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October 24, 2006

Via HAND DELIVERY

The Honorable Vernon A. Williams
Surface Transportation Board
1925 K Street, NW
Washington, DC 20423

Re: **Simplified Standards For Rail Rate Cases,
STB Ex Parte No. 646 (Sub-No. 1)**

Dear Secretary Williams:

Enclosed for filing in the above-captioned proceeding are the original and 20 copies of the Opening Comments of BNSF Railway Company. Also enclosed are three CDs containing electronic copies of these Opening Comments in Word format. Please note that these Opening Comments include an electronic appendix which consists of portions of BNSF Railway Company's Comments and supporting expert statements submitted in Ex Parte No. 657 (Sub-No.1), Major Issues in Rail Rate Cases, on issues that are relevant to this proceeding.

Please date stamp the extra copy of this letter and return it with our messenger.

Sincerely,



Anthony J. LaRocca
Counsel for BNSF Railway Company

Enclosures

cc: Parties of Record

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**BEFORE THE
SURFACE TRANSPORTATION BOARD**



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

SIMPLIFIED STANDARDS FOR RAIL RATE CASES

**OPENING COMMENTS OF
BNSF RAILWAY COMPANY**

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

SIMPLIFIED STANDARDS FOR RAIL RATE CASES

**OPENING COMMENTS OF
BNSF RAILWAY COMPANY**

Pursuant to the Board's July 28, 2006 Decision in Ex Parte No. 646 (Sub-No.1), Simplified Standards for Rail Rate Cases ("*EP 646 NPRM*"), and a September 15, 2006, decision addressing the schedule for comments, BNSF Railway Company ("BNSF") hereby submits its opening comments on the standards proposed by the Board to govern rate reasonableness cases where the value of the case does not justify the costs of a full stand-alone cost analysis.

I. INTRODUCTION

The Board acknowledged in its 1996 Non-Coal Guidelines that the task of developing rate reasonableness standards for small rate cases has not been an easy one. *Rate Guidelines – Non-Coal Proceedings*, 1 S.T.B. 1004, 1007 (1996) ("*Non-Coal Guidelines*"). For two decades interested parties and the agency's staff have proposed and evaluated a wide variety of rate reasonableness approaches to determine whether it is possible to simplify the presentation of rate reasonableness evidence in rate cases where the value of the case does not justify the costs of a full SAC case without undermining the economic principles underlying Constrained Market Pricing. The Board and the ICC concluded that most of these approaches failed to advance congressional policy, the public interest and the interests of potential litigants in small rate cases. BNSF acknowledges the importance in the current regulatory regime of having a fair and administrable rate reasonableness test for cases where a full SAC presentation is not justified and BNSF therefore applauds the Board for continuing its efforts to develop and refine such a test.

The economic principles and policies set out in the governing statute and in the 1985 *Coal Rate Guidelines* are difficult to apply in small cases, but the Board and the ICC have recognized that those principles and policies cannot simply be abandoned in the interest of simplification. The stakes are too high for the Nation's railroads and for those who rely on a financially sound and efficient rail freight network. As seen in Table 2 in the Board's *EP 646 NPRM*, a very large amount of railroad revenue is covered by the standards that the Board has proposed. Two-thirds of non-exempt rail traffic that moves at an R/VC ratio above 180% would be covered by the Board's proposed standards. Inappropriate standards governing small and medium-size rate cases would adversely affect the financial viability of the railroad industry and would undermine the public interest.

Two considerations must guide the Board in the development and implementation of appropriate standards for cases where the cost of presenting SAC evidence exceeds the value of the case. First, the framework of Constrained Market Pricing as set out in the *Coal Rate Guidelines* should be preserved to the maximum extent possible. CMP recognizes that railroads must be given broad discretion to set rates based on perceived market demand, with regulatory intervention only where individual shippers are being asked to pay for facilities from which they derive no benefit or to contribute more revenue than needed for the railroad to provide efficient service or to achieve revenue adequacy. CMP advances Congress' mandate to minimize regulation, to promote railroad revenue adequacy and to protect shippers against the abuse of market power by market dominant railroads. It carries out these statutory mandates with an appropriate recognition of the economics of railroad networks and the pervasive competition that exists for most of the traffic handled by the Nation's railroads. Regardless of the size of a particular rate dispute, the principles of CMP should govern any assessment of the

reasonableness of a challenged rate and deviations from CMP should be tolerated only to the extent necessary to ensure that shippers have access to the Board's rate regulation procedures.

