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**BEFORE THE  
SURFACE TRANSPORTATION BOARD**

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**STB Ex Parte No. 646 (Sub-No. 1)**

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**SIMPLIFIED STANDARDS FOR RAIL RATE CASES**

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**OPENING SUBMISSION OF UNION PACIFIC RAILROAD COMPANY**

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J. MICHAEL HEMMER  
LOUISE A. RINN  
GABRIEL S. MEYER  
Union Pacific Railroad Company  
1400 Douglas Street  
Omaha, Nebraska 68179  
Tel: (402) 544-5000

LINDA J. MORGAN  
MICHAEL L. ROSENTHAL  
Covington & Burling LLP  
1201 Pennsylvania Avenue, N.W.  
Washington, D.C. 20004-2401  
Tel: (202) 662-6000  
Fax: (202) 662-6291

*Attorneys for Union Pacific  
Railroad Company*

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Exhibit D: 2010 Projected Network - Major Constrained Corridor and Terminal Areas

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SURFACE TRANSPORTATION BOARD**

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**STB Ex Parte No. 646 (Sub-No. 1)**

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**SIMPLIFIED STANDARDS FOR RAIL RATE CASES**

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**OPENING SUBMISSION OF UNION PACIFIC RAILROAD COMPANY**

Union Pacific Railroad Company (“UP”) is filing this submission to address the proposals for medium-size and small rate cases that the Surface Transportation Board (“Board”) set out in its Notice of Proposed Rulemaking in Ex Parte No. 646 (Sub-No. 1) (STB served July 28, 2006) (“*NPRM*”). We appreciate the opportunity to comment on these important matters.

UP strongly supports the Board’s effort to comply with Congress’s directive that the Board “establish a simplified and expedited method for determining the reasonableness of challenged rail rates in those cases in which a full stand-alone cost presentation is too costly given the value of the case.” 49 U.S.C. § 10701(d)(3). Railroads and shippers will both benefit from the development of procedures that allow parties to resolve rate claims efficiently when the value of the case would not justify litigating a full stand-alone cost (“SAC”) presentation, as long as those procedures remain consistent with Congress’s other important directives, including the requirement that that the Board “make an adequate and continuing effort to assist [rail] carriers in attaining revenue levels” sufficient to “attract and retain capital in amounts adequate to provide a sound transportation system in the United States.” 49 U.S.C. § 10704(a)(2).

The Board should always adhere to sound economic principles when regulating railroad rates, but the stakes are particularly high in the current environment. This proceeding

comes at a time when railroads are facing the challenge of accommodating increasing demand for service on networks that are already capacity constrained. The outcome of this proceeding will affect whether railroads will be able to earn the revenue they need to maintain their current networks and justify private expenditures for the expansion of infrastructure required by growing shipper demand.

## **SUMMARY**

We begin our comments by describing the challenges that railroads face in meeting shipper demand for rail transportation and the principles that the Board should follow to ensure that any new standards it adopts for medium-size and small rate cases do not undermine railroads' ability to respond to that demand. We then discuss the Board's proposed simplified stand-alone cost ("Simplified-SAC") and Three-Benchmark ("Benchmark") methods, including the Board's proposed substantive standards and procedural requirements. Finally, we address the proposed eligibility criteria, the treatment of traffic that has been exempted from regulation, and the benefits of mandatory mediation.

Our ultimate conclusion is that the Board's Simplified-SAC proposal is a significant achievement in developing a simplified method for determining rate reasonableness that is consistent with constrained market pricing ("CMP"). Although we disagree with certain aspects of the Board's proposal, and our comments include specific suggestions for improving several substantive and procedural aspects of the proposal, our preliminary view is that the Board should adopt Simplified-SAC, with the changes we suggest, and apply it to all cases in which use of a simplified method is appropriate.

The Board should, however, reject the Benchmark method as inconsistent with fundamental economic principles and unnecessary in light of its Simplified-SAC proposal. It

may be possible to design simplified standards for the smallest rate cases that would provide a lower-cost approach than Simplified-SAC while remaining true to the economic principles of CMP, but the Benchmark method is not that standard. The Benchmark method provides no sound economic principle for objectively assessing the reasonableness of a rail rate. It will produce results that are unpredictable and provide no guidance for future cases: each case will turn on a case-specific selection of supposedly comparable traffic, and thus neither shippers nor railroads will be able to determine in advance whether a rate is likely to be found reasonable. This uncertainty will most likely increase litigation and frustrate efforts by parties to avoid disputes or resolve them through negotiation. Moreover, although one might expect that the Benchmark method would be substantially less costly for shippers than Simplified-SAC, the costs actually would be similar, and any small savings to shippers from using the Benchmark method would pale in comparison to the sacrifice in the accuracy of rate reasonableness determinations that would result from its application. So while we offer suggestions for limiting the Benchmark method's potential to cause harm, that method is fundamentally flawed and should not be adopted.

Finally, the Board should take steps to mitigate the tendency of simplified standards to encourage litigation rather than negotiation when parties disagree about appropriate rate levels. The Board's proposals place almost the entire cost burden of medium-size and small rate cases on railroads and therefore will encourage the filing of marginal, and even meritless, complaints as a means of creating leverage to bargain for below-market rates. Our comments discuss three ways to mitigate this problem. First, the Board's eligibility criteria should ensure that the full SAC test, which produces more accurate results and involves a more equal sharing of evidentiary burdens than the proposed simplified standards, is applied when appropriate given

the value of the case. Second, the Board's procedural schedule should provide for rulings on petitions for partial revocation of exemptions before railroads are required to engage in costly discovery and data production efforts. Third, the Board should require parties to engage in mediation at an early stage of the proceeding.

**I. RAILROADS WILL NOT BE ABLE TO ACCOMMODATE THE GROWING DEMAND FOR RAIL TRANSPORTATION IF RATE REASONABLENESS STANDARDS INTERFERE WITH THE MARKET SIGNALS THAT SHOULD GUIDE INVESTMENT.**

The rate reasonableness standards that the Board adopts in this proceeding will have important consequences for railroads and the shippers that depend on rail service. As the Board knows well, UP and other railroads are experiencing unprecedented levels of demand for service on networks that are already under strain, and demand continues to grow. Railroads will be unable to accommodate this growing demand without massive investments in new capacity. In the ordinary course of business, railroads must expend substantial resources just to maintain current capacity levels. They will not be able to fund or justify the additional investments needed to expand capacity if the Board's regulations prevent them from earning adequate revenues.

The Board must exercise care to ensure that any simplified rate reasonableness standards it adopts permit railroads to charge rates that allow them to invest in needed capacity. The Board's regulations should protect shippers from abuses of market power, but at the same time, the Board must avoid interfering with the operation of market forces and with rate levels that result from the interaction of supply and demand. Especially in an environment in which demand is outpacing supply, the Board's regulations must not prevent railroads from charging market-based rates that provide the returns needed to support investment in their networks. If regulation forces rates too low, the gap between demand and supply will grow even wider, and

the Board will have failed in its basic responsibility “to ensure the development and continuation of a sound rail transportation system . . . to meet the needs of the public.” 49 U.S.C. § 10101(4).

The Board should not underestimate the significance of medium-size and small rate cases. By the Board’s own estimate, nearly two-thirds of all regulated movements (as measured by revenue) would be presumed eligible to use one of the simplified standards proposed by the Board. *NPRM* at 37. In other words, more rail traffic would potentially be subject to regulation under the proposed simplified standards than under the full SAC test. Thus, the Board must ensure that any simplified methods it adopts adhere as closely as possible to the principles of CMP, which “provide the only economically precise measure of rate reasonableness.”<sup>1</sup>

**A. UP And Other Railroads Must Make New Capital Investments To Accommodate Increasing Demand.**

The Board is familiar with the challenges facing railroads today, and it accurately summarized them in the *NPRM*: “Rail capacity is strained, demand for transportation service is forecast to increase, and railroads must make capital investments to meet that demand.” *NPRM* at 11. Shippers acknowledge these challenges as well. The National Industrial Transportation League testified at a recent Government Accountability Office Rail Regulation Workshop that: “The rail industry is laboring under significant capacity constraints for the first time in 20 years. . . . We have reached a point where demand has exceeded the industry’s capacity to haul all of this traffic. . . . The inability of the rail industry to meet current demand causes even greater

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<sup>1</sup> *Rate Guidelines – Non-Coal Proceedings* (“*Simplified Guidelines*”), 1 S.T.B. 1004, 1021 (1996).

concern for the future.”<sup>2</sup> These concerns affect the entire railroad industry, and addressing them effectively is a priority for UP.

**1. Significant Investment In New Capacity Is Needed On An Industry-Wide Basis.**

Rail capacity is strained on an industry-wide basis because traffic has experienced consistent, strong growth over the past several years. Rail carload traffic has increased compared with the same period in the prior year for 9 of the past 10 full quarters, and intermodal traffic regularly sets new records.<sup>3</sup> The future promises more of the same. The U.S. Department of Transportation has projected that by 2020 overall demand for freight rail service (measured in tons) will increase 48 percent over 1998 levels.<sup>4</sup> Similarly, the American Association of State Highway and Transportation Officials (“AASHTO”) predicted in a recent report that, with modest economic growth, rail tonnage will grow 44 percent between 2000 and 2020.<sup>5</sup>

As demand grows, railroads will have to build new capacity to accommodate as much of that growth as returns allow, while continuing to maintain existing capacity. But if a railroad is not earning sufficient revenues to be financially self-sustaining over a long period and does not have a realistic prospect of ever earning such revenues, it will not be able to attract the capital necessary to maintain its existing network, much less to expand its capacity. Railroads

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<sup>2</sup> National Industrial Transportation League, Written Testimony of National Industrial Transportation League at Government Accountability Office Rail Regulation Workshop (Feb. 27, 2006).

<sup>3</sup> Association of American Railroads, Written Testimony of Association of American Railroads at 3, Before the Subcomm. on Surface Transportation and Merchant Marine of the S. Comm. on Science, Commerce, and Transportation, *Hearing on Economics, Service, and Capacity in the Freight Railroad Industry*, 109th Cong., 2d Sess. (June 21, 2006).

<sup>4</sup> U.S. Department of Transportation, Freight Analysis Framework, Table 1 (Oct. 2002), [http://ops.fhwa.dot.gov/freight/documents/faf\\_overview.pdf](http://ops.fhwa.dot.gov/freight/documents/faf_overview.pdf).

<sup>5</sup> American Association of State Highway and Transportation Officials, Freight-Rail Bottom Line Report 50-51 (2003), <http://freight.transportation.org/doc/FreightRailReport.pdf>.

have substantial sunk investments in long-lived assets such as track and equipment. They can continue to operate those assets for a significant period of time even when they are not earning adequate revenues, but they cannot continue forever. They will pare back spending – selling or abandoning less-used assets as they age rather than replacing them – and focus their resources on the most profitable traffic. Capacity will shrink rather than expand.

Railroads are compelled to be financially self-sustaining. In contrast to the extensive government funding of truck, barge, and airline infrastructure over the past 25 years, freight railroads have received little government financial assistance for infrastructure construction and maintenance. Instead, they have financed infrastructure improvements almost exclusively through their own earnings and borrowing. And by a variety of measures, railroads are at or near the top among all U.S. industries in terms of capital intensity. As an example, from 1995 through 2004, the average U.S. manufacturer spent 3.5 percent of its revenue on capital expenditures. The comparable figure for U.S. freight railroads was 17.8 percent, or more than five times higher.<sup>6</sup>

U.S. freight railroads have been expending, and will continue to expend, enormous resources to sustain and improve their infrastructure and operations to alleviate the service and capacity problems they face. From 1980 through 2005, Class I railroads invested some \$360 billion in capital and maintenance expenses related to their infrastructure and

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<sup>6</sup> Association of American Railroads, Written Testimony of Association of American Railroads at 10, Before the Subcomm. on Surface Transportation and Merchant Marine of the S. Comm. on Science, Commerce, and Transportation, *Hearing on Economics, Service, and Capacity in the Freight Railroad Industry*, 109th Cong., 2d Sess. (June 21, 2006).

equipment – equivalent, on average, to almost 45 percent of their operating revenue.<sup>7</sup> On a per-mile-of-road-owned basis, these expenditures have been trending sharply higher since 1990.<sup>8</sup>

Railroad capital spending, which is already substantial, must continue to rise if railroads are going to accommodate expected demand. In 2006, U.S. railroads will spend more than \$8.3 billion, up from around \$5.7 billion just four years ago, for laying new track, buying new equipment, and improving infrastructure. But even this increased level of investment will not be enough to handle expected future growth. AASHTO concludes that, if rail investment levels are not increased significantly, the rail network will experience an investment shortfall of \$53 billion by 2020 just in its attempt to handle existing traffic growth – *i.e.*, to retain current rail market share vis-à-vis other transportation modes as demand increases – a figure that does not take into account what will be needed to handle expected new demand for rail service.<sup>9</sup>

For railroads to make the capital investments required to close the gap between supply and demand, they must be allowed to earn the revenues needed to justify and fund those investments. The Board, of course, must protect shippers in unusual instances in which railroads may seek to charge abusive, unreasonable rates, but it also must protect the broad public interest by allowing railroads to charge non-abusive rates that reflect “competition and the demand for services” in order “to ensure the development and continuation of a sound rail transportation system.” 49 U.S.C. § 10101(1), (4).

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<sup>7</sup> See *id.* at 8.

<sup>8</sup> See *id.*

<sup>9</sup> See *Freight-Rail Bottom Line Report*, *supra* note 5, at 4.

**2. UP Faces Capacity Constraints And Must Make Substantial Investments In New Capacity To Meet Expected Demand.**

UP's experience generally parallels the experience of the rail industry as a whole. Since the summer of 2003, UP has set all-time carloading records in almost every month. *See* Ex. A. This traffic growth has affected UP's operations. As system-wide carloadings pushed above the level that had long been regarded as the top end of the range of UP's system fluid capacity in fall 2003, the network's performance began to suffer. *See* Ex. B.

UP has taken extraordinary measures to meet the rising demand and address service issues. Since 2003, UP has hired more than 11,000 new train crew employees to replace retiring employees and handle growing volumes. UP also has acquired more than 1,200 new locomotives, representing more than \$2 billion in capital expenditures. And UP has increased capital spending on track and terminal capacity expansion from the \$300 million per year range to the \$500 million per year range.

UP has also taken steps on the demand side to limit the growth in traffic seeking to use its constrained corridors as a way of improving service. These measures have included rate increases, which reflect market-based efforts to bring demand into balance with supply and which will help fund additional investment in the network. They have also included efforts to take on new business only when it can support the costs of adding the incremental capacity it consumes.

Despite these efforts, UP's network continues to suffer from significant capacity constraints. Capacity is most constrained in three broad areas of the network: (i) the Sunset Corridor between California, Texas, and Eastern gateways, (ii) the transcontinental corridors between Wyoming/Nebraska and the Eastern gateways, and (iii) UP's routes in the Texas/Gulf region. *See* Ex. C. Moreover, if demand grows as forecast over the next few years, the pressures

on UP's network will increase, and significant parts of UP's system will have more traffic than they can handle. *See* Ex. D.

UP is therefore continuing to take aggressive action to address existing capacity constraints and plan for the future. UP is budgeting hundreds of millions of dollars every year in capital spending to expand capacity, as well as making innovative operational changes aimed at increasing the throughput of its existing infrastructure. Even with all of these efforts, however, UP will be unable to accommodate the expected growth in demand without spending even more on additional capacity over the next several years.

Adding the capacity needed to accommodate expected growth will be extremely expensive. UP is currently spending \$700-800 million annually to expand the capacity of our facilities, equipment, and other capabilities. We are making this investment on top of the roughly \$1.9-2.0 billion in capital dollars and \$1.9 billion in maintenance expense dollars that we must spend every year just to maintain and renew the level of carrying capacity already in place.

UP's best estimate is that adding all of the capacity required to keep up with unconstrained demand growth would require spending an additional \$1 billion each year on growth capital. That is, \$1 billion over and above the \$700-800 million in capital that we are currently spending to expand our capacity, which is on top of the \$1.9-2.0 billion in capital to replace existing resources, and which does not count the roughly \$1.9 billion in operating expenses that we must spend each year to maintain existing resources.

UP is investing to address its current capacity constraints and to accommodate expected demand in response to market forces. In the current market environment, rail rates have increased because the demand for rail transportation service exceeds the available supply. Rising rates thus indicate increasing shipper demand for additional investment in transportation

capacity and provide railroads with the revenue needed to fund and provide adequate returns on that investment.

Rates that reflect the current market environment may be higher than those to which shippers became accustomed during the many decades that railroads were burdened by excess capacity, but they reflect the market process at work, not a failure of regulatory oversight. The Board has a congressionally mandated role to play in regulating rail rates in the absence of effective competition and where rates have been set at unreasonable levels, but it must act with care not to disrupt the market forces that are providing UP and other railroads the ability and incentive to invest in new capacity.

