-SARR lines in allocating through revenues between the SARR and the residual incumbent, the Board's ATC approach is less likely than MSP to produce distortions in the SAC results as compared to the results of a SAC analysis done without cross-over traffic. The relative density of a rail line is a critical determinant of the costs per unit of traffic that must be recovered on that line. By taking relative density into account when through revenues are allocated, use of ATC is more likely to produce

SAC results that approximate the results of a Full SAC analysis that does not rely on cross-over traffic. Second, the ATC approach is superior to the MSP approach because it does not assume an arbitrary 100-mile origin/destination mileage block. Since the average variable cost component of ATC reflects more accurately the relative efficiencies of handling trainload traffic, the ATC approach reduces the distortions that result from the use of short-haul cross-over traffic in a SAC analysis.

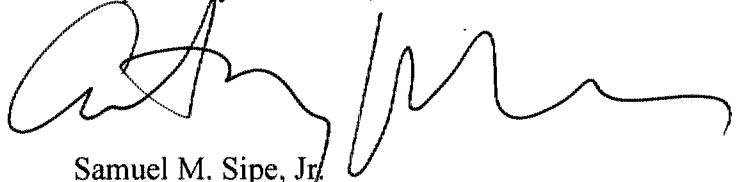
The adoption of an appropriate cross-over revenue allocation methodology is also important in medium-sized rate cases because such cases are likely to include a large volume of cross-over traffic. As noted above, the Board has stated that the traffic group in a medium-sized rate dispute “would consist of all movements that traveled over the selected route in the Test Year.” *EP 646 NPRM*, slip op. at 13. Use of the ATC methodology in medium-sized shipper cases is appropriate for the same reason it is appropriate in Full SAC cases; namely that it more accurately reflects the relative costs of the lines used to provide the on-SARR and off-SARR transportation for the shippers served by the SARR and therefore reduces any distortions that result from the use of cross-over traffic in a SAC analysis.

Moreover, BNSF has looked into the issue of how difficult or complex it would be to apply the ATC methodology in a medium-sized rate dispute since a primary purpose for the Board’s proposal to adopt the SSAC approach in a medium-sized rate dispute is to simplify the process and hold down the cost of making a SSAC presentation. Based upon its investigation, BNSF has determined that application of ATC in SSAC cases would not involve significant burdens. BNSF will provide additional detail in its comments in Ex Parte No. 646.

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October 4, 2006

Respectfully submitted,

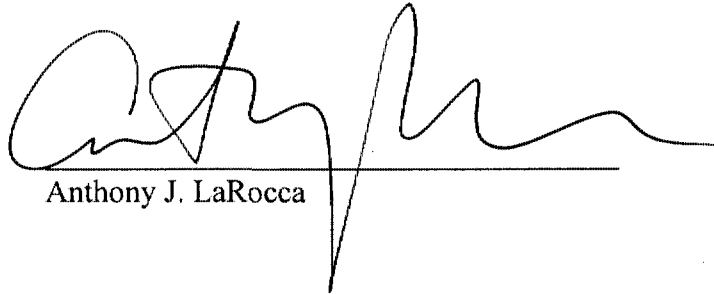
A handwritten signature in black ink, appearing to be "Samuel M. Sipe, Jr.", written over the typed name.

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CERTIFICATE OF SERVICE

I, Anthony J. LaRocca, hereby certify that on October 4, 2006, I caused a copy of BNSF Railway Company's Supplemental Comments 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).



Anthony J. LaRocca