Second, any standards governing small and medium-size rate cases must permit differential pricing and allow rate increases in some instances where they are warranted by market conditions. Simplified rate standards cannot be a one-way street. Rate standards that would operate only to reduce rates and net revenues without providing any opportunity to increase rates when market conditions permit would merely drive railroads farther away from revenue adequacy. The Board's standards must seek to identify maximum reasonable rates that continue to give railroads an opportunity to achieve revenue adequacy. This objective is particularly important in light of the recent increases in demand for rail transportation and the constraints on existing rail capacity. New investment in rail infrastructure is critical. BNSF, like other railroads, reinvests a substantial portion of its revenue in the railroad network. Any reduction in railroad revenues would inevitably cut into the amount spent on expanding and replacing existing railroad assets, to the detriment of railroads, shippers and the overall economy.

BNSF believes that the basic framework set out in the Board's *EP 646 NPRM* is consistent with these two considerations. It is appropriate to distinguish between medium-size and small rate disputes and to establish a more simplified approach for the smallest cases. Moreover, the basic standards proposed for each category of rate dispute advance the legitimate objective of simplifying and making more predictable the rate reasonableness analysis in cases where a full SAC presentation is not justified while remaining true to the maximum extent possible to the principles and policies set out in the *Coal Rate Guidelines* and the governing statute. BNSF has concerns regarding some aspects of the Board's proposals and urges

modifications in important areas, but it accepts the Board's basic framework as an appropriate effort to bring additional clarity to this difficult subject.

BNSF's position on the Board's specific proposals is set out in detail below and is supported by testimony in an attached Verified Statement from Mr. John C. Klick, Senior Managing Director of FTI Consulting Inc.'s economic practice. As discussed further below, BNSF accepts the Board's proposal to use a simplified form of SAC analysis in medium-size cases. The basic approach proposed by the Board to the presentation of SAC evidence on costs and revenues advances the interests of simplification without unduly compromising the principles underlying the SAC methodology. However, BNSF is concerned that the Board proposes that discovery burdens in simplified SAC cases be borne solely by railroad defendants. BNSF proposes a cost sharing arrangement that would more fairly allocate the costs and burdens of presenting evidence in a simplified SAC case.

While BNSF accepts the Board's basic methodology for the presentation of simplified SAC evidence, BNSF has a serious concern regarding the rate reduction methodology to be used in simplified SAC cases. In its *EP 646 NPRM*, the Board stated that it intends to use the same methodology in simplified SAC cases that it adopts in Ex Parte No 657 (Sub-No.1), *Major Issues in Rail Rate Cases*. It would be a serious error for the Board to adopt a methodology that sets maximum reasonable rates at a uniform cost-per-ton-mile or R/VC ratio, as the Board proposed in Ex Parte No. 657. BNSF explained its objections to such a rate reduction methodology at length in its comments in Ex Parte No. 657 (Sub-No.1), and it explains below why the rate reduction methodologies proposed in that proceeding would be highly inappropriate in simplified SAC cases.

BNSF also accepts the Board's proposal to set maximum reasonable rates in small cases by examining the R/VC ratios on comparable traffic adjusted to account for a railroad's need to earn adequate revenues, so long as the comparable traffic group is truly based on traffic with demand characteristics that are similar to those of the issue traffic. However, BNSF opposes the Board's proposed modification of the RSAM standard that is used to determine the revenue need adjustment factor. To be a meaningful benchmark for the revenue needs of a revenue inadequate railroad, the RSAM should focus only on traffic that is relatively demand inelastic, *i.e.*, traffic that exceeds the statutory jurisdictional threshold. BNSF also objects to the Board's proposed use of the mean of the comparable group as the maximum rate that can be charged by traffic within the group since such a standard would inevitably result in a ratcheting down of rates that is inconsistent with the statutory revenue adequacy mandate.