**B. The Board Should Not Depart From Sound Economic Principles In Addressing Medium-Size and Small Rate Cases.**

The Board must take care to ensure that its rate reasonableness regulations allow market forces to operate and guide investment in rail capacity. The Board's standards should not encourage litigation. Rather, they should encourage railroads and shippers to focus on market conditions and negotiate rates that reflect market forces. Regulation should come into play only as a last resort, if a railroad and a shipper cannot address their differing perceptions of market conditions through negotiation and in the absence of effective competition for the transportation at issue. Regulation of rates should be based on meaningful, market-based standards that allow railroads to earn revenues adequate to provide a safe, efficient, and sound rail transportation system. This is not only sound economics, it is the policy of the United States Government. *See* 49 U.S.C. § 10101(1)-(4), (6).

The Board's predecessor, the Interstate Commerce Commission ("ICC"), struck a balance between market forces and regulation when it adopted the CMP method for determining

rate reasonableness in the *Coal Rate Guidelines* (“*Guidelines*”).<sup>10</sup> CMP is grounded on the economic necessity for railroads to price their traffic differentially. The need to price traffic differentially stems from the fact that railroads have substantial “unattributable costs” – joint and common costs that cannot be directly attributed to particular traffic.<sup>11</sup> “Any means of allocating these costs among shippers other than actual market demand” – *i.e.*, any non-demand-based formula that apportions a pro rata share of joint and common costs to each movement – “is arbitrary and may not permit a carrier to cover all of its costs.”<sup>12</sup> The fundamental problem with using non-demand-based formulas is that shippers have varying degrees of sensitivity to price changes that such formulas cannot take into account. Thus, the formulaic allocations “do not necessarily reflect the carrier’s ability (or inability) actually to impose the assigned allocations and cover its costs.”<sup>13</sup> “If a carrier sought to apply [a] formula price to all of its traffic, it would lose that traffic for which the demand could not support the price assigned,” in which case “the remaining shippers might be required to pay a larger portion of the carrier’s unattributable costs.”<sup>14</sup>

The ICC adopted CMP after years of unsuccessful efforts to develop an economically sound methodology for regulating rates in the absence of effective competition.<sup>15</sup>

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<sup>10</sup> *Coal Rate Guidelines, Nationwide*, 1 I.C.C.2d 520 (1985), *aff’d sub nom. Consol. Rail Corp. v. United States*, 812 F.2d 1444 (3d Cir. 1987).

<sup>11</sup> The cost to construct rail track is an example of an “unattributable cost” – a single track can be shared by many different services, but the railroad would have to cover the same cost whether one or many trains uses the asset. By contrast, locomotive fuel costs can readily be attributed to individual train movements and among tons carried on the train.

<sup>12</sup> *Guidelines*, 1 I.C.C.2d at 526.

<sup>13</sup> *Id.*

<sup>14</sup> *Id.*

<sup>15</sup> *See id.* at 521-25.

“Under CMP, the carriers are expected to use the market demand which they observed as the basis for their pricing.”<sup>16</sup> Regulatory interference with market outcomes is to occur only in those rare instances in which a carrier establishes a rate that violates one of four constraints that CMP places on railroads’ differential pricing.<sup>17</sup> In practice, most rate cases have focused on the SAC constraint. The SAC constraint computes “the rate a competitor in the market-place would need to charge in serving a captive shipper or a group of shippers who benefit from sharing joint and common costs.”<sup>18</sup> “It is, in other words, a simulated competitive price.”<sup>19</sup>

Our comments below focus on how the Board’s proposed Simplified-SAC and Benchmark methods measure up to CMP and demand-based differential pricing principles, and how the Board’s proposals could be improved to help ensure that railroads can earn the revenues needed to support investment in new capacity. In Part II we discuss Simplified-SAC. In Part III we discuss the Benchmark method. We then discuss several topics that relate to both methods. We discuss the Board’s proposed eligibility criteria in Part IV, the Board’s proposed treatment of cases involving traffic that has been exempted from regulation in Part V, and a new proposal for mandatory mediation in Part VI.

## **II. SIMPLIFIED-SAC**

UP agrees with the Board’s objectives in proposing Simplified-SAC, and we believe that the proposal establishes a viable framework for a streamlined application of CMP. However, we do not agree with all of the Board’s proposals for Simplified-SAC. In the sections

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<sup>16</sup> *Id.* at 527.

<sup>17</sup> *See id.* at 534-46.

<sup>18</sup> *Id.* at 528.

<sup>19</sup> *Id.*

below, we describe our disagreements and suggest several refinements to the Board's proposals that would produce more accurate and equitable results without increasing, and potentially decreasing, the costs to parties of litigating medium-size and small rate cases.

**A. Methodology**

**1. Route**

UP disagrees with the Board's current proposal, which would allow the shipper to select a route for the challenged movement that is different from the primary route used to handle the traffic under either of two circumstances: (1) the shipper could select any route that had been used in the prior twelve months; or (2) the shipper could select a route that had not been used in the prior twelve months if the shipper were to demonstrate that the selected route "has sufficient existing capacity to handle the additional traffic." *NPRM* at 12.

The Board should not allow the shipper to select a route for the challenged movement that is different from the primary route used to handle the traffic. The fundamental premise of Simplified-SAC is that the SAC test can be simplified by requiring parties to base their evidentiary submissions on the defendant's existing traffic and facilities. By largely eliminating disputes over the level of road property investment and operating costs (and the hundreds or thousands of factors that play a role in determining that investment level and those costs), Simplified-SAC would reduce the amount and complexity of the evidence that parties must submit and that the Board must analyze. This in turn would reduce the cost to bring a complaint and the time needed to render a decision, and it should also make the outcome more predictable. The Board cannot allow the shipper to select a route that is different from the primary route used to handle the challenged movement without undermining the premise of Simplified-SAC or introducing into Simplified-SAC many of the complicated investment and

operational issues that are inherent in a full SAC case, thereby losing or diminishing the benefits of a simplified proceeding.

**a) A railroad's selection of a primary route and the railroad's investment and operating costs are highly interdependent.**

Allowing the shipper to select a route other than the primary route used to handle the challenged movement is problematic because the primary route both reflects and influences the railroad's road property investment and operating costs. The primary route might not be the shortest distance between origin and destination, but it will reflect the most efficient way for the railroad to handle the traffic, given the operating characteristics of the traffic and the route and the operating and capacity constraints that affect its network. Thus, although a shipper might be able to suggest a superficially plausible alternative route for the challenged movement, a more detailed analysis would explain the railroad's route selection and typically show that use of the alternative route would require the railroad to incur increased road property investment and operating costs. If use of an alternative route would require the railroad to incur additional costs, Simplified-SAC could not be applied to determine the maximum reasonable rate for the rerouted movement, because actual road property investment and actual system-average operating costs would no longer be appropriate measures of the costs involved.

UP's use of directional operations demonstrates the complicated interaction between a carrier's routing decisions and its investment and operating costs.<sup>20</sup> UP operates directionally over essentially parallel lines on many different parts of its network, such as from Houston to St. Louis and from Houston to New Orleans. Traffic moving directionally obviously

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<sup>20</sup> "Directional operations" means routing traffic over two generally parallel lines so that traffic moving in one direction is largely confined to one line and traffic moving in the opposite direction is largely confined to the other line.

will not always use the shorter of the two lines, but directional operations are a proven method that UP uses to increase the capacity of existing facilities without making additional investment in double track, sidings, or new signals, and they reduce overall operating costs by minimizing train meets and delay.<sup>21</sup>

As another example, UP often routes traffic to designated yards for blocking or for storage-in-transit purposes, even though other superficially similar facilities are located more directly between a movement's origin and destination, because UP has assigned the designated facilities specialized functions in order to increase capacity or to reduce operating costs. For instance, in the Houston area, UP primarily uses its yard in Englewood, Texas, to classify traffic moving east or west, and its yard in Settegast, Texas, to classify traffic moving north or south. As another illustration, UP routes manifest traffic moving from Southern California to Midwest gateways via Salt Lake City, rather than over the Sunset Corridor, in order to take advantage of its classification facilities at North Platte, Nebraska.

Similarly, UP routes some traffic over longer routes to avoid congested segments and minimize the overall costs associated with delays to traffic using both routes. For example, UP routes westbound empty coal trains over its Falls City and Hiawatha subdivisions to free up capacity for eastbound and southbound trains moving between Marysville, Topeka, and Kansas City, Kansas.

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<sup>21</sup> See, e.g., *Union Pac. Corp., Union Pac. R.R., & Mo. Pac. R.R. – Control & Merger – S. Pac. Rail Corp., S. Pac. Transp. Co., St. Louis Sw. Ry, SPCSL Corp., & Denver & Rio Grande W.R.R.*, STB Fin. Docket No. 32760 (Sub-No. 21), slip op. at 13 (STB served Dec. 21, 1998) (“The directional running patterns instituted by UP have increased the carrying capacity of UP’s (formerly SP’s) Houston-Fair Oaks line.”).

In all of these examples, if a different route were used, UP would have to invest in new facilities or incur higher operating costs to maintain the existing level of service for the issue traffic and the other traffic that shares its network.

**b) The Board's proposed rules for route selection would allow shippers to avoid significant investment and operating costs.**

The Board implicitly acknowledged at least some of the complicated investment and operating issues associated with route selection by proposing its "twelve-month rule" – *i.e.*, if the challenged movement did not use the selected route in the prior twelve months, the shipper must "demonstrate that the route selected has sufficient existing capacity to handle the additional traffic." *NPRM* at 12. The proposed rule, however, does not adequately address the many capacity and operating issues that would be raised by the shipper's selection of a route other than the primary route used to handle the traffic, and adequately addressing those issues would significantly complicate the Simplified-SAC analysis without providing commensurate benefits.

For example, the proposed rule would allow the shipper to select a route that does not have sufficient capacity to handle the challenged movement efficiently on a consistent basis. In any twelve-month period, a railroad might temporarily use alternative routes in response to a variety of disruptions on its lines or its connections' lines that affected the primary route. The primary route might be affected for a significant period because of capacity construction, major planned maintenance work (*e.g.*, tie or rail replacement, undercutting), or efforts to recover from significant natural disasters (*e.g.*, flooding, hurricanes). The primary route might be affected by a major signal outage, a derailment, a washout, or any number of random events. Or dispatchers might be reacting to short-term issues, such as a primary route with above-normal congestion or an alternative route with below-normal congestion. A railroad's ability to accommodate temporary deviations from a primary route is one of the many benefits of having an extensive

network with alternative routes (unlike a stand-alone railroad), but it does not mean that the carrier could reroute the traffic on a full-time basis without investing in new capacity or incurring increased operating costs for traffic that shares the alternative route.

As another example, the proposed rule would allow the shipper to select a route in order to avoid responsibility for investments that the defendant has made or would need to make to handle the challenged movement. The defendant might have changed the primary route for the challenged movement because traffic growth had consumed the available capacity on the prior route and the most efficient response was to reroute the challenged movement, but the proposed rule would allow the shipper to return the traffic to the capacity-constrained route without taking responsibility for the investments or operating costs that would be necessary to handle the traffic. Similarly, the defendant might have changed the primary route after investing in new facilities on the new primary route, and the proposed rule would allow the shipper to avoid accounting for the cost of the new facilities by selecting the prior route.

The Board cannot simply presume that the challenged movement could use any route that the traffic traversed within the prior twelve months. If the Board allows the shipper to select a route other than the primary route used to handle the traffic, it must allow the defendant an opportunity to demonstrate that the selected route does not have sufficient capacity to handle the challenged movement efficiently on a consistent basis or that additional investment or operating costs would be required to do so.

However, the Board need not introduce this additional level of complexity into the analysis because there is no reason to allow the shipper to depart from the primary route under Simplified-SAC. Railroads' incentives are to minimize operating costs and maximize existing capacity. As the Board has recognized, the adoption of Simplified-SAC will not change

these basic incentives. *NPRM* at 12. Moreover, the process for resolving disputes regarding route selection and available capacity would multiply the costs of a proceeding. The parties would need to conduct discovery regarding facilities and traffic levels on two routes rather than one, and they would be required to address issues regarding network configuration and operating plans that the Board has otherwise eliminated from Simplified-SAC. *Id.* at 13.

## **2. Configuration**

UP agrees with the Board's proposal that the complainant's stand-alone railroad ("SARR") consist of the existing facilities along the selected route, leaving room for the shipper to eliminate certain facilities if it presents "compelling evidence" that they "have fallen into disuse by the railroad." *NPRM* at 12. We submit, however, that rationality and fairness require the Board to allow the defendant to add new facilities to the existing configuration if it presents "compelling evidence" that it is in the process of making new investments to handle expected traffic moving over the selected route.

UP's proposal to account for investment in progress and planned investment is necessary to ensure that Simplified-SAC does not penalize railroads that are now constructing new capacity or deter them from investing in new capacity. UP's proposal would also help ensure that rates for challenged movements reflect the type of demand-based pricing factors that should come into play when traffic moves over capacity-constrained lines.

### **a) Simplified-SAC should not penalize or deter new investments in capacity.**

Under the Board's current proposal, Simplified-SAC would penalize railroads that are in the process of adding capacity and would potentially discourage railroads that are planning capacity additions, because the analysis would not take into account investments that are underway or that will be completed during the five-year prescription period. Such an outcome

would be contrary to the Board's intent that Simplified-SAC not deter railroads "from making the investments in their rail networks that are needed to meet rising demand." *NPRM* at 11. It also would be contrary to the federal policy of "ensur[ing] the development and continuation of a sound rail transportation system." 49 U.S.C. § 10101(4).

The problem arises because Simplified-SAC makes no provision for incorporating capital investment projects that are already underway or that will be completed during the prescription period. In the *NPRM*, the Board asserted that Simplified-SAC would not deter investment because it "would incorporate those new capital investments and ensure that the maximum lawful rate includes a reasonable return on the replacement costs of those investments." *NPRM* at 11. However, the Board's approach would affirmatively exclude such investments from the Simplified-SAC analysis by assuming that no new construction will occur after completion of the SARR, even though traffic volumes are allowed to grow throughout the prescription period: the Board proposes to "re-calculate the maximum lawful rate [each year during the prescription period] to reflect actual changes in traffic volumes, revenues, and URCS costs," while also proposing to modify URCS to reflect an assumption that "there would be no construction work in progress once the SARR is built." *Id.* at 14, 51.

The Board's assumption that there would be no further construction on SARR segments once the SARR is built is entirely unrealistic, at least for SARRs that would replicate segments of UP. As discussed above, UP has significant capacity constraints across its network, and it is investing at record levels to expand capacity in order to accommodate increasing traffic volumes. *See* pp. 9-10, *supra*. Under the Board's approach, complainants would benefit from increasing traffic volumes while failing to account for investments needed to accommodate that traffic. Such a result would be fundamentally at odds with Congress's directive that the Board

assist rail carriers in attaining revenue levels needed to “attract and retain capital in amounts adequate to provide a sound transportation system in the United States.” 49 U.S.C. § 10704(a)(2).

UP’s proposal would ensure that the Simplified-SAC analysis credits railroads for new capital investment along the selected route and would thus counteract the investment disincentives that otherwise would be created.

**b) Simplified-SAC should recognize that traffic moving over capacity constrained segments should pay higher rates.**

UP’s proposal to account for ongoing and planned investment in new capacity would help ensure that rates better reflect existing capacity constraints and the demand for new investment. The Board should expect, and even encourage, railroads to charge higher rates for movements that use capacity-constrained lines than for movements that use lines with excess capacity because railroads generally incur higher costs when they operate over capacity-constrained lines. Moreover, railroads should be encouraged to apply market-based pricing principles to gauge whether demand will support additional investment and to generate the revenues needed to fund that investment. Railroads will invest more if they know that they will be allowed to earn appropriate returns on their investment.

The Board’s Simplified-SAC proposal does not contain any provision that would allow railroads to set higher rates for movements that traverse capacity-constrained lines. The proposal assumes that all traffic will incur system-average operating costs, and it makes no allowance for a carrier to charge differentially higher rates to support capacity investments.

UP’s proposal would allow railroads to charge higher rates for traffic moving over those capacity-constrained lines that are undergoing capacity expansion projects. Our proposal would not ensure that rates fully reflect capacity constraints – because demand-based pricing

would still be constrained and the Simplified-SAC constraint still would not take increased operating costs into account – but it would help allow rates to reflect capacity constraints and thereby encourage new investment in capacity by taking into account ongoing and planned investments in capacity.

### **3. Test Year**

UP agrees, pending our review of comments filed by other parties, with the Board's proposal to examine the reasonableness of challenged rates based on a one-year analysis, using the most recently completed four calendar quarters preceding the filing of the complaint. UP expects to be able to produce the necessary four quarters of data on a timely basis under the Board's proposed procedural schedule for Simplified-SAC.

### **4. Traffic Group**

UP agrees with the Board's proposal that the traffic group consist of all movements that traveled over the selected route in the Test Year and that no rerouting of non-issue traffic should be permitted. Allowing the shipper to reroute non-issue traffic would be inconsistent with the Board's recognition that the shipper should not be free to reroute the challenged movement. *NPRM* at 12. Moreover, allowing the shipper to reroute non-issue traffic would open the door to the many complications of calculating investment and operating costs discussed above in connection with the Board's proposal to allow the shipper to select an alternative route for the challenged movement. *See* pp. 14-18, *supra*.