BNSF addresses below issues raised by the *EP 646 NPRM* that apply generally to both small and medium-size rate disputes. In particular, BNSF is troubled by the Board's proposed treatment of petitions for partial revocation of existing exemptions. The Board appears to assume that a petition for partial revocation of an exemption can be adequately addressed in the context of a rate complaint and an answer to the complaint, without any separate evidentiary proceedings addressed to the issue of revocation. The absence of procedures for the development and presentation of evidence on this important issue is a shortcoming in the Board's proposals. As BNSF explains more fully below, an exemption may not be revoked without a careful review of the railroad defendant's market power – not just market dominance – as well as a review of the policies and market conditions that led to the adoption of an exemption in the first place. A separate, threshold inquiry must be made in cases where the complainant seeks a partial revocation of an existing exemption.

II. ISSUES OF GENERAL APPLICATION

A. Eligibility Criteria

The Board properly acknowledged in the *EP 646 NPRM*, slip op. at 9, that in developing eligibility criteria for rate reasonableness standards for small and medium size cases, it must keep in mind that "CMP, with its SAC constraint, continues to be our preferred and the most accurate procedure available for determining the reasonableness of rail rates where there is an absence of effective competition." In its 1996 *Non-Coal Guidelines*, the Board similarly noted that because "CMP provides the only economically precise measure of rate reasonableness," CMP "must be used wherever possible." *Non-Coal Guidelines*, 1 S.T.B. at 1021. Under this principle, deviations from CMP and the SAC constraint should be strictly limited: "[B]ecause precision must be sacrificed for simplicity, any simplified procedures will necessarily be very rough and imprecise. . . . Because of their roughness . . . the simplified procedures must be used as sparingly as possible, reserved for only those cases where CMP is not a realistic option." *Id.* Limiting the application of simpler, imprecise procedures is consistent with the statutory preference for SAC proceedings and with the Board's obligation to give railroads the opportunity to achieve revenue adequacy.¹

It is therefore appropriate for the Board to establish eligibility criteria for shippers' use of rate standards other than SAC that limit the use of alternative standards to cases where the cost of bringing a SAC case would exceed the maximum value of any relief that could be obtained. Indeed, the governing statute directs the Board to apply such criteria. The statute directs the Board to establish simplified procedures for "determining the reasonableness of challenged rail

¹ See *Non-Coal Guidelines*, 1 S.T.B. at 1008-09 ("The ICC expressed confidence that reliance 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 subjected to rate reasonableness review using such simplified procedures.").

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 same objective – to minimize deviations from CMP and SAC to the maximum extent possible – also justifies the Board’s decision to establish two tiers of simplified cases, one for medium-size cases where a simplified version of the SAC test can be applied and one for truly small cases where the lesser value of the case justifies the use of more rudimentary procedures.

The specific eligibility thresholds proposed by the Board appear to be appropriate and workable. The Board’s eligibility criteria start with the premise that a complainant should bring a rate reasonableness challenge under the Full-SAC test so long as the maximum value of the case exceeds the cost of litigation under the SAC test.² This approach ensures that CMP and the SAC test are used to test the reasonableness of rates to the maximum extent possible, and it appears to be the scheme contemplated by the statute. If the maximum value of a case is less than the cost to bring a Full-SAC case, then a Full-SAC case is not justified. However, under those circumstances, the rate challenge should be brought under the simplified SAC approach so long as the maximum value of the case exceeds the cost of litigating a simplified SAC case. Finally, if the cost to bring a simplified SAC case exceeds the value of the case, then the rate challenge should be brought under the most crude, three-benchmark test.

The Board’s assumptions about how much it costs to litigate Full-SAC and simplified SAC cases, which are the bases for the eligibility criteria, are reasonable. The Board assumes that the cost to litigate a Full-SAC case would not exceed \$3.5 million, and therefore any case that has a maximum value exceeding \$3.5 million (calculated over the five-year rate prescription period) should be brought under the Full-SAC standard. The maximum case value of \$3.5

² The Board’s NPRM refers to SAC proceedings carried out under the *Coal Rate Guidelines* as “Full-SAC” proceedings, and BNSF adopts that terminology here.

million is appropriate, although it is quite generous to shippers and may result in some litigation under the simplified SAC standard that should actually be brought under the Full-SAC standard. The \$3.5 million cost assumption is based on statements by shippers regarding the cost of bringing SAC litigation in recent cases. For two reasons, this estimate of future SAC litigation costs is probably high.

First, even if \$3.5 million is a reasonable estimate of past SAC litigation costs, those costs will likely decrease once the Board establishes new rules in the Ex Parte 657 proceeding and clarifies issues that have been the source of contention in the past, such as revenue allocation on cross-over traffic and indexing of operating costs. The Board proposes to resolve these and other issues with new rules in Ex Parte No. 657, thus substantially reducing the litigation expense in future SAC cases.

Second, shippers themselves have largely been responsible for the high costs of SAC litigation in recent cases, and therefore shippers have the ability to reduce litigation expenses through better tailored SAC presentations. SAC litigation has been unnecessarily complicated by complainants' own overreaching litigation strategies. For example, shippers have relied on gerrymandered traffic groups that bear no resemblance to what a true least-cost, most-efficient railroad would handle. The *AEPCO* and *Otter Tail* cases provide two examples of SAC litigation costs being driven by overreaching and unrealistic SARR configurations.³

³ In *Arizona Electric Power Cooperative v. The Burlington Northern and Santa Fe Railway Co.*, STB Docket No. 42058 (served Mar. 15, 2005), AEPCO initially challenged rates only from New Mexico mine origins, then amended its complaint to challenge rates from both Colorado and PRB mine origins as well, then settled its claims with respect to non-New Mexico origins and again removed those claims from the case. AEPCO rerouted the traffic and attempted to use trackage rights to avoid building a significant part of the railroad. *Id.*, slip op. at 4-9. AEPCO's convoluted claims resulted in motions to dismiss and many additional pleadings for both sides. In *Otter Tail Power Co. v. BNSF Railway Co.*, STB Docket No. 42071 (served Jan. 27, 2006), Otter Tail modeled its proposed SARR four times using the discredited "string"

SAC litigation is complex, but complainants have made it more complicated than necessary. As SAC standards become clearer through precedent and new rules, and as shippers see that their misguided litigation strategies do not pay off in the end, SAC litigation costs will come down significantly. It should be possible for future complainants to litigate a Full-SAC dispute for well less than \$3.5 million, thus justifying the Board's limit on eligibility for the use of the proposed simplified SAC standard.

It is also reasonable to assume that a simplified SAC case could be litigated at a cost not to exceed \$200,000, thus requiring that a case with a maximum case value exceeding \$200,000 be brought under the simplified SAC standards (or, if the complainant wishes, under the Full-SAC test). Only those cases where the value of the case does not exceed \$200,000 should be brought under the three-benchmark approach. The complainant's litigation costs in a simplified SAC case should not exceed \$200,000 given that most of the burdens and costs of discovery and development of relevant evidence are on the defendant railroad. BNSF discusses this issue further in the section addressing the simplified SAC methodology. Moreover, the simplified procedures proposed by the Board for such cases will limit disputes over the assessment of SAC costs and revenues and further ensure that complainants' litigation expenses should not exceed \$200,000.

program – on opening, in an errata to the opening evidence, in supplemental opening evidence after it changed its traffic group, and on rebuttal, after it again changed its traffic group. It then switched to the Rail Traffic Controller (“RTC”) software for a fifth modeling effort at the suggestion of the Board. Otter Tail presented an ever-changing traffic group in its continuing efforts to maximize revenue contribution from cross-over traffic. Otter Tail's repeated modifications to its case led to multiple additional filings and vastly increased litigation costs for both parties.