### **5. Cross-Over Traffic**

UP disagrees with the Board's proposal to apportion the revenue from cross-over traffic between the on-SARR and off-SARR portions of the movement based on the revenue

allocation methodology that it adopts in *Major Issues In Rail Rate Cases*.<sup>22</sup> In *Major Issues*, UP proposed that the Board adopt an approach to cross-over revenue allocation that 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 operation.<sup>23</sup> We demonstrated that the alternatives – the Board's proposed Average Total Cost ("ATC") and the Board's current practice of using a mileage-based prorate ("MSP") – produce arbitrary results that are biased toward over-assigning revenue to segments that were part of the SARR.<sup>24</sup> Our proposed approach is the only one that avoids the inherent problems of attempting to allocate contribution and implements SAC theory by mirroring the outcome that would occur in a contestable world.<sup>25</sup>

We recognize, however, that our proposal in *Major Issues* would not be suitable for cases under Simplified-SAC. Under Simplified-SAC, the SARR would be replicating the incumbent's configuration, operating plan, operating costs, and traffic grouping. Under those circumstances, if the SARR were apportioned cross-over revenue equal only to the incumbent's avoided costs of handling the cross-over traffic, it would not have the opportunity to recover any contribution to fixed costs from that traffic. Moreover, under the Board's current proposal, the complainant would not have the option it has under a full SAC analysis to obtain for the SARR

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<sup>22</sup> STB Ex Parte No. 657 (Sub-No. 1) (STB served Feb. 27, 2006) ("*Major Issues*").

<sup>23</sup> See Opening Submission of Union Pacific Railroad Company at 29-30, *Major Issues In Rail Rate Cases*, STB Ex Parte No. 657 (Sub-No. 1) (May 1, 2006) ("UP Major Issues Op.").

<sup>24</sup> See UP Major Issues Op. at 23-28 & UP Major Issues Op., Verified Statement of Kevin Neels at 10-14.

<sup>25</sup> See Reply Submission of Union Pacific Railroad Company at 18-24, *Major Issues In Rail Rate Cases*, STB Ex Parte No. 657 (Sub-No. 1) (May 31, 2006) ("UP Major Issues Reply"); Rebuttal Submission of Union Pacific Railroad Company at 22-33, *Major Issues In Rail Rate Cases*, STB Ex Parte No. 657 (Sub-No. 1) (June 30, 2006) ("UP Major Issues Reb.").

the full contribution available from cross-over traffic by replicating the incumbent's end-to-end service.<sup>26</sup>

Under the circumstances created by Simplified-SAC, we see two possible ways for the Board to address cross-over revenue allocation. First, the Board could adopt ATC. As UP has observed, ATC “modestly improve[s] on past approaches, by more accurately measuring the relative costs associated with the stand-alone and residual incumbent segments traversed by each movement of cross-over traffic.”<sup>27</sup> Second, the Board could allow the complainant the option to build the full network needed to truly stand alone. Although such an undertaking might be impractical under SAC, Simplified-SAC provides parties with all of the basic tools required to calculate the necessary road property investment and operating costs, regardless of the size of the network. We also intend to review carefully other parties' proposals for addressing this issue.

## **6. Road Property Investment**

UP generally agrees with the Board's proposal for simplifying road property investment analysis under Simplified-SAC, but the Board should allow parties to present evidence that rolling average costs or costs derived from regressions based on prior SAC cases should not be applied in a particular case brought under Simplified-SAC. The existing data are insufficient to justify the Board's un rebuttable presumption that cost results from prior SAC cases can be applied to any case brought under Simplified-SAC.

UP is particularly concerned with this issue because none of the SAC cases that would be used to calculate the rolling averages and regressions involved the geography or mix of traffic likely to be at issue in Simplified-SAC cases involving UP. Our primary concern relates

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<sup>26</sup> See UP Major Issues Reply at 22; UP Major Issues Reb. at 30.

<sup>27</sup> UP Major Issues Op. at 23.

to the calculation of land, public improvements, and building and facility costs – the costs that can be expected to vary depending on differences in geography and traffic mix.

**a) Land and public improvement costs**

The UP traffic likely to be at issue in Simplified-SAC cases moves in different geographic regions than the regions at issue in the SAC cases that the Board proposes to use to develop road property investment costs for Simplified-SAC. There are several categories of UP traffic likely to be at issue in cases filed under Simplified-SAC, but many Simplified-SAC cases would share no terrain or facilities encompassed in prior or pending full SAC cases and would involve SARRs that carry a very different mix of traffic. These include Simplified-SAC cases involving: (i) traffic moving within the Gulf Coast region, (ii) traffic from Houston to Eastern gateways, and (iii) traffic originating or terminating on the West Coast. Only three of the six cases the Board proposes to use even involved rail operations in the Western U.S. Moreover, none of the three western cases involved the regions likely to be at issue in UP cases; instead, they involved traffic moving (i) from the Powder River Basin in Wyoming (“PRB”) through Montana, North Dakota, and Minnesota, to South Dakota,<sup>28</sup> (ii) from the PRB through Nebraska to Colorado,<sup>29</sup> and (iii) from the PRB through Nebraska, Missouri, Kansas, and Oklahoma, to Texas (outside the Gulf Coast region).<sup>30</sup>

In UP’s experience, these geographic differences are likely to have a significant effect on the costs of land and public improvements. For example, the cost of land in the Gulf

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<sup>28</sup> See *Otter Tail Power Co. v. BNSF Ry.*, STB Docket No. 42071, slip op. at 23 (STB served Jan. 27, 2006).

<sup>29</sup> See *Pub. Serv. Co. of Colo. d/b/a/ Xcel Energy v. Burlington N. & S.F. Ry.*, STB Docket No. 42057, slip op. at 44 (STB served June 8, 2004).

<sup>30</sup> See *Tex. Mun. Power Agency v. Burlington N. & S.F. Ry.*, 6 S.T.B. 573, 644 (2003).

Coast region and many California locations is significantly higher than the cost for comparable categories of property in the regions at issue in prior SAC cases. UP recently appraised portions of a line running from Oakland, California, toward San Jose, California. UP's across-the-fence approach appraised industrial parcels at approximately \$436,000-653,000 per acre, commercial parcels at \$653,000-871,000 per acre, and residential parcels at \$697,000-1.5 million per acre. As another example, UP recently appraised portions of its Glidden Subdivision in and near Houston. UP's across-the-fence appraisal valued industrial parcels at approximately \$47,000-170,000 per acre, commercial parcels at \$134,000-218,000 per acre, and residential parcels at \$76,000 per acre. All of these values substantially exceed the rolling average prices per acre set forth in the *NPRM*. See *NPRM* at 40, Table A-2.

UP's experience is also consistent with the data in the *NPRM* regarding public improvement costs for SAC cases in the Western U.S., which show costs that are significantly higher in the West than in the East. *Id.* at 47.

The Board recognizes that differences in geography will affect actual land and public improvement costs, but it proposes to disregard those differences in an effort to reduce the costs of Simplified-SAC. The Board observed in the *NPRM* that "land prices are affected by location." *Id.* at 41. It also observed that there was a "large disparity" in the six recent SAC cases with respect to public improvements because of "geographic differences between eastern and western cases." *Id.* at 47. However, the Board contends in the *NPRM* that costs of developing more accurate valuations outweigh the value of added precision. *Id.* at 41.

UP understands the Board's concerns, but they are not necessarily applicable to the cases that will be brought under Simplified-SAC, and they should not preclude parties from attempting to submit evidence that would produce more accurate results than the rolling average

costs that would otherwise be used. The Board's concerns are based on experience with SAC cases, in which parties typically "hire an appraiser to conduct real estate appraisals for land across thousands of miles." *NPRM* at 41. Many Simplified-SAC cases, however, will involve much shorter routes. Moreover, parties would not need to develop actual costs for all categories of land or every mile of the route. They could focus instead on specific categories or parts of the route where the actual costs differ enough from the rolling average costs to make the additional expense worthwhile. In fact, if the Board requires parties to meet an appropriately high standard of proof before allowing departures from rolling average costs, parties will offer case-specific evidence only when the added precision outweighs the costs of developing more accurate evidence.

**b) Building and facility costs**

The UP traffic likely to be at issue in Simplified-SAC cases will include a mix of traffic that is different from the traffic typically at issue in the SAC cases that the Board proposes to use to develop road property investment costs for Simplified-SAC. Most full SAC cases have involved coal-only railroads: the shipper is challenging coal rates, and cross-over traffic consists of only other coal traffic. Under Simplified-SAC, by contrast, shippers would be required to include all traffic that moves over the route used by the challenged movement. *NPRM* at 11.

The Board's proposal for calculating building and facility costs does not take into account the effect of traffic mix. Under the Board's proposal, building and facility costs would be calculated using the relationship between costs and tonnages that has been observed in cases decided under full SAC. However, building and facility costs per ton should be significantly higher for railroads that carry a broad mix of traffic than for coal-only railroads. For example, many more employees would be necessary to staff and operate a railroad that carries a mix of coal, manifest, intermodal, and automotive traffic than one that carries the same total tonnage but

focuses solely on coal – and thus the buildings and facilities needed to support those employees would be significantly more extensive and more costly.

Moreover, coal-only railroads do not include all of the facilities necessary to handle a mix of coal, manifest, intermodal, and automotive traffic. For example, a coal-only railroad would not include buildings and facilities associated with intermodal yards and auto ramps. The number and size of buildings and facilities needed to operate a railroad carrying a mix of traffic including intermodal and automotive traffic would be more extensive than those required to operate a railroad carrying only coal.

UP is not suggesting that the Board discard its current proposal. The Board can reasonably apply its proposed method in the absence of better evidence. But it should not foreclose parties from presenting case-specific cost evidence when the shortcomings of the proposed method are evident. We recognize the Board's efforts to balance cost and accuracy in implementing Simplified-SAC, but if the Board requires parties to satisfy a high standard of proof before allowing departures from the proposed method of establishing costs, parties will only attempt to meet that standard when the loss of accuracy would be significant, and thus cost and accuracy would be appropriately balanced based on the facts of each case.

## **7. Operating Expenses**

UP generally agrees with the Board's proposed approach to calculating operating expenses for the SARR under Simplified-SAC, but the Board should recognize an exception for cases involving movements of hazardous materials. As we discuss in more detail on pages 41-43, movements of hazardous materials impose costs on railroads that greatly exceed system-average costs due to the safety precautions that railroads must take in connection with hazardous materials and the risks that they face from transporting hazardous materials. The costs of handling these materials may rise even higher as a result of regulations under consideration by

the Department of Homeland Security and the Federal Railroad Administration. At least for UP, movements of hazardous materials tend to be concentrated in certain areas and on certain routes, and it would be unfair and produce inaccurate results if a complainant were allowed to design a SARR that would handle a significant amount of hazardous materials but calculate total operating costs as though the SARR were moving system-average traffic.

Moreover, although we generally agree with the Board's proposed approach to calculating operating expenses for other traffic, there are several issues that we are continuing to evaluate, and we look forward to reviewing any comments filed by other parties regarding these issues.

*First*, we have concerns with the Board's acknowledgement that SARR training and start-up costs will be understated by using URCS costs to develop SARR operating expenses and the lack of a proposal to include these expenses in a Simplified-SAC analysis. *See NPRM* at 50. We do not have a specific proposal to offer at this time, but we are continuing to evaluate the issue, and we will review carefully any comments filed by other parties addressing this issue.

*Second*, we have concerns with the Board's proposal to calculate SARR equipment expenses based on the historic, book value of equipment purchased by the defendant. *See id.* The Board correctly recognizes that it would be inappropriate simply to use equipment costs as calculated by URCS and that using current costs would be preferable to using historic costs, but it suggests that using current costs would be inconsistent with efforts to simplify the calculation of operating expenses. *See id.* We recognize that the Board has tried to strike a balance between accuracy and simplicity, but we will review carefully any comments filed by other parties that address this issue.

*Third*, we observe that the Board's proposal does not specifically address situations in which the challenged movement traverses trackage rights that the incumbent has over a non-party railroad. Under the Board's proposal, the URCS unit cost for joint facilities, which includes trackage rights costs, would be used to account for trackage rights costs, rather than the actual trackage rights fees. This would be a reasonable approach for most cases under Simplified-SAC because it would eliminate the costs of collecting and analyzing information about actual trackage rights payments without significantly affecting the accuracy of the overall analysis. However, the Board should not foreclose the possibility of using actual trackage rights payments when they would have a significant impact on the result – *i.e.*, when a SARR would use the incumbent's trackage rights for a substantial portion of the route.

#### **8. Discounted Cash Flow Analysis**

UP agrees, pending our review of comments filed by other parties, with the Board's proposal to modify the discounted cash flow analysis to shorten the comparison period to one year.

#### **9. Internal Cross-Subsidy Inquiry**

UP agrees, pending our review of comments filed by other parties, with the principle that the internal cross-subsidiary inquiry set forth in *PPL*,<sup>31</sup> as refined in *Otter Tail*,<sup>32</sup> should apply in any simplified version of SAC.

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<sup>31</sup> *PPL Montana, LLC v. Burlington N. & S.F. Ry.*, STB Docket No. 42054 (STB served Aug. 20, 2002), *aff'd sub nom. PPL Montana, LLC v. STB*, 437 F.3d 1240 (D.C. Cir. 2006).

<sup>32</sup> *Otter Tail* at 11-13.

## 10. Maximum Reasonable Rate

UP agrees with the Board's proposal to use the same maximum rate determination method in cases decided under SAC and Simplified-SAC, as long as the Board continues to use the "percent reduction method" in SAC cases.

The Board is currently reevaluating the appropriate method of maximum rate determination in *Major Issues*. In that proceeding, UP and other parties objected to the Board's proposed new methods and to the various proposals advanced in the comments filed by shippers as inconsistent with the *Guidelines*' rejection of rate regulation based on cost allocations in favor of demand-based, differential pricing principles. Our objections in that proceeding apply with equal force here, and we incorporate them by reference and ask the Board to take notice of them as if they were filed in this proceeding.<sup>33</sup>

Even if the Board were to adopt a method other than the percentage reduction measure for SAC cases, it should still apply the percentage reduction method to cases decided under Simplified-SAC. As BNSF has pointed out, the flaws in the Board's proposed Maximum Contribution Methodology ("MCM") and Maximum Markup Methodology ("MMM") are even more pronounced in the context of Simplified-SAC.<sup>34</sup> Simplified-SAC cases will typically involve a broad range of traffic because the SARR would handle the full mix of traffic handled by the defendant over the route used by the challenged movement – *i.e.*, traffic with widely different cost and demand characteristics. The Board itself has recognized that MCM would not be well-suited to cases that involve a mix of traffic with "differing costs structures per ton-mile,"

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<sup>33</sup> See UP Major Issues Op. at 20-21; UP Major Issues Reply at 4-16; UP Major Issues Reb. at 15-22.

<sup>34</sup> See Supplemental Comments of BNSF Railway Company at 6-10, *Major Issues In Rail Rate Cases*, STB Ex Parte No. 657 (Sub-No. 1) (Oct. 4, 2006).

because “MCM would treat these movements similarly for purposes of their contribution towards the total SAC costs.”<sup>35</sup> MMM would take differing cost structures into account to some degree, but if MMM calculations are based on system-average costs, they may significantly understate the costs of serving certain traffic, including movements of hazardous chemicals and high/wide traffic. *See* pp. 41-43, *infra*. Moreover, MMM and MCM would both entirely fail to account for the variations in demand that exist both across individual movements and across shippers of various commodities, and thus they would prevent defendant railroads from engaging in necessary differential pricing.

Moreover, in *Major Issues*, the Board’s justification for considering methods other than the percentage reduction method was the purely hypothetical concern that a railroad could manipulate its rate for the challenged movement in order to influence the outcome of a SAC test.<sup>36</sup> That scenario is even less plausible for medium-size or small rate cases: a profit-maximizing railroad would not establish rates for its tens of thousands of medium-size and small shipments that are well above market level in order to influence the outcome in potential rate cases. First, such an approach would invite tens of thousands of rate cases. Second, in every instance in which a shipper did not file a rate case or did not win, the railroad would have mispriced the traffic and thus would be earning lower revenues than it otherwise could have earned. Finally, the percentage reduction method would be considerably less complicated and less costly for parties to apply than any of the Board’s proposals in *Major Issues*, and those advantages commend its use as part of Simplified-SAC.

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<sup>35</sup> *Major Issues* at 13.

<sup>36</sup> *See id.* at 7.

## **11. 5-Year Rate Relief**

UP generally agrees, pending review of comments filed by other parties, with the Board's proposal to establish a five-year prescription period and the Board's proposal for calculating the maximum lawful rate for each year within that period. As discussed above, however, the Board should modify its proposal regarding the SARR's configuration to account for capacity additions that the defendant commences or completes during the five-year period.

### **B. Jurisdictional Threshold**

UP supports the concept of simplifying variable cost calculations in medium-size and small rate disputes by prohibiting the use of movement-specific adjustments to URCS system-average costs, with three important reservations that apply to jurisdictional threshold calculations:

*First*, the Board should make clear that it does not intend to depart from precedent by excluding from variable cost calculations defendants' costs associated with payments to third parties or shippers that are not reflected in URCS costs.

*Second*, the Board should allow parties to increase the accuracy of variable cost calculations for the issue traffic by substituting a limited number of readily obtainable and non-controversial movement-specific inputs for values calculated by the URCS Phase III model.

*Third*, the Board should allow parties to increase the accuracy of variable cost calculations for the issue traffic by substituting movement-specific inputs when the challenged movement imposes special costs on the defendant, as is the case for movements of hazardous materials and high/wide traffic.

UP's reservations apply only to jurisdictional threshold calculations. We are not proposing that any movement-specific adjustments to URCS be used to calculate operating costs under the Board's proposed Simplified-SAC analysis – with the exception of operating costs in

cases involving the movement of hazardous materials (*see* pp. 28-29, *supra*) – because of the large number of movements for which adjustments would be required.

Our proposal would not affect the number of disputes that could use Simplified-SAC because the burden of incorporating additional movement-specific adjustments would not be significant and would fall entirely on railroad defendants.

### **1. Payments To Third Parties And Shippers**

The Board's proposal to use unadjusted URCS costs for the jurisdictional inquiry in medium-size and small rate disputes does not address the precedent governing railroads' payments to third parties or shippers that provide services related to the issue traffic. As UP explained in *Major Issues*, the treatment of these payments is often a significant issue in rate cases because railroads frequently make payments to third parties or shippers that are not captured as costs by URCS.<sup>37</sup> In past cases, the Board has recognized that these payments are legitimate expenses that must be included in variable cost calculations. The Board should clarify that it does not intend to change its treatment of these payments for jurisdictional threshold purposes.

The most common situations in which the "payments to third parties" issue is likely to arise in medium-size and small rate cases are those in which the defendant pays a third-party railroad to complete a haul, even though the defendant retains ultimate responsibility for providing the service, or pays the shipper (or its contractor) to perform plant switching at the shipper's facility. In these situations, the costs incurred by the defendant for the services performed by the third party or the shipper are not reflected as expenses in Schedule 410 of its

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<sup>37</sup> See UP Major Issues Op. at 37-40; UP Major Issues Reb. at 41-42.

Annual Report R-1.<sup>38</sup> Because the costs are not reflected in the railroad's Schedule 410, they are not included in its URCS costs. In other words, these payments would be entirely excluded from variable cost calculations that rely solely on the URCS Phase III model.

In many prior cases, the Board has held that these types of payments to third parties and shippers are legitimate costs that must be included in variable cost calculations. *See, e.g., FMC Wyo. Corp. v. Union Pac. R.R.*, 4 S.T.B. 699, 760-61 (2000); *Pub. Serv. Co. of Colo. v. Burlington N. & S.F. Ry.*, STB Docket No. 42057, slip op. at 143 (STB served June 8, 2004); *Carolina Power & Light Co. v. Norfolk S. Ry.*, STB Docket No. 42072, slip op. at 129 (STB served Dec. 23, 2003); *Tex. Mun. Power Agency v. Burlington N. & S.F. Ry.*, 6 S.T.B. 573, 642 (2003); *Pielet Bros. Trading Co. v. Chicago & N.W. Transp. Co.*, ICC Docket No. 39756, slip op. at 3 (ICC served Aug. 11, 1987); *Petition of Denver & R.G.W.R.R. & Salt Lake, G. & W. Ry. for Review of a Decision of the Pub. Serv. Comm'n of Utah Pursuant to 49 U.S.C. 11501*, ICC Docket No. 39060, slip op. at 8-9 (ICC served Nov. 14, 1985), *aff'd in relevant part sub nom. Utah Power & Light Co. v. ICC*, 747 F.2d 721, 740-41 (D.C. Cir. 1984).

UP does not believe that the Board intends to reverse well-established precedent by excluding railroad payments to third parties from jurisdictional threshold calculations. The Board's justification for precluding movement-specific adjustments to URCS – avoidance of the complex, costly, and time-consuming process of making adjustment-by-adjustment inquiries – does not apply to these payments. The parties can readily identify these payments and calculate their effect on variable costs. Moreover, this is not a question of making reasonable trade-offs

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<sup>38</sup> The Board's Uniform System of Accounts instructs railroads to treat these costs as offsets to revenue rather than record them in operating expense accounts. *See* 49 C.F.R. Part 1201, Instructions for Transportation Revenue Account 101.

between accuracy and expense – these payments are not included in URCS, so reliance on URCS will not provide a reasonable approximation of the actual costs involved. Unless these payments are included, the jurisdictional threshold calculations will exclude these “legitimate costs.”<sup>39</sup>

UP’s concern can be illustrated using an example that is familiar to the Board – UP’s lease agreement with Missouri & Northern Arkansas Railroad (“MNA”). Under that lease agreement, UP establishes the line-haul rates for traffic moving to or from the leased lines, and it pays MNA a fixed amount per car to originate or terminate the traffic. UP is the only rail carrier that is a party to the rates. UP’s rates cover the entire route from origin to destination, and UP retains ultimate responsibility for originating or terminating the traffic it interchanges with MNA. Moreover, UP would be obligated to pay the same fixed amount to MNA even if the Board were to prescribe a lower maximum rate, and thus the payment is plainly a cost to UP. In this situation, the Board cannot accurately calculate the jurisdictional threshold without including the cost of UP’s payment to MNA. The only approach consistent with the Board’s proposal to use unadjusted URCS costs would be to develop the variable costs for the services UP provides using the URCS Phase III model and then add to those costs the fee UP pays MNA for handling the traffic on the leased lines.

## **2. Movement-Specific Inputs**

The Board should allow parties to make more accurate jurisdictional threshold calculations by expanding slightly the number of movement-specific inputs that could be used. Specifically, the Board should allow parties to substitute for calculated or system-average inputs three actual operating statistics: (i) number of locomotives, (ii) empty miles, and (iii) tare weight

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<sup>39</sup> *FMC*, 4 S.T.B. at 760.

of cars. The Board should also allow parties to substitute for system-average costs two readily available and potentially significant movement-specific costs: (i) railroad and private line car costs, and (ii) trackage rights payments.

Parties would not be required to make these movement-specific adjustments, and in many cases they may conclude that such adjustments are not worth the time or effort. But in situations in which these adjustments would have a meaningful impact on the result, the parties should be able to agree on each of these elements in short order, particularly with the benefit of staff-supervised technical conferences.

**a) Movement-specific operating statistics**

The concerns that have led the Board to propose a prohibition on movement-specific adjustments to URCS involve the development of movement-specific unit costs (*e.g.*, the maintenance-of-way cost per gross ton-mile on the lines used by the challenged movement), not the development of movement-specific operating characteristics (*e.g.*, the number of gross ton-miles for the challenged movement). *See NPRM* at 15-16 (citing *Major Issues* at 23-27).

The Board could improve the accuracy of its jurisdictional threshold calculations without undermining its effort to simplify and reduce the costs of rate cases if it were to expand slightly the number of movement-specific operating characteristics used to run the URCS Phase III model.

For example, the URCS Phase III model uses locomotive consist size and the total number of loaded and empty miles in a movement as the key operating statistics for calculating locomotive ownership costs, maintenance costs, and fuel costs. However, the user does not directly input these statistics. For consist size, the user inputs the type of movement involved (single-car, unit-train, multiple-car), and the model then assigns the average locomotive consist size for that type of movement, based on operating statistics contained in the defendant's Annual

Report R-1. For miles, the user inputs the number of loaded miles, and the model then calculates the number of empty miles, which is either based on operating statistics from the R-1, or, in the case of unit-train movements, presumed to be the same as the number of loaded miles. The Phase III model, however, can readily accommodate data regarding actual consist sizes and empty miles, which would increase the accuracy of jurisdictional threshold calculations without undermining the Board's proposal to use unadjusted URCS.

UP's proposal is consistent with the Board's effort to simplify jurisdictional threshold calculations. UP can readily produce the data it is proposing to use. Other railroads likely maintain similar information. Moreover, the Board has addressed concerns about the time and expense involved in developing such movement-specific data through its recent rulemaking that created the technical conference process. According to public reports, the new process has been an outstanding success.<sup>40</sup>

Moreover, UP's proposal to use several additional movement-specific operating statistics does not involve departures from system-average unit costs or system-average variability factors. Parties would continue to use those system-average figures – they would simply apply those figures to additional movement-specific operating characteristics.

The use of additional movement-specific operating statistics would only increase the accuracy of the Board's jurisdictional threshold calculations. The Phase III model already allows parties to tailor the variable cost calculation using movement-specific characteristics in a

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<sup>40</sup> See Press Release, Surface Transportation Board, Surface Transportation Board Announces Success of 1st Technical Conference in a Major Rail-Rate Case (July 16, 2003); Press Release, Surface Transportation Board, Surface Transportation Board Announces Success of Technical Conference in a Major Rail-Rate Case (Dec. 19, 2003); Press Release, Surface Transportation Board, Surface Transportation Board Announces Success of Technical Conference in a Major Rail-Rate Case (May 14, 2004).

number of ways, and UP's proposal will further improve the accuracy of those calculations. The Board justifies its reliance on the Phase III model by arguing that Congress placed its stamp of approval on URCS. *See NPRM* at 15 (citing 49 U.S.C. § 10707(d)(1)(B)). But while Congress approved the Board's use of unadjusted URCS *costs* to calculate variable costs, it never suggested that URCS costs could be applied to anything other than the actual operating characteristics of challenged movements.

**b) Movement-specific operating costs**

UP recognizes that its proposal to use actual car rental costs and trackage rights payments for jurisdictional threshold calculations does involve the substitution of actual costs for system-average costs. Nevertheless, there are important reasons to allow these two modest departures from the use of system-average URCS costs.

The inclusion or exclusion of actual car rental costs can have a dramatic effect on variable cost calculations.<sup>41</sup> The issue arises because the calculation of the URCS system-average unit cost for car rental does not distinguish between movements for which railroads pay car rental costs and those for which they do not. Instead, URCS calculates system-average unit costs for car rental as though every movement on a railroad in a particular car type is responsible for a proportionate share of the carrier's total rental costs for cars of that type. Consequently, the URCS system-average unit costs for car rental systematically understate the car rental costs of movements for which a railroad actually pays car rental costs, and conversely, overstate the car rental costs on zero-mileage rates. The understatement can be significant when a railroad pays car rental on only a small portion of the cars of a particular type, or when rental costs differ

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<sup>41</sup> *See FMC*, 4 S.T.B. at 760; Petition of BP Amoco Chemical Co. To Clarify Scope of Proceeding, Or To Broaden It at 3, *Major Issues In Rail Rate Cases*, STB Ex Parte No. 657 (Sub-No. 1) (Mar. 27, 2006).

significantly among sub-types of equipment within each car type, as is the case for tank cars. Use of system-average car rental costs would be a reasonable approach for developing the total costs of handling a cross-section of a railroad's traffic, which is what the Board is proposing to do with respect to the operating cost component of Simplified-SAC, but it would not be a reasonable or rational approach for calculating the jurisdictional threshold for a single challenged movement.

In light of Board precedent, use of actual car rental costs in jurisdictional threshold calculations is not a controversial issue. Indeed, the use of actual car rental costs has been the generally accepted practice.<sup>42</sup> Moreover, the parties will readily be able to agree upon the existence and amount of car rental costs paid in connection with the challenged movement, and use of actual car rental costs will significantly increase the accuracy of jurisdictional threshold calculations.

A similar issue can potentially arise when the defendant pays a trackage rights fee to operate the challenged movement over the lines of a non-defendant railroad. As discussed above at page 30, this would not be a problem in most cases. However, if the challenged movement uses long segments of trackage rights, the URCS system-average cost for joint facilities might significantly understate the trackage rights payments that are actually related to the challenged movement.

In light of Board precedent, use of actual trackage rights payments in jurisdictional threshold calculations is not controversial.<sup>43</sup> The parties will readily be able to determine the existence and amount of any trackage rights fees paid in connection with the

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<sup>42</sup> See *FMC*, 4 S.T.B. at 760.

<sup>43</sup> See *Xcel Energy* at 144-45.

challenged movement, and use of actual payments in cases involving the use of substantial trackage rights will significantly increase the accuracy of jurisdictional threshold calculations.

### **3. Hazardous Materials And High/Wide Traffic**

The Board should allow parties to make more accurate jurisdictional threshold calculations for movements of hazardous materials and high/wide traffic by permitting them to submit evidence regarding the special costs associated with such atypical and higher-than-average-cost movements. Unless railroads can include these special costs in jurisdictional threshold calculations, they may find themselves significantly under-compensated for some of the most costly traffic they handle.

High/wide movements are movements of large pieces of what is usually high-value equipment, such as transformers, generators, and boilers for electrical generating plants and certain types of farm and construction equipment and aircraft parts. These movements occur relatively infrequently, but they involve significant costs when they do occur, and those costs far exceed those that would be calculated using the Phase III model. For example, some high/wide shipments require movement in special dedicated trains because of shipment size and the speed restrictions placed on trains carrying these large items. The need to use special trains and employ speed restrictions not only increases the costs of the high/wide movement itself, but also adds to congestion and causes delay and disruption to other traffic. For example, trains may not be able to move over adjacent track while a high/wide shipment is en route. High/wide traffic also imposes special costs even when not moved in a dedicated train. For example, high/wide traffic moving in manifest train service will incur above-average switching costs because it generally cannot be automatically classified over a hump but instead must be manually switched from train to train. High/wide traffic also requires extra switching in order to comply with operating procedures governing the placement of high/wide traffic at an appropriate position

within a train. High/wide movements also require pre-clearance over a specified route to ensure that the track can handle the weight and that the shipment can pass over, under, or through bridges, overpasses, and other track structures.

Movements of hazardous materials also involve costs that far exceed those that would be calculated using the Phase III model. Railroads have an extraordinary record of transporting hazardous materials safely, and they devote considerable resources to ensuring that hazardous materials are transported as safely as possible. UP pays to train not only its own employees, but also public safety employees in the communities it services, about operating and safety procedures that apply to movements of hazardous materials. In addition, UP personnel monitor time-sensitive shipments of volatile substances, track hazardous materials movements, assess the quality of the track structure in locations traversed by heavy volumes of hazardous materials, and perform a range of other activities that would be understated by utilizing system-average URCS costs. Besides all of the existing efforts UP undertakes to protect the public, its employees, and its property from a safety incident, the Department of Homeland Security, the Federal Railroad Administration, and other government agencies are proposing numerous additional measures that would impose additional costs.

Moreover, despite comprehensive safety efforts, railroads face the risk that hazardous material incidents could lead to staggering losses. Rail rates should reflect these risks, both to compensate railroads for taking them and to ensure that the rates are not subsidizing, and therefore unduly encouraging, rail transportation of hazardous materials. In past decisions, the agency has recognized that “susceptibility to loss or damage is a cost factor to consider in

determining the reasonableness of rates.”<sup>44</sup> The Phase III model, however, does not recognize the special risks and associated costs that apply to movements of hazardous materials.

UP has not yet developed specific proposals to account for the special costs associated with movements of hazardous materials and high/wide traffic, and we cannot know whether such movements will ever be at issue in a rate case. The Board, however, should not adopt rules that would foreclose parties from addressing these costs should the issue ever arise.

### **C. Procedural Schedule**

UP does not object to the proposed procedural schedule, except with respect to cases in which the complaint seeks a partial revocation of an exemption in order to challenge a rate, which are discussed below in Part V.

Although UP does not object to the proposed schedule, we believe that most cases could be completed in less time and with fewer filings than the proposed schedule allows. We suggest that the Board consider a schedule that includes two rounds of simultaneous evidentiary filings rather than three, with a technical conference between the first and second rounds. Our proposed approach would shorten the proposed schedule by more than a month and allow the reply rounds to focus more usefully on the key issues in dispute.

Our suggestion reflects a fundamental difference between a full SAC case and a case under Simplified-SAC. A full SAC case requires three rounds of evidence on stand-alone issues because the defendant must await the shipper’s opening evidence regarding configuration and traffic selection before it can file a reply, and then the shipper is entitled to file rebuttal. Under Simplified-SAC, there would be no question about configuration and traffic selection

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<sup>44</sup> *Nationwide Increased Freight Rates & Charges*, 1977, 359 I.C.C. 312, 335 (1978).

because the rules would require the shipper to replicate the defendant's actual infrastructure and operations. Thus, there should be no reason why both parties could not simultaneously prepare opening evidence on variable cost and stand-alone issues, participate in a technical conference to narrow their disagreements, and then file simultaneous reply evidence.

We also suspect that other opportunities to shorten the schedule might become apparent as parties gain more experience with Simplified-SAC.

#### **D. Discovery**

UP does not object to the discovery that defendant railroads would be required to provide to complainants under Simplified-SAC. However, the Board should recognize that the proposed discovery rules will tend to encourage litigation because they place almost the entire cost burden on railroads, and it should take steps to counteract that tendency. We therefore outline several proposals that would help counteract the incentive shippers would have to invoke the regulatory process before exhausting reasonable efforts to reach a negotiated resolution. We also propose two minor modifications to the Board's specific proposals regarding railroad and complainant disclosures.

##### **1. Proposals For Avoiding Misuse Of The Regulatory Process**

UP does not object to the substance of the discovery requirements proposed by the Board. We are deeply concerned, however, that the Board's proposals would require the defendant to bear nearly all of the burdens of conducting a case under Simplified-SAC, thereby creating a no-lose situation for shippers deciding whether or not to invoke the regulatory process.