B. Jurisdictional Threshold

The Board proposes to use the incumbent's unadjusted URCS costs to calculate the variable costs of the issue movements for purposes of determining the jurisdictional threshold in simplified SAC and small rate cases. The Board explains that the use of unadjusted URCS costs would avoid the complexity and substantial discovery associated with examining the numerous and contentious shipper and railroad adjustments to URCS costs that have been proposed in prior SAC cases. According to the Board, using Phase III of the URCS model, which considers the characteristics of specific movements, is a quick and administratively simple process that will help reduce the cost and complexity of medium and small rate cases without unduly sacrificing accuracy in the determination of variable costs. *EP 646 NPRM*, slip op. at 14-16 and 28-29.

BNSF generally supports the Board's proposal to use system-average URCS to determine the jurisdictional threshold in rate cases brought under the simplified SAC and small rate case procedures. However, BNSF urges the Board to make two modest changes to its proposal. First, in calculating system-average URCS costs, the Board should account for the possibility that the incumbent uses a third party to provide a portion of the transportation service. Payments to third-party service providers are properly included in the variable cost calculation.⁴

Second, the Board should provide a limited opportunity for the parties to carry out a more accurate development of variable costs at the end of a proceeding if the Board prescribes a rate

⁴ The law makes clear that payments to third parties are variable costs that should be included in the calculation of the movement's variable costs. *Pielet Bros. Trading Co. v. Chicago and North Western Transp. Co., et al*, No. 39756 (ICC served Aug. 11, 1987); *Pielet Bros. Scrap Iron & Metal, Inc. v. The Atchison, Topeka and Santa Fe Ry. Co., et al*, No. 39814, 1987 ICC Lexis 251 (ICC decided June 16, 1987); *Cabot Corp. v. Southern Pac. Transp. Co., et al*, No. 40464 (ICC served Jan. 9, 1991); *Petition of the Denver & Rio Grande Western R.R. & Salt Lake, Garfield & Western Ry. for Review of a Decision of the Public Serv. Comm'n of Utah Pursuant to 49 U.S.C. 11501*, No. 39060 (ICC served Mar. 2, 1983), *aff'd in relevant part sub nom., Utah Power & Light Co. v. ICC*, 747 F.2d 721, 740 (D.C. Cir. 1984), *reh'g denied*, 764 F.2d 685 (D.C. Cir 1985).

at, or close to, the jurisdictional threshold. Where movement-specific adjustments are required to produce a more accurate estimate of variable costs for the issue traffic and such adjustments would likely affect the level of any prescribed rate, a litigant should be permitted to demonstrate through clear and convincing evidence that such adjustments are warranted. The types of factors that might become relevant at this stage of the proceeding would include equipment and operating characteristics that are inconsistent with URCS system-average assumptions. It is unlikely that such an inquiry will be necessary in the vast majority of cases, given that rates would rarely be set near the jurisdictional threshold level and given that the value of any adjustments would rarely outweigh the costs of developing and presenting the necessary evidence. But the importance of the jurisdictional inquiry would justify a modest change in the Board's proposed standards to allow the parties to address this issue in appropriate cases.

C. Exempt Traffic

The Board proposes to make the simplified SAC and small rate case procedures in this proceeding available to shippers of commodities that have been exempted from regulation under the Board's class exemption authority in 49 U.S.C. 10502(a). The Board states in the NPRM that such shippers should include with their complaints a separate request for a partial revocation of the pertinent class exemption for the traffic at issue pursuant to 49 U.S.C. 10502(d). Under the proposal, the railroads would file with their answers a separate response to that request. *EP 646 NPRM*, slip op. at 17 and 30.

BNSF objects to the application of the proposed standards to exempt traffic. In the Board's 1996 *Non-Coal Guidelines*, the Board expressly justified the application of more crude rate reasonableness standards in small cases on grounds that "only a very small portion of rail traffic could be subjected to rate reasonableness review using such simplified procedures." *Non-Coal Guidelines*, 1 S.T.B. at 1008-9. The Board explained that "rates for traffic or services that

are exempted from regulation pursuant to 49 U.S.C. 10502 or its predecessor . . . are free from challenge.” *Id.* at 1009. It would not be appropriate for the Board to abandon this rationale and to expand significantly the scope of the Board’s regulation of rail rates.