Under the Board's proposals, the defendant must identify all of the traffic that moved over the route replicated by the SARR, provide volume and revenue information about each of those movements, calculate operating and equipment costs for each of those movements, calculate revenue allocations for each cross-over movement, and provide all of this information

to the complainant. The defendant also must produce almost all of the information required to calculate road property investment. The disproportionate allocation of burdens will tend to encourage litigation, and it might even be used as leverage against railroads in negotiations. Moreover, the disproportionate allocation of burdens may chill railroads from setting rates at levels that would provide needed revenue and ultimately be found reasonable but that might prompt challenges.

The Board should take several steps to counteract the incentives that otherwise would exist for shippers to bring an unlimited number of cases under Simplified-SAC:

*First*, the Board should implement a system of mandatory mediation that must run its course before discovery could proceed beyond the initial disclosure stage. We refer the Board to Part VI of our comments and to the AAR's Opening Comments for a more detailed discussion of mandatory mediation issues.

*Second*, the Board should rule on petitions for partial revocation of exemptions before requiring defendants to proceed with disclosures other than those related to jurisdictional threshold calculations. As discussed below in Part V, a ruling early in the proceeding would be more consistent with the congressional mandates to minimize regulation and to exempt classes of traffic from regulation "to the maximum extent" when continuing regulation is not necessary, 49 U.S.C. §§ 10101(2), 10502(a).

*Third*, the Board should limit the number of cases that could be brought under Simplified-SAC by adhering to its proposed eligibility criteria, and particularly its proposed claim aggregation rule. We address eligibility criteria in more detail below in Part IV.

*Fourth*, the Board should adopt the proposal set forth in the AAR's Opening Comments that the losing party pay all costs associated with discovery.

## **2. Proposed Minor Changes to Disclosure Requirements**

The Board should make two minor changes to the parties' initial disclosure requirements:

*First*, the Board should require parties to include in their initial disclosures all workpapers sufficient to show how they derived the inputs to the Phase III model, rather than "all documents that [they] relied upon." *NPRM* at 18. We agree with the Board's proposal to require this disclosure early in the proceeding, but we see no need for parties to produce any more or less than the type of workpapers that parties produce to support their variable cost calculations in full SAC proceedings.

*Second*, the Board should require the complainant to include in its initial disclosures "all documents relating to any feasible transportation alternative for the challenged movement," rather than "all documents relied upon in formulating [its] assessment" of feasible transportation alternatives. *Id.* at 18. Under the current proposal, the complainant could avoid disclosing relevant documents regarding feasible transportation alternatives by not "relying" on them "in formulating [its] assessment." We do not believe that the Board intended to create this loophole, particularly because transportation alternatives will likely play a much more significant role in medium-size and small rate cases than they have in the coal cases that have been brought under the full SAC test.

### **E. Reality Checks To Avoid Obvious Errors And Unfairness**

Simplified-SAC, even if modified in accordance with our suggestions, will always be less precise than a full SAC test. The Board should therefore remain open to evidence that the application of Simplified-SAC in a particular case has produced a result that is plainly flawed or illogical – for example, a result that would require a defendant to provide high-cost or high-risk

service, such as transportation of hazardous chemicals or high/wide traffic, at a rate below the market rate for similarly situated but less costly services.

We cannot catalogue all the ways in which a party might provide a reality check to the results produced by Simplified-SAC – the Board would have to consider evidence that a party submits on a case-by-case basis. For example, a defendant might demonstrate that it was also charging the challenged rate to a shipper in the same geographic region that had effective competition from other rail carriers or modes of transportation for the transportation to which the rate applies. In such a case, the Board would be committing clear error if it reduced the rate for the shipper that was able to invoke the regulatory process below the rate for the shipper that could not seek relief, because it would be setting a “reasonable” rate below an actual competitive rate when the whole point of the SAC analysis is to “produce[] a simulated competitive rate against which [to] judge the challenged rate.” *NPRM* at 6.

The Board should require parties to satisfy a high standard of proof before it disregards results obtained under Simplified-SAC, but if the results are obviously wrong, the Board would have no rational basis for prescribing a maximum rate based on the flawed result.

### **III. BENCHMARK METHOD**

The Board should not adopt the proposed Benchmark method for small rate cases. In *Simplified Guidelines*, the Board acknowledged that it cannot rely on formulaic applications of revenue-to-variable cost (“r/vc”) benchmarks to regulate rates. The Board examined each of the benchmarks it proposes to use in the new Benchmark method and concluded that “none of the r/vc measures alone provides a sufficient, all-purpose test of rate reasonableness, and that, even in combination, these measures can only provide a starting point for what must become a more

particularized analysis.”<sup>45</sup> Although the Board claims in the *NPRM* that its Benchmark proposal simply “retains the method of *Simplified Guidelines* with certain modifications and refinements,” *NPRM* at 3, the new proposal is what the Board expressly rejected in *Simplified Guidelines* – a formulaic application of r/vc benchmarks – and it suffers from the same basic flaws as all r/vc benchmark tests that have previously been considered and rejected by the Board and by the courts.

The Board should abandon efforts to develop a formulaic r/vc benchmark method for small rate cases and instead apply Simplified-SAC. In *Simplified Guidelines*, the Board justified use of r/vc benchmarks on the ground that CMP was not “susceptible to adequate simplification without losing its effectiveness.”<sup>46</sup> That justification no longer exists now that the Board has concluded that “it is now possible to craft a Simplified-SAC approach.” *NPRM* at 10. If the Board gives appropriate consideration to the incremental costs of applying Simplified-SAC in relation to the sacrifice of quality inherent in applying the Benchmark method, it will conclude that Simplified-SAC should be the standard in all cases in which a full stand-alone cost presentation is too costly given the value of the case.

If the Board persists in pursuing an approach to rate regulation that involves r/vc benchmarks, it still should not adopt the Benchmark method, at least not without making several changes to help ensure that the method more closely achieves the stated objective of comparing the r/vc ratios of truly comparable traffic. We describe those changes below.<sup>47</sup>

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<sup>45</sup> *Simplified Guidelines*, 1 S.T.B. at 1020.

<sup>46</sup> *Id.* at 1021.

<sup>47</sup> The discussion below focuses on substantive issues. With respect to discovery, we commend the Board for proposing to limit discovery. We offer only two suggestions. First, the Board should make the same minor changes to the disclosure requirements that were discussed (continued...)

**A. The Board Should Apply Simplified-SAC To All Rate Cases In Which A Full SAC Presentation Is Too Costly Given The Value Of The Case.**

The Board's adoption of Simplified-SAC, with the modifications described above, would fully satisfy Congress's directive that the Board establish a simplified and expedited method for challenging rail rates in those cases in which a full stand-alone cost presentation is too costly, given the value of the case. 49 U.S.C. § 10701(d)(3). The Board apparently believes that an even lower-cost method is required for very small cases, but it has not correctly evaluated whether the Benchmark method would in fact be a lower-cost method or whether any added costs of applying Simplified-SAC would outweigh the sacrifice in quality inherent in the Benchmark method.

**1. The Cost To A Shipper Of A Benchmark Case Would Be Similar To The Cost Of A Simplified-SAC Case.**

The Board has not correctly evaluated the cost to shippers of applying Simplified-SAC because it fails to recognize that most of the costs will be borne by the defendant railroad. In fact, Simplified-SAC will impose relatively low costs on shippers, and those costs will be comparable to the costs that would be imposed on shippers under the Benchmark method.

In the *NPRM*, the Board concluded that shippers could not use Simplified-SAC in cases with a maximum value less than \$200,000. The Board based the \$200,000 figure on 1996 testimony of witnesses representing the railroad industry that it would be possible to conduct a simplified SAC analysis for between \$25,000 and \$85,000. *NRPM* at 36. The Board apparently

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above in connection with Simplified-SAC. *See* p. 46, *supra*. Second, the Board should limit the parties to a total of twenty document requests and interrogatories, but provide them with the flexibility to divide the requests as they see fit, rather than specify that they have ten of each. *See NPRM* at 31.

increased the amount to \$200,000 to reflect inflation and its belief that the \$25,000-85,000 estimate did not include the costs of counsel or discovery. *Id.*

In fact, Simplified-SAC should cost a shipper significantly less than \$200,000. The \$25,000-85,000 range that the Board used to establish the \$200,000 floor included all of the costs necessary to obtain and process the required data and perform the required analyses.<sup>48</sup> Under the Board's proposal, however, the shipper would bear almost none of those costs. Under the Board's proposal, the defendant would bear the vast majority of the costs of Simplified-SAC. The defendant would be required to "develop and provide to the shipper key cost and revenue division information." *NPRM* at 36. The defendant would thus bear the cost of identifying the traffic that moves on the SARR, *id.* at 18; the cost of calculating operating and equipment costs for each movement on the SARR, *id.*; and the cost of calculating revenue divisions for cross-over traffic, *id.* at 18-19. The only significant task left for the shipper would be to develop the road property investment units, to which it would apply rolling-average costs developed by the Board. The shipper would thus bear only a small fraction of the costs included in the original \$25,000-85,000 estimate.

The *NPRM* provides no estimate of the cost to a shipper of using the Benchmark method, but it likely would be similar to the cost of using Simplified-SAC. The Board adjusted the \$25,000-85,000 estimated cost of applying Simplified-SAC to include the cost of counsel and the costs of discovery, but the costs of counsel and discovery should be similar under both the Benchmark method and Simplified-SAC. A shipper would have the same obligation to make

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<sup>48</sup> See Reply Comments of the Association of American Railroads, Reply Verified Statement of Craig F. Rockey & John C. Klick at 20-26, *Rate Guidelines – Non-Coal Proceedings*, STB Ex Parte No. 347 (Sub-No. 2), (Mar. 19, 1996).

initial disclosures regarding variable costs under both methods. *Compare NPRM* at 18 with *id.* at 31. A shipper also would have the same obligation to make disclosures about market dominance issues under both methods. *Compare id.* at 18 with *id.* at 31. A shipper invoking the Benchmark method also would be subject to discovery and motions to compel. *Id.* at 31-32. Moreover, a shipper invoking the Benchmark method would have to hire consultants and counsel to analyze Waybill Sample data to propose a comparison group, analyze the comparison group proposed by the defendant, participate in a technical conference to discuss the comparison groups, prepare a final comparison group, and then calculate the resulting rate. *Id.* at 20. In sum, the Benchmark method imposes different obligations on shippers than Simplified-SAC, but there is no basis for assuming that a shipper's costs would be significantly lower than they would be under Simplified-SAC.<sup>49</sup>

**2. The Board Would Have To Balance Any Savings From The Benchmark Method Against The Loss Of Accuracy.**

Even if the Board were to determine that the Benchmark analysis would be a lower-cost approach for the shipper than Simplified-SAC, that determination alone would not justify adoption of the Benchmark method. The Board would still have to weigh any cost

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<sup>49</sup> The Board also contends that the Benchmark method has an additional positive attribute in that it would allow shippers "to make an informed estimate of possible outcomes before filing a complaint." *NPRM* at 25. We disagree. The outcome of a case under the Benchmark method would depend almost entirely on the selection of a comparable traffic group, but the Board has provided the parties with little guidance as to how it would make its selection. Moreover, rate reasonableness findings in past cases would provide little guidance for future cases because, as the Board points out, even with respect to a movement used in a particular comparison group, if the rate for that movement were challenged, that movement's "comparison group would almost certainly be different." *Id.* at 27 n.47. Finally, a shipper could not make an informed estimate of possible outcomes without information about how its rate compares to other rates, but the Board would not release Waybill Sample data until after the shipper has filed a complaint and would not reveal unmasked revenues until the end of the proceeding. *See id.* at 32-33.

savings against the loss of accuracy.<sup>50</sup> The Board has implicitly recognized that there is a significant trade-off involved as one moves from SAC to Simplified-SAC to the Benchmark method. The Board states that “CMP, with its SAC constraint, continues to be our preferred and the most accurate procedure available.” *NPRM* at 9. Simplified-SAC is thus viewed as less accurate than SAC, and the Benchmark method is viewed even less favorably, as a last-ditch approach to be used only “where the value of the case cannot justify even the cost of a Simplified-SAC presentation.” *Id.* at 9.

Despite being aware of the trade-offs, the Board never balances the cost savings against the loss of accuracy inherent in its proposed simplified methods, particular as between Simplified-SAC and the Benchmark method. Congress required the Board to develop a method that is less costly than SAC, and the Board responded by proposing Simplified-SAC. The Board, however, never justifies adopting an additional, even less-accurate approach with only a tenuous connection to CMP principles. This is striking, particularly given the Board’s prior conclusion that a formulaic approach would create too much conflict with the national rail transportation policy, and given Congress’s statement that it did “not intend to erode the Constrained Market Pricing principles adopted by the ICC for full stand-alone cost presentations.”<sup>51</sup>

**B. The Benchmark Method Suffers From The Same Flaws As Previously Rejected R/VC Benchmark Approaches.**

The Board is undoubtedly aware of the many criticisms that have been leveled against the use of formulaic r/vc benchmark approaches to rate regulation, and it would serve little purpose to repeat them in these Comments. The same fundamental criticisms have been

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<sup>50</sup> See *Burlington N.R.R. v. ICC* (“*BN v. ICC*”) 985 F.2d 589, 599 (D.C. Cir. 1993).

<sup>51</sup> S. Rep. No. 176, 104th Cong., 1st Sess. 8 (1995).

offered by parties in agency proceedings,<sup>52</sup> by courts,<sup>53</sup> and most recently, by the Board itself.<sup>54</sup>

In fact, in *Simplified Guidelines*, the Board rejected what is being proposed in the *NPRM* – the formulaic application of three r/vc benchmarks – explaining that “even in combination, these measures can only provide a starting point for what must become a more particularized analysis.”<sup>55</sup>

In the *NPRM*, the Board reverses its prior position and attempts to justify that shift by pointing to three features that purportedly distinguish the current proposal from other formulaic approaches it has rejected: (i) it applies only to small rate disputes, (ii) it incorporates a new adjustment to the mean r/vc ratio of the comparison group to serve as a “revenue-need adjustment factor,” and (iii) it incorporates the use of a “confidence interval” around the adjusted mean r/vc ratio of the comparison group. *NPRM* at 28 n.49.

We have already addressed the Board’s first justification and explained in detail why the Board has not adequately justified using the Benchmark method rather than Simplified-SAC based on the amount in dispute. Moreover, the Board cannot lightly dismiss the potential harm to railroads from the application of a flawed rate reasonableness method in small rate cases. The Board’s own estimate shows that twenty-five percent of the traffic presumed eligible for a

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<sup>52</sup> See, e.g., Opening Comments of the Association of American Railroads at 38-55, *Rate Guidelines – Non-Coal Proceedings*, STB Ex Parte No. 347 (Sub-No. 2), (Feb. 20, 1996); Reply Comments of the Association of American Railroads at 15-18, 28-29, 31-35, *Rate Guidelines – Non-Coal Proceedings*, STB Ex Parte No. 347 (Sub-No. 2), (Mar. 19, 1996); Comments of the Association of American Railroads at 45-67, *Rate Guidelines – Non-Coal Proceedings*, STB Ex Parte No. 347 (Sub-No. 2), (July 31, 1987).

<sup>53</sup> See *BN v. ICC*, 985 F.2d at 597-99.

<sup>54</sup> See *Simplified Guidelines*, 1 S.T.B. at 1019-39.

<sup>55</sup> *Id.* at 1020.

simplified approach – that is, traffic generating approximately \$1.33 billion in revenues – would be presumed eligible to use the Benchmark method. *NPRM* at 37.

In the next two sections, we explain why the Board’s proposed use of a “revenue-need adjustment factor” and a “confidence interval” do not justify the Board’s change of heart.

**1. The Board’s Use Of A “Revenue-Need Adjustment Factor” Does Not Remedy The Fundamental Problems Inherent In R/VC Benchmarks.**

The Benchmark proposal is based on the R/VC<sub>COMP</sub> test that the Board adopted as one of its three r/vc benchmarks in *Simplified Guidelines*.<sup>56</sup> Under R/VC<sub>COMP</sub>, a challenged rate is deemed unreasonable if it produces an r/vc ratio that is above the mean r/vc ratio for a group of traffic that is purportedly comparable to the issue traffic. The mean r/vc ratio for the comparison group thus becomes the maximum allowed for the issue traffic.