The statute permits a party to seek a revocation of an existing exemption. 49 U.S.C. §10502(d). But consistent with Congress’ strong deregulation policy, the standards for revocation of an existing exemption are stringent. The Board should make clear that it will not entertain a rate complaint on previously exempt traffic unless and until the Board determines that the statutory standards for a partial revocation have been met.

In describing the standards for partial revocation of class exemptions, the ICC emphasized that “a revocation petition focuses on traffic that has been previously exempted from [] regulation on the basis of [the] agency’s conclusion that the marketplace itself is sufficiently competitive so as not to require continued government regulation.” *Rail General Exemption Authority – Miscellaneous Agricultural Commodities – Petition of G&T Terminal Packaging Co. to Revoke Conrail Exemption (G&T)*, Ex Parte No. 346 (Sub-No. 14A), 8 I.C.C.2d 674, 677 (1992). Therefore, the ICC held that the party seeking revocation “has a burden of showing that [the agency’s] prior findings supporting the initial exemption were clearly wrong, or that changed circumstances require [the agency] to revisit them.” *Id.* As the ICC explained,

Congress has directed [the agency] to exempt rail service whenever regulation is not necessary to protect against abuse of market power. Therefore, the first thing we look at in assessing a petition to revoke an exemption is whether the carrier possesses substantial market power. If it does not, then there is generally no basis for revoking an exemption. If it does, then we focus on whether regulation is necessary to protect against carrier abuse of shippers as a result of such market power. Finally, in assessing whether regulation is necessary or appropriate, we address whether regulation or exemption would, on balance, better advance the objectives of the [National Rail Transportation Policy] and the interest of the shipping public overall.

Id. at 682.

The class exemptions identified at 49 C.F.R. 1039 were established on the basis of substantial evidence assessing the railroads' market share of the traffic at issue as well as on the characteristics of the markets for those types of traffic. *See, e.g., Rail General Exemption Authority – Miscellaneous Agricultural Commodities*, Ex Parte No. 346 (Sub-No. 14), 367 I.C.C. 298, 302-303 (1983). In the proceedings establishing the class exemptions, the ICC found that there are highly competitive markets for the transportation of these commodities. *See, e.g., Rail General Exemption Authority – Lumber or Wood Products*, Ex Parte No. 346 (Sub-No. 25), 7 I.C.C.2d 673, 687 (Appendix 1) (1991) (“*Lumber/Wood Exemption*”). Significant competitive options were available to shippers, including not only competitive intermodal transportation options (rail, truck, and barge), but also product and geographic competition, that constrained the railroads' pricing power. The ICC found that the railroads did not possess substantial market power in the markets for transportation of the exempted commodities. Any request to revoke an existing exemption would require a reevaluation of the prior market power determination, which could not be accomplished merely by examining the competitive factors that are currently considered in market dominance determinations.

Where it exempted categories of traffic from regulation, the ICC further found that exemption, rather than regulation, of these classes of traffic advanced the objectives of the Rail Transportation Policy (“RTP”) (49 U.S.C. §10101) and was compelled by the statutory mandate to deregulate rail transportation to the maximum extent possible. Specifically, the ICC consistently found that exemptions would significantly advance the directives of paragraphs 1 through 5 of the RTP to encourage competition and competitively-determined rate levels, minimize Federal regulation, promote efficiency, allow railroads to earn adequate returns, foster

sound economic conditions in the industry, and eliminate non-compensatory rates. Further, the exemption would give shippers and railroads the flexibility to respond immediately to market changes and would enable railroads to compete more effectively with other modes in meeting shipper needs. See *-Lumber/Wood Exemption*, 7 I.C.C. 2d at 675.⁵

As the U.S. Department of Transportation (DOT) pointed out in its recent comments in Ex Parte No. 661, *Rail Fuel Surcharges*, the Board is obligated to give effect to Congress' affirmative command that the exemption authority be used whenever regulation is not necessary. In strongly opposing the Board's proposed partial revocation of class exemptions in that proceeding, DOT stressed that "the fundamental premise for every exercise of this authority was that competition – intramodal, intermodal, product, or geographic – for the traffic in question was pervasive . . . That premise was validated separately for each commodity or traffic type and only after a careful examination of all the relevant facts. . . . There has been no finding, or even a suggestion, that market place forces no longer determine the appropriate level of rates and service for all or any part of this traffic." U.S. DOT Comments at 5 (filed Oct. 2, 2006).