The Board’s proposal to add a “revenue-need adjustment factor” to R/VC<sub>COMP</sub> does not address the fundamental problem with R/VC<sub>COMP</sub>. The fundamental problem with R/VC<sub>COMP</sub> is that railroads are supposed to set individual rates at varying levels based on each movement’s unique demand characteristics. Thus, there is no principled basis for concluding that a rate is unreasonably high simply because it produces an r/vc ratio that falls above the mean r/vc ratio for some group of supposedly comparable traffic. In the words of an economics expert who has testified for shippers in rate cases, R/VC<sub>COMP</sub> “provides no economic principle, no

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<sup>56</sup> Although the Board claims that it is retaining the approach it adopted in *Simplified Guidelines*, it is actually proposing to recalculate the RSAM and R/VC<sub>>180</sub> benchmarks and eliminate the independent roles they played under *Simplified Guidelines*. Under the Board’s proposed rules, the new RSAM and R/VC<sub>TOTAL</sub> figures would be used only to adjust the average markup determined using R/VC<sub>COMP</sub>; they would no longer serve as independent benchmarks of the appropriate degree of differential pricing, as was contemplated in *Simplified Guidelines*.

theoretically definable test” against which a rate “can in principle be objectively assessed.”<sup>57</sup>

In fact, as the D.C. Circuit observed in reversing the ICC’s decision to apply  $R/VC_{COMP}$  in *BN v. ICC*, if the challenged rate produces an  $r/vc$  ratio above the mean  $r/vc$  ratio for a comparison group, the logical conclusion is not that the rate for the issue traffic is unreasonably high; instead, “it seems most probable that the transportation and demand characteristics of the two groups are in fact different.”<sup>58</sup>

The Benchmark test would differ from  $R/VC_{COMP}$  only in that the  $r/vc$  ratio for each movement in the comparison group would be adjusted by a “revenue-adjustment need factor” – a ratio calculated as  $RSAM \div R/VC_{TOTAL}$ . *NPRM* at 25. The new revenue-need adjustment factor addresses a practical problem with  $R/VC_{COMP}$ :  $R/VC_{COMP}$  will tend to perpetuate the inadequate rate structure of carriers that have not achieved revenue adequacy because it inherently presumes that, where comparison traffic is priced below the issue traffic, the issue traffic is overpriced, rather than that the comparison traffic is underpriced.<sup>59</sup> Under the proposed Benchmark approach, if the defendant is revenue inadequate, the Board would not presume that the mean  $r/vc$  ratio for the comparison group reflects the maximum lawful rates the defendant could charge for those movements. Instead, it would presume that the defendant could

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<sup>57</sup> *BN v. ICC*, 985 F.2d at 598 (quoting Verified Statement of Alfred Kahn, Sept. 30, 1987 at 4 in *McCarty Farms, Inc. v. Burlington N., Inc.*).

<sup>58</sup> *Id.* at 597. Indeed, the Board adopts that same logic elsewhere in the *NPRM*, particularly when it explains that differences in  $r/vc$  ratios observed for movements within the comparison group “reflect inevitable differences between movements.” *NPRM* at 27.

<sup>59</sup> See *Simplified Guidelines*, 1 S.T.B. at 1035-36.

lawfully charge more for those movements, and that “the adjusted r/vc ratios would fairly reflect the maximum lawful rates the carrier could charge.” *NPRM* at 27.<sup>60</sup>

However, the Benchmark test, even with the inclusion of the new revenue-need adjustment factor, still suffers from the same fundamental flaw as  $R/VC_{COMP}$  because it still caps the challenged rate based on rates for traffic with different demand characteristics. Application of the revenue-need adjustment factor would allow a revenue inadequate carrier to set rates slightly higher than if the adjustment factor were not applied, but it would not provide a more principled basis for concluding that those rates actually reflect an appropriate maximum rate.<sup>61</sup>

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<sup>60</sup> The Board does not attempt to justify its presumption that application of the revenue-need adjustment factor to traffic in the comparison group would produce “adjusted r/vc ratios [that] would fairly reflect the maximum lawful rates the carrier could charge.” *NPRM* at 27. The Board tries to avoid a fight over the validity of the revenue-need adjustment factor by describing it as “a crude adjustment,” but it does not even merit that characterization. *Id.* The Board has no objective basis for assuming that a revenue-inadequate carrier could lawfully raise rates for traffic in the comparison group by no more than the amount calculated by the revenue-need adjustment factor. It also has no objective basis for assuming that a revenue inadequate carrier could lawfully raise rates for traffic in the comparison group but not for the challenged movement as well. (In fact, such a presumption is logically inconsistent with the Board’s more general assumption that “all movements in the comparison group should be similar to the issue movement.” *Id.*) The revenue-need adjustment factor is a wholly artificial tool that removes the Benchmark method one step further from any link to objective reality and highlights the lack of objective factors in the Board’s analysis.

<sup>61</sup> Even if the adjusted r/vc ratio reflected the maximum lawful rates a carrier could charge, the fact that the challenged rate was above the mean would still be irrelevant. The fundamental notion of differential pricing is that railroads will set different rates to reflect different demand characteristics. By definition, some shippers will have above-average r/vc ratios, and one will always have the highest r/vc ratio. There is no logical basis for holding that a challenged rate is unreasonable simply because it has an above-average, or even the highest, r/vc ratio. Rate reasonableness must be determined by some measure other than by reference to other rates.

The Board contends that it is justified in choosing the average because it is “an obvious place to begin when there is no information that would incline the decision-maker to prefer one estimate over another.” *NPRM* at 27 (quoting *Tenn. Gas Pipeline Co. v. FERC*, 926 F.2d 1206, 1213 (D.C. Cir. 1991)). However, there is information that should incline the Board to respect a railroad’s decision to price the challenged movement higher than supposedly comparable traffic: “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 (continued...) ”

In fact, in many respects, it is a less principled approach than  $R/VC_{COMP}$  because it introduces another baseless assumption into the analysis – the assumption that “the adjusted  $r/vc$  ratios would fairly reflect the maximum lawful rates the carrier could charge.” *NPRM* at 27.<sup>62</sup>

**2. The Board’s Use Of A “Confidence Interval” Around The Mean Of The Comparison Group Does Not Remedy The Fundamental Problems Inherent In  $R/VC$  Benchmarks.**

The Benchmark test would be different from  $R/VC_{COMP}$  not only because it uses adjusted  $r/vc$  ratios for the comparison group, but also because the challenged rate would not be deemed unreasonable if it fell within “a reasonable *confidence interval* around the estimate of the mean for the adjusted comparison group.” *NPRM* at 26 (emphasis added). However, application of a confidence interval does not address the fundamental problem with  $R/VC_{COMP}$ . The Board is apparently proposing to apply a confidence interval because the comparison group will be drawn from the Waybill Sample, and thus it will be only a sample of all traffic that might be considered comparable to the challenged movement. *NPRM* at 26 n.46. However, the fundamental problem with  $R/VC_{COMP}$  has nothing to do with the level of confidence in how accurately one can calculate the mean  $r/vc$  ratio of the comparison group; the fundamental problem is that the mean  $r/vc$  ratio of the comparison group provides no objective basis for determining whether the rate for the challenged movement is unreasonably high.

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correctly – that the issue traffic either costs more to transport or has a less elastic demand.” *BN v. ICC*, 985 F.2d at 597.

Moreover, the Board cannot plausibly justify a decision not to depart from an average by claiming lack of information when the lack of information results from a self-imposed handicap. The Board has previously encouraged parties to supplement benchmark evidence “with specific evidence as to why the markup on the traffic at issue should be higher or lower than that of the comparison traffic.” *Simplified Guidelines*, 1 S.T.B. at 1034. In the *NPRM*, the Board is not proposing to use an average because such evidence does not exist; it is proposing to use an average because it does not want to consider evidence that might support a departure.

<sup>62</sup> See note 60, *supra*.

**C. The Benchmark Method Could Not Even Be Used To Develop Relevant Rate Comparisons Without Significant Modifications.**

If the Board decides to adopt a formulaic r/vc benchmark approach despite the many acknowledged problems associated with such an approach, the Board should, at the very least, modify its proposal in several respects to better ensure that the challenged rate is in fact compared to rates for truly comparable traffic.

**1. The Board Must Address The Effects Of Rate Changes Over Time Within The Comparison Group.**

The Board must modify its Benchmark proposal to address the fact that current rates charged for comparison group movements may not be reflected in the Waybill Sample.

Under the Benchmark method, the challenged movement's r/vc ratio would be compared with the adjusted mean r/vc ratio for the movements in the comparison group. That comparison involves a potentially significant disconnect, however, because the r/vc ratio for the challenged movement would be based on the rate currently in effect, while the mean r/vc ratio for movements in the comparison group would be based on rate data drawn from the Waybill Sample. *NPRM* at 32-33. This is a potentially significant problem because the rates for comparison group traffic will often be outdated by the time the Waybill Sample data are available.<sup>63</sup> In fact, in recent years, Waybill Sample data have typically not been made available until September or October of the year after the sample year. Thus, unless the Board corrects this problem, a challenge to a rate set in June 2007 could potentially be analyzed based on rates that had not been available in the market since January 2005.

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<sup>63</sup> We presume that the Board could account for changes in variable costs over time by applying a recognized cost index, such as RCAF-A. However, we are not aware of a similar index that could be applied to rates.

We do not believe there is any justification for setting maximum rates based on the rates for comparable traffic, but even if there were any conceivable justification for doing so, it would vanish entirely if the rates for comparable traffic are not the current market rates. The Board's regulations must allow railroads to set rates that reflect current market conditions and forward-looking investment and operating costs. Current rates reflect a railroad's assessment of those conditions and costs, and use of outdated rates would be inappropriately backward-looking and could prevent railroads from setting rates in response to conditions that currently affect the transportation market.

**2. The Board Must Not Include Non-Defendant Traffic In The Comparison Group.**

The Board must modify its Benchmark proposal so that the reasonableness of a defendant's rates would not depend on rates charged by non-defendants.

The Board's Benchmark proposal contemplates that the reasonableness of the defendant's rates might be assessed based on rates for supposedly comparable traffic movements that include traffic moving on non-defendant carriers. *NPRM* at 25 n.45. The Board proposes to address the issues that arise from mixing defendant and non-defendant traffic by applying to each movement the revenue-need adjustment factor for the carrier involved in the movement. *Id.*

The Board's proposal is insufficient to address the many problems associated with using non-defendant rates to assess the reasonableness of a rate charged by the defendant. The Board's proposal implies that the maximum reasonable rate for each movement depends solely on the movement's cost and demand characteristics. However, whether a defendant's rate for a particular movement is reasonable depends not only on the movement's characteristics, but also on the characteristics of the defendant railroad, particularly its revenue needs and mix of traffic. If the defendant has to cover high fixed and common costs, it must be allowed to charge higher

rates for the same traffic than a railroad without the same high fixed and common costs; if the defendant has few high-demand shippers, it must be allowed to charge those shippers higher rates for the same traffic than a railroad that is able to spread its fixed costs among a larger group of high-demand shippers.

In other words, even if the Board's revenue-need adjustment factor had any merit, application of the adjustment to a non-defendant's rate would reveal only the lawful maximum rate that could be charged by the non-defendant – a rate completely distinct from the maximum that a different railroad with different revenue needs and a different mix of shippers could lawfully charge for a movement, even if the traffic shared the exact same movement characteristics.

In *Simplified Guidelines*, the Board acknowledged the role that carrier-specific factors play in determining whether a particular rate is reasonable:

“[T]he correct Ramsey pricing level is a factor not only of demand elasticity, but of railroad-specific elements as well. The railroad-specific variables include the particular revenue requirements of each carrier and the available revenue contribution from other sectors of each carrier's traffic base.”<sup>64</sup>

The Board addressed this problem in *Simplified Guidelines* by instructing parties to bring the issue to the Board's attention in individual cases so that the Board could either exclude the traffic or find a way to adjust for railroad-specific differences in its analysis.<sup>65</sup>

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<sup>64</sup> *Simplified Guidelines*, 1 S.T.B. at 1036 (footnote omitted); see also *id.* at 1033-34 (“How a particular carrier's revenue requirements can and should be allocated within its traffic base – *i.e.*, the proper markup to be applied to individual traffic components – is affected by such factors as the mix of competitive and captive traffic handled by that carrier, the degree of competition that it faces on its competitive traffic, and the relative density of the routes that it operates.”).

<sup>65</sup> *Id.* at 1036.

The Board's Benchmark proposal does not even leave room for parties to raise the issue and present relevant evidence in a particular case, much less for the Board to develop and apply some type of appropriate adjustment to its formulaic result. Under these circumstances, it would be inappropriate to include non-defendant movements in any comparison group.

**3. The Board Must Allow Parties To Submit Any Relevant Evidence To Ensure That Comparison Group Traffic Is Actually Comparable To The Issue Traffic.**

The Board must modify its Benchmark proposal to allow parties to submit any relevant information that would help the Board select the most appropriate comparison group.

The Board's Benchmark proposal contemplates that the comparison group will be determined through a process in which each party submits a "final offer comparison group" and is then "given an opportunity to challenge the other party's comparison group and support its own in simultaneous rebuttal filings." *NPRM* at 20. Under the Board's proposal, however, the parties would be restricted in their efforts to challenge the other party's comparison group and support their own because "the analysis and arguments must rest on publicly available information or on (non-rate) information provided in the Waybill Sample." *Id.*

The Board's restrictive approach stands in sharp contrast to the Board's position in *Simplified Guidelines*. In *Simplified Guidelines*, the Board provided that defendants would always be allowed "to present whatever additional information is available that bears on the reasonableness of the pricing of the traffic at issue," including "any qualitative information regarding the issue traffic that might affect the relative pricing of that traffic vis-à-vis the other traffic carried by the defendant railroads."<sup>66</sup> Indeed, in discussing R/VC<sub>COMP</sub>, the Board

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<sup>66</sup> *Id.* at 1022-23.

specifically provided that, if anyone knew of a reason that “particular traffic is not truly comparable, the parties can and should bring that to our attention in an individual case.”<sup>67</sup> In the *NPRM*, the Board proposes to do away with the protections against invalid comparisons that the Board found necessary in *Simplified Guidelines*.

In the *NPRM*, the Board claims that it will assess comparability by “reviewing a variety of factors” that “could affect demand characteristics and operating costs.” *NPRM* at 20. However, its actual proposal – to restrict its consideration to publicly available information and (non-rate) information provided in the Waybill Sample – would preclude parties from presenting evidence that indisputably would be relevant in deciding whether their own or their opponent’s final offer comparison group is most comparable to the issue traffic in terms of both demand characteristics and operating costs.

- a) **The Board’s proposed restriction of evidence regarding potentially comparable traffic could prevent parties from identifying traffic that is moving under different demand conditions because it is subject to effective intramodal or intermodal competition.**

There should be no debate that an appropriate comparison group should not include traffic over which a railroad does not have market dominance, because traffic subject to effective competition and traffic over which a carrier has market dominance would plainly have different demand characteristics. The Board’s proposal, however, has no formal mechanism that would prevent parties from including non-market-dominant traffic in a comparison group. The proposal contemplates that the comparison group will be selected from “all movements in the most recent Waybill Sample that have the same 2-digit STCC code as the issue movement and an

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<sup>67</sup> *Id.* at 1035.

R/VC ratio above 180%.” *NPRM* at 33. As the Board has recognized, however, traffic with r/vc ratios above the 180 percent safe harbor “often is not captive.”<sup>68</sup> Moreover, any presumption that a carrier has market dominance over any traffic with an r/vc ratio above the 180 percent safe harbor would be inappropriate: a finding that a rate produces an r/vc ratio “equal to or greater than 180 percent does not establish a presumption that such rail carrier has or does not have market dominance over such transportation.” 49 U.S.C. § 10707(d)(2).

In many situations, a party will be able to establish the presence of intermodal or intramodal competition from public documents – for example, documents showing that other rail carriers have access to particular origins and destinations. In other situations, however, evidence regarding competition, particularly intermodal competition, might not be in the public domain – it might be information that railroads have obtained from a particular shipper or on their own. The Board’s rules should not preclude a party from relying on non-public information to argue that certain movements should not be included in a comparison group.

**b) The Board’s proposed restriction of evidence regarding potentially comparable traffic could prevent parties from identifying traffic that has very different operating costs because of different car supply arrangements.**

There also should be no debate that an appropriate comparison group should not include traffic that moves under different car supply arrangements than the issue traffic, because traffic moving under different car supply arrangements will have different operating costs. But information about car supply arrangements typically will not be found in publicly available data and is not reflected in the Waybill Sample. Moreover, differences in car supply arrangements can have dramatic effects on r/vc calculations based on system-average URCS.

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<sup>68</sup> *Rate Guidelines – Non-Coal Proceedings*, STB Ex Parte No. 347 (Sub-No. 2), slip op. at 5 n.5 (STB Decision served Dec. 1, 1995).

For example, if one relies on Waybill Sample data and system-average URCS, traffic moving under a full-mileage rate will have a higher r/vc ratio than otherwise-comparable traffic moving under a zero-mileage rate. The difference will exist for two reasons. First, on the revenue side, a railroad must set its rate higher for traffic moving under full-mileage rates so that it can pay the mileage allowance. Second, on the cost side, the use of system-average URCS costs will dilute the actual cost impact of paying a mileage allowance so that the actual cost difference will not be reflected. *See pp. 39-40, supra.*

In other words, if the r/vc ratio for issue traffic moving under a full-mileage rate is compared to r/vc ratios for traffic moving under zero-mileage rates, the issue traffic's r/vc ratio will appear higher because the traffic is operating under very different cost conditions – it is paying a mileage allowance. The Board's rules should not preclude parties from identifying situations in which reliance on data from the Waybill Sample and system-average URCS would produce such inappropriate comparisons.

- c) **The Board's proposed restriction of evidence regarding potentially comparable traffic could prevent parties from identifying a variety of other circumstances that make specific comparisons inappropriate.**

Finally, the Board's proposal to restrict evidence regarding the comparability of traffic to information that is publicly available or provided in the Waybill Sample would prevent parties from identifying a wide range of factors that the agency could not rationally ignore in selecting a traffic group that can meaningfully be compared to the issue traffic.