DOT is correct that there is no reason to believe that market conditions have changed since the ICC's conclusions were reached or that reregulation of previously exempt traffic is necessary. For a shipper whose traffic is now exempt from STB regulation to obtain a revocation of that exemption, it would be necessary to revisit the ICC's findings supporting the

⁵ See similar language in *Rail General Exemption Authority - Miscellaneous Manufactured Commodities*, Ex Parte No. 346 (Sub-No. 24), 6 I.C.C. 2d 186, 190-91 (1989); *Rail General Exemption Authority – Exemption of Grease or Inedible Tallow, Etc.*, Ex Parte No. 346 (Sub-No. 31), 10 I.C.C.2d 453, 458-59 (1994); *Rail General Exemption Authority – Exemption of Hydraulic Cement*, Ex Parte No. 346 (Sub-No. 34), 10 I.C.C.2d 649, 653 (1995). Other RTP objectives the Commission found were better advanced through the exemptions included reduction of overhead expenses, administrative and paperwork burdens, and delays and costs associated with tariff filing as well as promotion of more efficient use of equipment and more economical investment decisions.

grant of an exemption and to conclude that they are no longer valid. Such an exercise would likely involve a significant review of evidence, which clearly could not be carried out in the simple exchange of pleadings.

The Board should not even entertain a rate complaint involving exempt traffic unless the complainant has already obtained a partial revocation of the exemption under the appropriate legal standards. BNSF therefore proposes that the Board address and resolve any request for revocation of an exemption as a threshold matter prior to entertaining a rate proceeding. Upon receipt of a petition for partial revocation of the class exemption for purposes of a rate challenge, the Board should solicit the appropriate evidence on the existence of substantial market power and the impact of reregulation on the overall advancement of the RTP objectives, prior to initiating a rate proceeding. If the Board were to find that there is justification for a partial revocation of the class exemption, it could then establish a procedural schedule for an appropriate rate proceeding.

III. MEDIUM-SIZE RATE DISPUTES

BNSF believes that it is important to preserve as much as possible of the basic SAC methodology in medium-size rate disputes consistent with the objective of simplification. BNSF agrees that the Board's experience in recent SAC litigation has provided a basis for the development of simplified assumptions that can be used in cases where a Full-SAC analysis is not justified by the costs to develop and present Full-SAC evidence. While BNSF is concerned about some of the specific assumptions that would be used in a simplified SAC ("SSAC") case, BNSF nevertheless believes that the basic approach proposed by the Board for developing SAC costs and revenues advances the interests of simplification without unduly compromising CMP principles. BNSF comments below on the Board's specific proposals and suggests modifications and clarifications in a few areas.

A. Discovery Burdens

The Board's proposal for medium-size cases imposes disproportionate discovery burdens and hence expenses on railroads. While a complainant would bear essentially no discovery burden – and therefore no discovery costs – the railroad defendant would be required to engage in extensive data processing to identify and present for complainants' use data on the traffic moving over the issue traffic route, on-SARR and off-SARR miles, the costs of every movement on the selected route, and the revenue to be allocated between the SARR and the residual incumbent on the significant quantities of cross-over traffic that will inevitably be included in SSAC cases. Detailed programming would be necessary to extract data concerning a vast number of individual movements, and the data must be carefully vetted to ensure accuracy. Both the data extraction and processing are time-intensive and costly. Moreover, the Board's proposal for a one-year DCF and a five-year rate prescription would require BNSF to update prior SSAC analysis each year over a five-year period.