For example, as discussed above, railroads incur costs for high/wide movements that exceed system-average costs, often by a significant margin, but high/wide traffic cannot always be identified solely based on data in the public domain or in the Waybill Sample.

As another example, movements of hazardous materials generally can be identified based on STCC codes contained in the Waybill Sample, but the costs of moving hazardous materials, even materials of the same type, can vary significantly depending on the shipper, origin, destination, route, and a variety of other movement-specific circumstances that would not be public knowledge. The Board should not adopt any procedure that would preclude a railroad from bringing significant, non-public cost-related information to the Board's attention.

As a final example, railroads frequently established rates through contracts, and those contracts often include non-public terms and conditions that affect the overall economic value of the parties' arrangements. In addition, contract rates often reflect outdated judgments about market conditions, which severely limit their value for purposes of assessing current rates. There are thus strong arguments for excluding all contract traffic from comparison groups. At the very least, however, the Board should not adopt any procedure that would preclude a railroad from bringing to the Board's attention any significant, non-public contractual terms or other non-public information about the circumstances under which the parties entered into particular contracts that would affect the validity of a rate comparison.

**4. The Board Must Recognize That Use Of Capacity Constrained Lines And Facilities Is A Relevant Pricing Factor When Selecting The Most Appropriate Comparison Group.**

The Board must consider evidence regarding capacity constraints that affect the defendant's network and thus the defendant's pricing in selecting the most appropriate comparison group.

In presenting examples of factors that would be considered in selecting the most appropriate comparison group – *i.e.*, “length of movement, commodity type, terrain involved,” *NPRM* at 20 – the Board excludes one factor that is particularly relevant in today's capacity constrained environment: traffic may be competing with other traffic for scarce capacity.

For example, even in the case of two equidistant movements of the same commodity in the same type of car over the same type of terrain, market forces would dictate a higher rate for the first movement if it traversed a congested line and was essentially competing for scarce capacity with other traffic that could potentially move over the same route.

Under these circumstances, it would not only be bad economics to use the second shipment's rate to assess whether the first shipment's rate is too high, but it would also be bad public policy. As discussed above, a railroad's ability to charge a higher rate to the first shipper (and the other shippers using the congested segment) both signals a demand for additional investment and provides the revenues needed to support that investment. If the railroad could not charge higher rates, then it would not have the same ability to invest in new capacity needed to accommodate the demand. In addition, the higher rates encourage shippers to use more efficient alternatives when they are available – for example, it would encourage a grain shipper to truck its grain to an elevator located on a less constrained line. If the railroad could not charge more on capacity-constrained routes, then relatively more shippers would seek to use those routes, thereby increasing the gap between demand and supply and decreasing the quality of service the railroad could offer shippers that do not have the same options.

#### **5. The Board Must Guard Against The Problem Of Feedback.**

The Board must modify its Benchmark proposal to protect against the possibility that repeated application of a mean figure as the basis for a regulatory ceiling could have a feedback effect that would lower the mean for future cases. The Board recognizes the feedback issue and even notes that a court has expressed concern about feedback, but it takes no steps to address the issue. *NPRM* at 27-28 & 27 n.48. Instead, the Board asserts that feedback “should not be a significant concern” for two practical reasons: (i) “the revenue adequacy adjustment . . .

would have a countervailing effect,” and (ii) “only a small percentage of a carrier’s traffic would likely be eligible to use the Three-Benchmark approach.” *Id.* at 28.

The D.C. Circuit, in the very case noted by the Board, rejected a similar “practical defense” on the ground that it “does nothing to give R/VC any glimmer of supporting principle or intellectual coherence.”<sup>69</sup> The practical factors identified by the Board might preclude rates from spiraling all the way down to the jurisdictional threshold, but they do not provide a real solution to the Benchmark approach’s tendency to reduce rates, not on any principled basis, but merely through iterative applications.<sup>70</sup>

**6. The Board Must Adopt A Method To Address Cases In Which There Will Be Little Or No Comparable Traffic.**

The Board proposal to apply the Benchmark method to small rate complaints is notable for a surprising omission: it does not address how the Board will proceed when the Waybill Sample contains little or no traffic that is comparable to the issue traffic. This is not a hypothetical issue: in *Simplified Guidelines*, the Board observed, based on experience, that “it can be difficult, with some types of small or isolated shipments, to obtain a sufficient data base of similar traffic to use for comparison,”<sup>71</sup> and that “[t]here may well be some cases in which there is no readily identifiable traffic that is truly comparable.”<sup>72</sup> In fact, the Board was not able to identify a comparable traffic group in *South-West Car Parts* – the only case in which it has

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<sup>69</sup> *BN v. ICC*, 985 F.2d at 597.

<sup>70</sup> Moreover, for any carrier that is revenue adequate, the Board’s “revenue adequacy adjustment” would not provide any countervailing effect and would actually accelerate the feedback process by reducing rates *below* the mean r/vc ratio of the comparison group.

<sup>71</sup> *Simplified Guidelines*, 1 S.T.B. at 1011.

<sup>72</sup> *Id.* at 1035.

applied the approach adopted in *Simplified Guidelines*.<sup>73</sup> The issue will be a recurring one, especially for certain types of traffic, such as high/wide traffic.

In *Simplified Guidelines*, the Board proposed to address the problem by forgoing the  $R/VC_{COMP}$  benchmark and relying on the other two benchmarks for guidance.<sup>74</sup> That is what the Board ultimately did in *South-West Car Parts*.<sup>75</sup> This option, however, is not available to the Board under the current proposal. Without the  $R/VC_{COMP}$  benchmark, the reformulated RSAM and  $R/VC_{TOTAL}$  benchmarks would provide no guidance, either separately or in combination, for assessing the reasonableness of a challenged rate.

This provides a further reason why the Board should use Simplified-SAC as the standard in small cases as well as medium-size rate cases.

#### IV. ELIGIBILITY CRITERIA

UP agrees with the Board's approach to establishing eligibility standards for the proposed simplified rate standards based on the "Maximum Value of the Case." *NPRM* at 33. The Board's approach is consistent with Congress's directive to establish simplified standards "in those cases in which a full stand-alone cost presentation is too costly, given the value of the case." 49 U.S.C. § 10701(d)(3).

UP also agrees that the dividing line between full SAC and Simplified-SAC cases should be no higher than \$3.5 million. *See NPRM* at 33. The Board's estimate that it would cost \$3.5 million for a party to present evidence in a full SAC case is consistent with our experience

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<sup>73</sup> *See South-West R.R. Car Parts v. Mo. Pac. R.R.*, STB Docket No. 40073, slip op. at 7-8 (STB served Dec. 31, 1996).

<sup>74</sup> *Simplified Guidelines*, 1 S.T.B. at 1035.

<sup>75</sup> *See South-West Car Parts* at 8-9.

in SAC cases.<sup>76</sup> However, the Board should bear in mind that the cost to complainants is likely to be significantly lower than the cost to defendants, because the defendant railroad bears the bulk of discovery costs in a SAC case.<sup>77</sup>

We disagree with the Board's proposal to treat the proposed eligibility standards as presumptions that a shipper could rebut. *NPRM* at 34. The Board has set the standards so that shippers bringing legitimately medium-size or small rate cases would be able to use simplified standards, and it should not expand eligibility any further. As the Board has recognized, use of simplified standards can be expected to have a negative impact on a railroad's ability to earn adequate revenues.<sup>78</sup> That is why CMP, with its SAC constraint, remains the "preferred . . . procedure" for rate reasonableness determinations and "must be used whenever possible." *NPRM* at 9 & n.16 (quoting *Simplified Guidelines*, 1 S.T.B. at 1021). Simplified standards, by contrast, "must be used as sparingly as possible, reserved for only those cases where CMP is not a realistic option." *Id.* at 11 (quoting *Simplified Guidelines*, 1 S.T.B. at 1021).

Even under the Board's current proposal, it is difficult to characterize CMP and the SAC test as "preferred." Under the Board's own eligibility estimate, only one-third of all regulated movements (as measured by revenue) would be classified as "large disputes;" two-thirds of all regulated movements would be presumed eligible to use some type of simplified standard. *NPRM* at 37. The Board should not further undermine the preferred status of CMP

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<sup>76</sup> See UP Major Issues Reply at 40. The cost to present evidence in a full SAC case may fall in the future as a result of the Board's resolution of several issues that have proven to be particularly contentious in SAC cases through its rulemaking in *Major Issues*.

<sup>77</sup> See *id.* at 39-40.

<sup>78</sup> See *Simplified Guidelines*, 1 S.T.B. at 1008-09 ("[R]eliance on a cruder method would not significantly affect a carrier's overall ability to earn adequate revenues, because only a very small portion of rail traffic could be subject to rate reasonableness review using such simplified procedures.").

and SAC and thus railroads' ability to earn adequate revenues by allowing even more cases to qualify for simplified procedures.

Finally, UP disagrees with the Board's eligibility criteria to the extent that the Board draws a distinction between medium-size and small rate cases. While drawing such a distinction would make sense if the Board had available a simplified approach that cost less than Simplified-SAC but was still accurate and consistent with CMP, the Benchmark method is not such an approach. As discussed above, a shipper's costs under Simplified-SAC would be significantly lower than the \$200,000 figure estimated by the Board and not significantly higher than its costs under the Benchmark method, and any slight cost advantage of the Benchmark method would be far outweighed by the loss of accuracy under that method as compared to Simplified-SAC.

## **V. EXEMPT TRAFFIC**

UP disagrees with the Board's proposed procedures for handling complaints that involve traffic subject to a class exemption. The Board would require parties to proceed with discovery and evidentiary filings regarding rate reasonableness issues while it considered a complainant's petition for partial revocation of the pertinent class exemption. *NPRM* at 17, 30.

The Board's approach would encourage inappropriate litigation because it would allow shippers of traffic for which rate relief likely will not be available – *i.e.*, traffic for which the agency has already determined that continuing regulation is not necessary to prevent abuses of market power – to invoke the agency's simplified standards and impose the substantial costs of rate case discovery on a defendant without bearing a comparable burden. The Board's approach would also impose unnecessary costs on defendants, who are likely to prevail in arguing that the exemption should not be partially revoked.

The Board should adopt a different approach: when a complainant petitions for partial revocation of an exemption in order to challenge a rate, the agency should address the threshold issue of revocation first, before requiring the defendant to make any of the special disclosures required under the proposed simplified standards or to provide discovery relating solely to the reasonableness of the challenged rate.

We recognize that in at least one case, *FMC Wyoming v. Union Pacific Railroad*, the Board deferred its decision on the complainant's petition for partial revocation of an exemption until its decision on the merits of the rate complaint, but cases under simplified standards will present very different considerations.<sup>79</sup> In *FMC*, the complaint challenged sixteen different rates, covering the transportation of six different commodities, only one of which was subject to an exemption, and the complainant intended to include that traffic in the SAAR traffic group even if it could not challenge the exempt rate.<sup>80</sup> Thus, the defendant was not required to incur significant incremental discovery or evidentiary burdens to address a rate that was later confirmed to be exempt – UP would have had to provide SAC discovery and prepare SAC evidence no matter what the result of the revocation petition. By contrast, cases under the simplified standards likely will involve only one commodity, and if that commodity is exempt, and the exemption is not revoked, any effort and expense associated with a rate reasonableness analysis will have been wasted.

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<sup>79</sup> *FMC Wyoming Corp. v. Union Pac. R.R.*, STB Docket No. 42022, slip op. at 3 (STB served Aug. 31, 1998).

<sup>80</sup> *Id.* at 4.

The most appropriate model for the Board's approach to cases involving exempt traffic is not *FMC*, but *Sierra Pacific Power v. Union Pacific Railroad*.<sup>81</sup> In *Sierra Pacific*, the Board bifurcated the market dominance and rate reasonableness phases of the proceeding and postponed the submission and consideration of rate reasonableness evidence because it had "considerable doubts" about the complainants' ability to demonstrate market dominance.<sup>82</sup> Those "considerable doubts" were based on the agency's findings in an earlier case that had addressed the complainant's competitive options.<sup>83</sup> The same logic should lead the Board to bifurcate rate cases that involve revisiting prior exemption decisions, at least absent the special circumstances at play in *FMC*.

We also share the view expressed in the AAR's Opening Comments that the standards for revoking exemptions should not be altered to afford preferred treatment to those who seek to bring medium-size or small rate cases. A revocation petition must meet stringent standards: it is not enough to show that the carrier has market dominance over the transportation at issue or that a rate would be considered unreasonable under the simplified standards – a petitioner must show that the carrier has market power and has abused that market power. This standard was imposed by Congress, which affirmatively instructed the Board to exempt traffic from regulation when regulation "is not needed to protect shippers from the abuse of market power." 49 U.S.C. § 10502(a)(2)(B).

Whether or not the Board changes the proposed procedural schedule in cases involving exempt traffic, the Board should reinforce the standards that apply to petitions for

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<sup>81</sup> *Sierra Pac. Power Co. v. Union Pac. R.R.*, STB Docket No. 42012 (STB served Jan. 26 1998).

<sup>82</sup> *Id.* at 5.

<sup>83</sup> *See id.* at 3-5.

revocation so that it does not encourage fruitless litigation. “[A] revocation petition focuses on traffic that has previously been exempted from [Board] regulation on the basis of this agency’s conclusion that the marketplace itself is sufficiently competitive so as not to require continued government regulation. Thus, a party has a burden of showing that [the Board’s] prior findings supporting the initial exemption were clearly wrong, or that changed circumstances require [the agency] to revisit them.”<sup>84</sup> A party petitioning to revoke an exemption must show that a carrier “possesses substantial market power” and that “regulation is necessary to protect against carrier abuse of shippers as a result of such market power.”<sup>85</sup> The Board should also remind potential complainants that a proper market power inquiry requires consideration of factors that would not be considered under the Board’s market dominance test, such as the effects of product and geographic competition.<sup>86</sup>

## **VI. MANDATORY MEDIATION**

The Board’s proposals do not include mandatory mediation, but they should. The Board should adopt a rule requiring mandatory, non-binding mediation along the lines proposed in the AAR’s Opening Comments.

Mediation could play an important role in helping parties resolve medium-size and small rate disputes through negotiation, before they begin to incur the costs of litigation. Mediation could be structured as a very low-cost process, affordable for the smallest of shippers,

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<sup>84</sup> *Rail Exemption Misc. Agricultural Commodities*, 8 I.C.C.2d 674, 677 (1992), *aff’d in relevant part sub nom. Mr. Sprout, Inc. v. United States*, 8 F.3d 118 (2d Cir. 1993).

<sup>85</sup> *Id.* at 682.

<sup>86</sup> *Id.* at 683-84 & 683 n.22 (describing the “various facets to a market power inquiry” as including “product and geographic competition,” in addition to “the rate levels of various transportation alternatives” and “the level of rates charged by the allegedly dominant carrier in relation to its costs”).

and it would provide a Board-sponsored forum even for shippers that are unwilling to expend the modest resources necessary to pursue a rate complaint under simplified standards. Moreover, the publicly available evidence suggests that mediation has been effective in helping parties reach settlements in small rate cases.<sup>87</sup> The Board should not overlook the benefits of mediation as it develops its final rules.

## **VII. CONCLUSION**

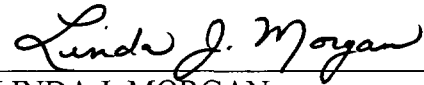
The Board's Simplified-SAC proposal is a significant step toward developing a simplified method for determining rate reasonableness for cases in which a full SAC presentation would be too costly given the value of the case. The Board should adopt Simplified-SAC, with the modifications described above, and apply it to all cases in which use of a simplified method is appropriate. By contrast, the Board's Benchmark proposal does not correct the basic flaws in formulaic approaches to rate reasonableness that the Board and courts have previously rejected, and it is unnecessary in light of the low-cost approach provided by Simplified-SAC.

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<sup>87</sup> See Press Release, Surface Transportation Board, Surface Transportation Board Announces Settlement of First "Small" Rate Case (June 6, 24, 2005).

Respectfully submitted,

J. MICHAEL HEMMER  
LOUISE A. RINN  
GABRIEL S. MEYER  
Union Pacific Railroad Company  
1400 Douglas Street  
Omaha, Nebraska 68179  
Tel: (402) 544-5000

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

LINDA J. MORGAN  
MICHAEL L. ROSENTHAL  
Covington & Burling LLP  
1201 Pennsylvania Avenue, N.W.  
Washington, D.C. 20004-2401  
Tel: (202) 662-6000  
Fax: (202) 662-6291

*Attorneys for Union Pacific  
Railroad Company*

October 24, 2006

### **CERTIFICATE OF SERVICE**

I, Michael L. Rosenthal, hereby certify that on this 24th day of October, 2006, I caused a copy of the Opening 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. 646 (Sub-No. 1).

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

Michael L. Rosenthal

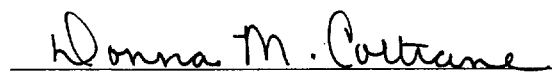
## VERIFICATION

STATE OF NEBRASKA     )  
                                      ) ss  
COUNTY OF DOUGLAS    )

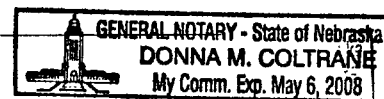
I, Thomas C. Haley, Assistant Vice President - Network and Capital Planning for Union Pacific Railroad Company ("UP"), being duly sworn, depose and state that I have assisted in the preparation of the foregoing Opening Submission of Union Pacific Railroad Company in STB Ex Parte No. 646 (Sub-No. 1). I further depose and state that I have reviewed the portion of UP's Opening Submission relating to UP's current capacity constraints and UP's need to make investments in new capacity, that I know its contents, and that those contents are true as stated to the best of my knowledge, information, and belief.

  
THOMAS C. HALEY

SUBSCRIBED AND SWORN TO before me this 23<sup>rd</sup> day of October 2006.

  
Notary Public

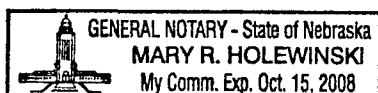
My Commission expires:

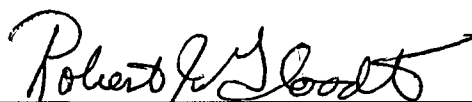


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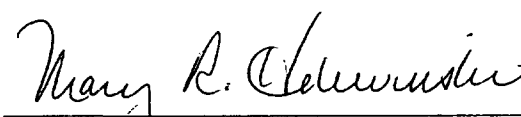
STATE OF NEBRASKA     )  
                                      ) ss  
COUNTY OF DOUGLAS    )

I, Robert J. Gloodt, Senior Manager—Appraisals for Union Pacific Railroad Company (“UP”), being duly sworn, depose and state that I have assisted in the preparation of the foregoing Opening Submission of Union Pacific Railroad Company in STB Ex Parte No. 646 (Sub-No. 1). I further depose and state that I have reviewed the portion of UP’s Opening Submission relating to UP’s recent appraisals of land values in California and the Gulf Coast, that I know its contents, and that those contents are true as stated to the best of my knowledge, information, and belief.



  
ROBERT J. GLOODT

SUBSCRIBED AND SWORN TO before me this 20<sup>th</sup> day of October 2006.

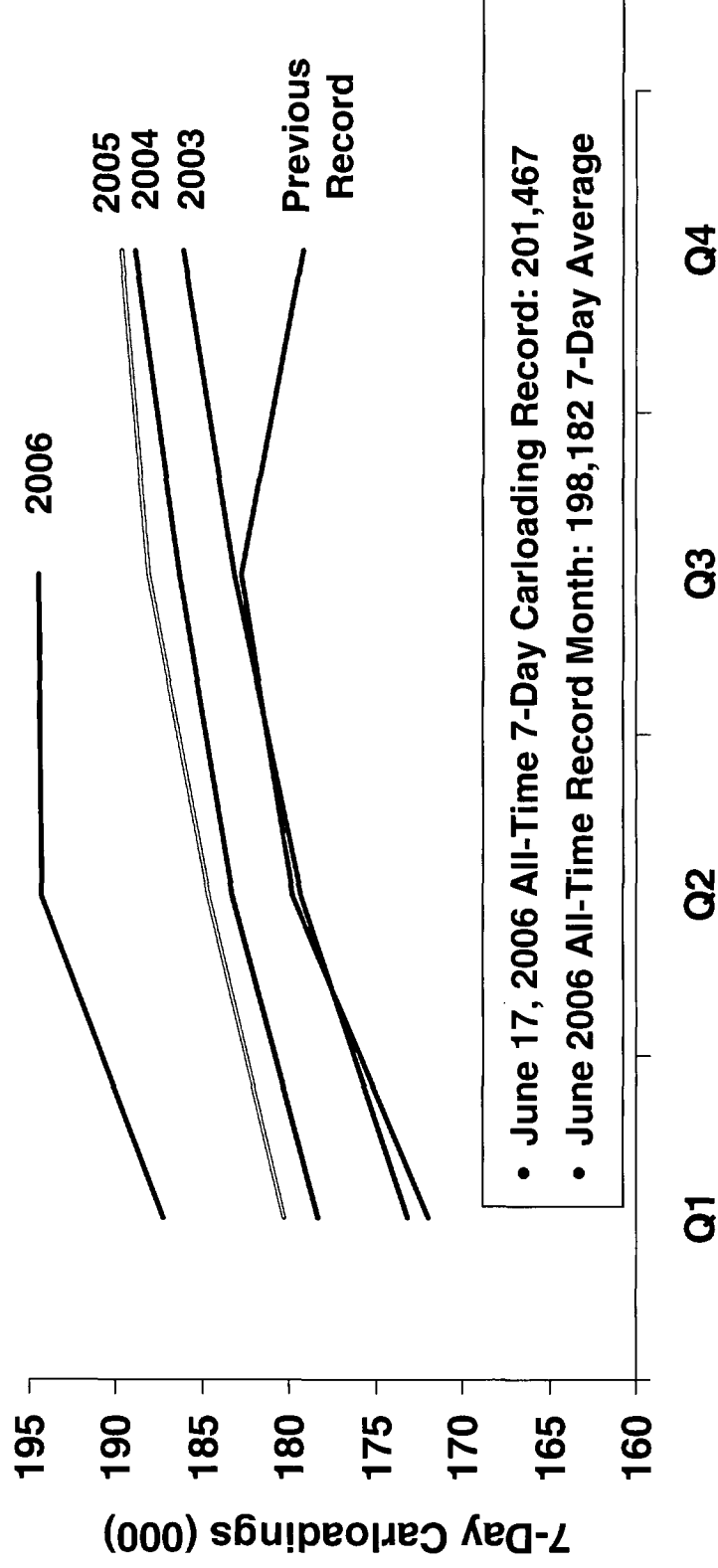
  
Notary Public

My Commission expires: October 15, 2008



# Sustained Demand

## Exhibit A

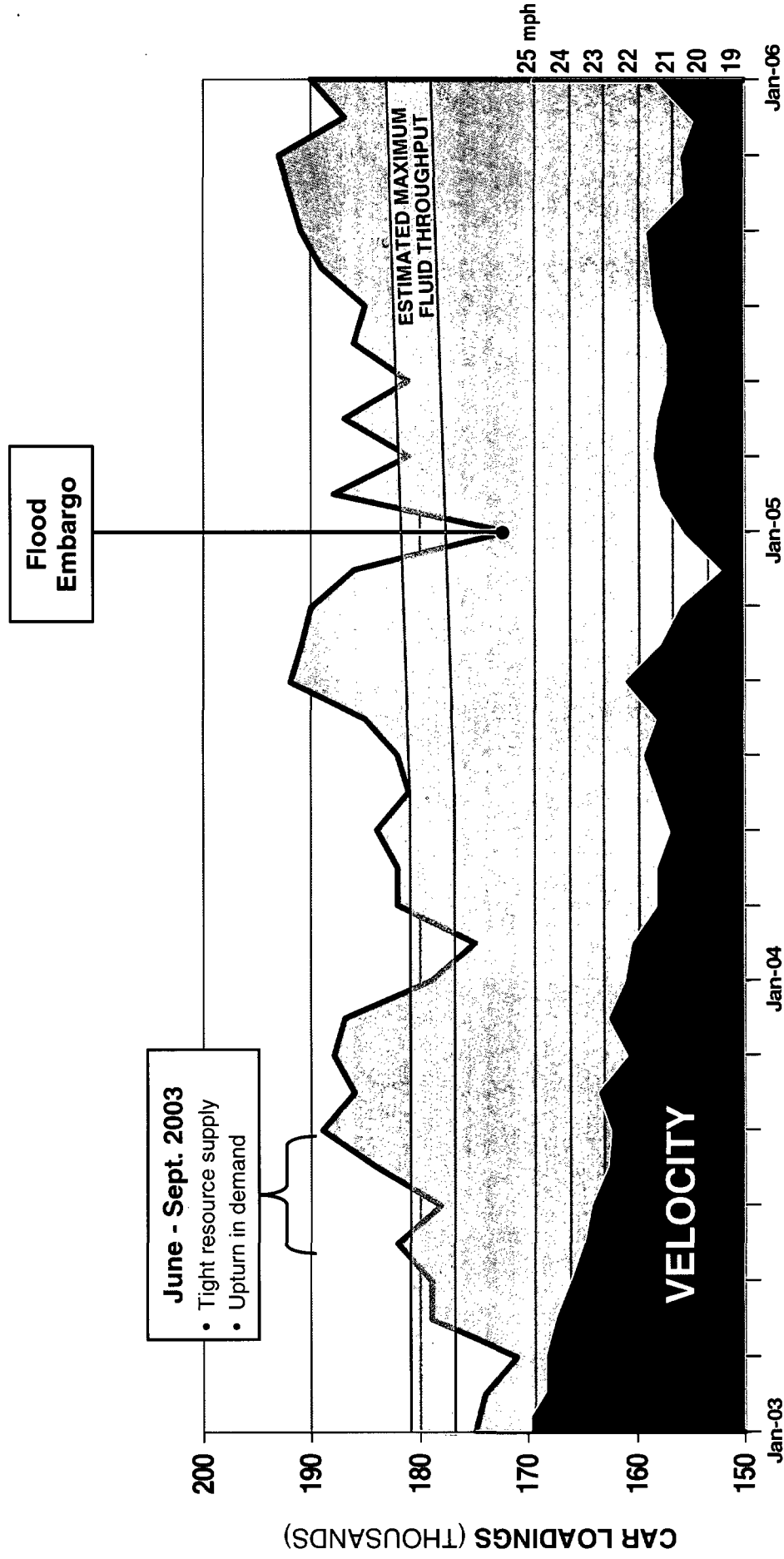


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# Union Pacific Timeline (2003 - 2006)

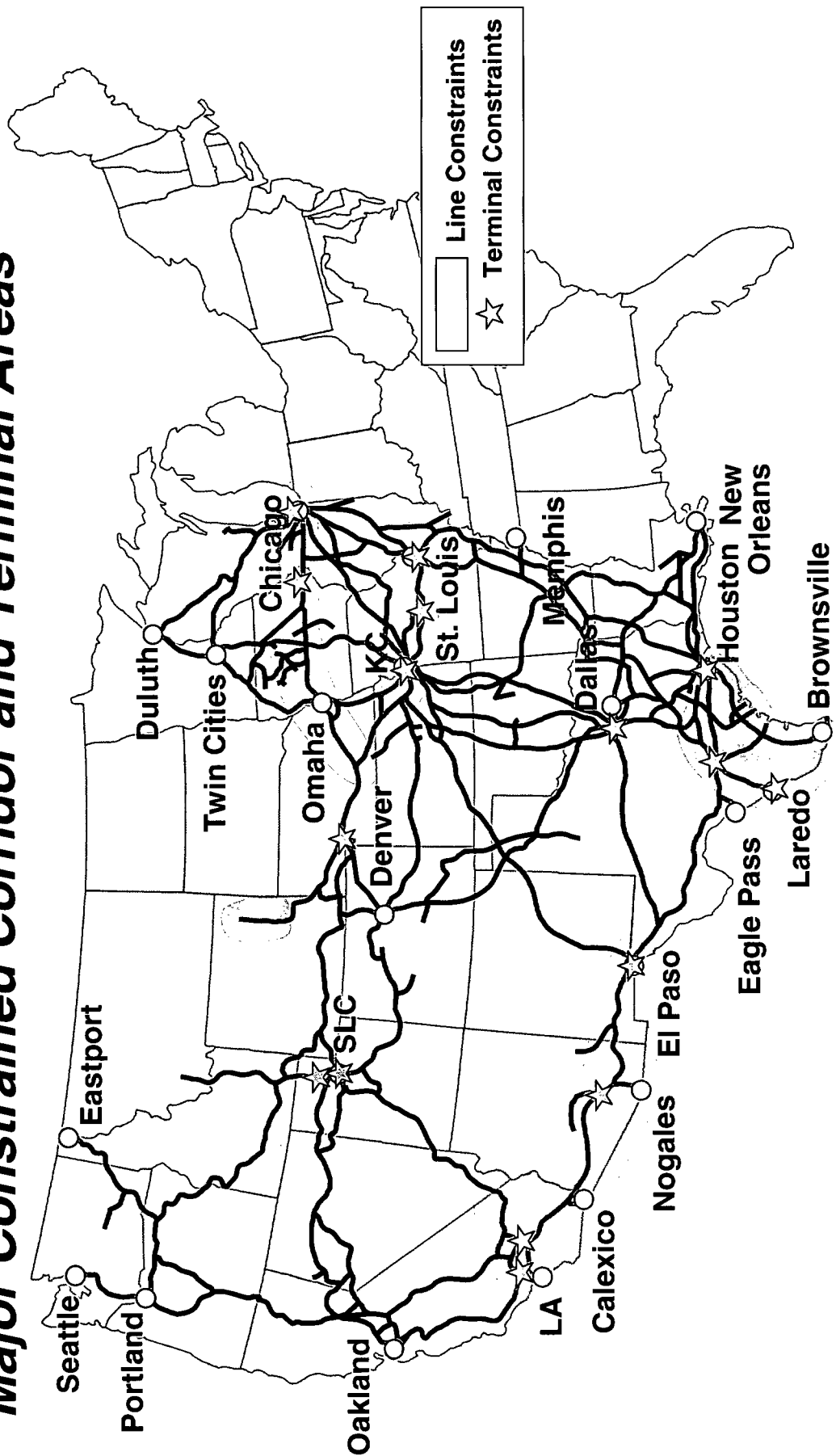


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# 2006 Projected Network

## *Major Constrained Corridor and Terminal Areas*

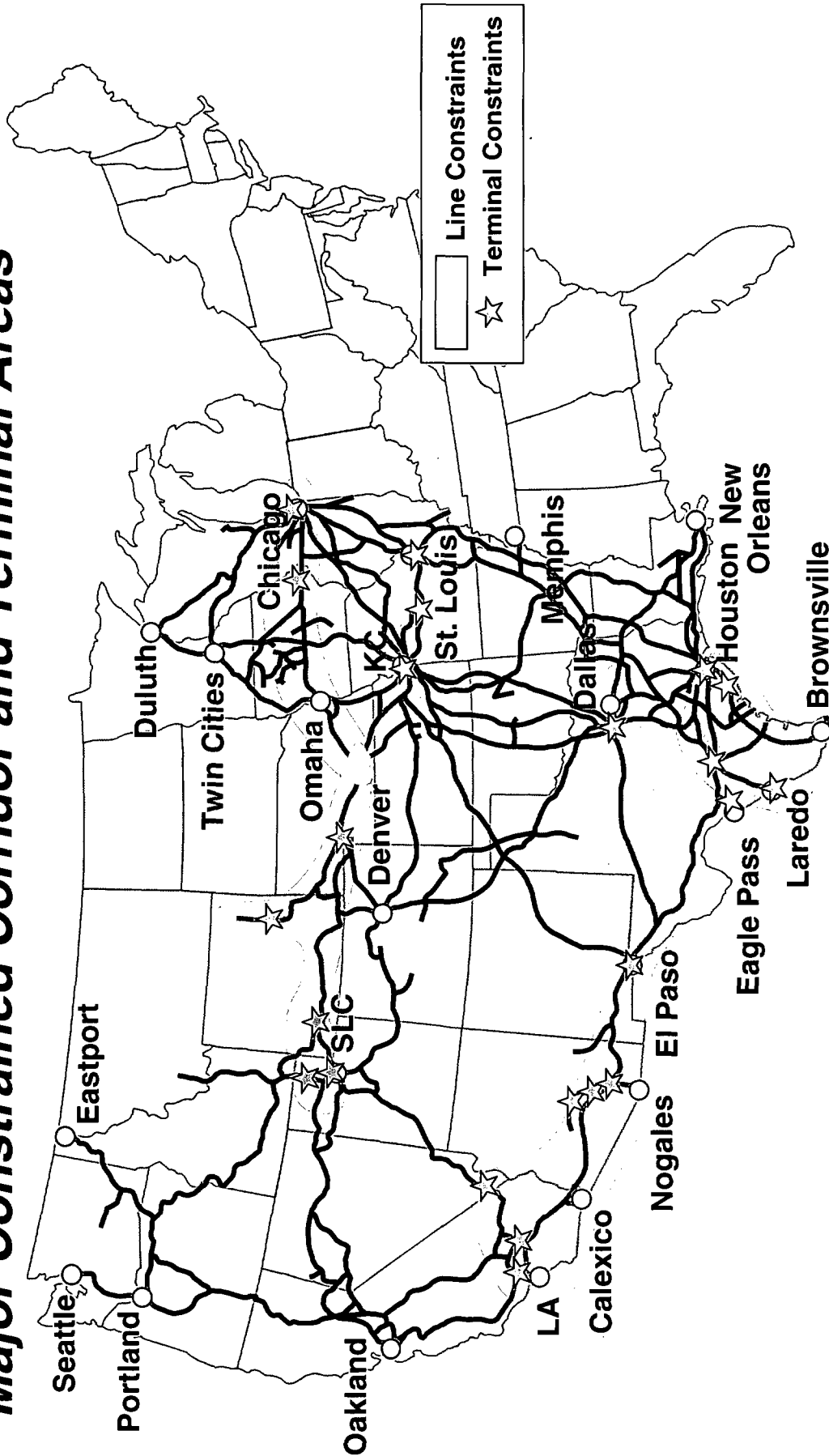


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# 2010 Projected Network

## *Major Constrained Corridor and Terminal Areas*



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