BNSF acknowledges that the data necessary to carry out a SSAC analysis are in its possession and therefore some discovery burdens are unavoidable. But BNSF is concerned that the Board's proposal invites shippers to file complaints at relatively little cost and no risk, while the defendant railroad would be required to prepare the case for the complainant with significant expenditures of time and resources. Such an inequitable approach can only lead to needless and unjustified litigation as shippers elect to roll the dice and see whether the Board can be convinced to impose maximum rates in circumstances where a more accurate Full-SAC analysis would not justify rate regulation.

To level the playing field and discourage baseless complaints, BNSF urges the Board to modify its proposals to provide that if a shipper loses its case, it should be required to pay the defendant's discovery expenses. Defendants would keep track of programming and processing

time in individual cases. If the shipper fails to demonstrate that the challenged rate is unreasonable, defendants would submit evidence of its discovery costs to the shipper for reimbursement. The Board could resolve any disputes that arise over the propriety of a defendant's efforts or the amount charged to compensate for the resources expended in the discovery process.

B. SARR Route And Configuration

Under the Board's proposal, the shipper would identify its "preferred" route for the issue traffic, and this route would become the route of the SARR. The SARR would then consist of all of the existing facilities along the selected route and it would carry all of the traffic that the defendant carries in the real world over that route. However, the Board proposes that the route selected by the shipper need not be the route generally used by the defendant in the real world for the issue traffic. The Board would allow the shipper to choose any route that has been used by any portion of the issue traffic in the prior 12 months without any further justification. If the issue traffic has not used the selected route in the prior 12 months, the shipper would only have to demonstrate that the route has sufficient capacity to handle the additional traffic. *EP 646 NPRM*, slip op. at 12.

BNSF objects to the Board's proposal relating to the route for the SARR. The Board's proposal would allow a complainant to try to shift the issue traffic to a dense route, regardless of the efficiency of that route, to benefit from economies of density that it does not enjoy in the real world. In Full-SAC cases, the Board has acknowledged that such a strategy would be inappropriate unless the complainant could demonstrate that the new route was at least as efficient as the existing route. But under the Board's proposal, the only threshold that a shipper has to meet in order to select a route not used by the issue traffic in the past year is to show that the selected route has adequate capacity to handle the issue traffic. The existence of adequate

capacity for incremental traffic, especially the relatively low volumes of incremental traffic at issue in SSAC cases, would say little or nothing about the relative efficiency of handling the traffic over an alternative route. Moreover, an important premise underlying the Board's SSAC methodology is that the incumbent is efficient in its handling of the existing traffic. It is therefore proper to assume that the existing route for the issue traffic is the most efficient route and that any other route for the issue traffic would create costs that would not be justifiable in a contestable market.

Instead of the approach proposed by the Board, BNSF proposes that the Board require the shipper to select the predominant route used by the issue traffic in the real world as the route for the SARR in SSAC cases.⁶ This approach is consistent with the premise that the incumbent is already operating efficiently and that any alternative route would be inefficient. BNSF's proposed approach would also be consistent with the principal objective of the SAC constraint which, as the Board described it, is "to restrain a railroad from exploiting market power over a captive shipper by charging more than it needs to earn a reasonable return on the replacement cost of the infrastructure used to serve that shipper." *EP 646 NPRM*, slip op. at 10 (emphasis added).

C. Revenue on Cross-Over Traffic

Cases brought under the Board's proposed SSAC methodology are likely to include a significant amount of cross-over traffic. The Board has stated that the traffic group in a medium-size rate dispute "would consist of all movements that traveled over the selected route in the Test

⁶ An alternative approach might be to require the shipper seeking to use an alternative route to establish that the alternative route was as efficient as the real world route. However, litigation over the efficiency of alternative routes could significantly increase litigation costs and undermine the goal of simplification. A requirement that the complainant use the predominant real world route is a superior approach in the context of simplified SAC.

Year.” *EP 646 NPRM*, slip op. at 13. But the SARR will consist only of the lines used by the defendant to provide the issue traffic service. It is therefore reasonable to assume that in most SSAC cases, a large portion of the traffic using the SARR lines will be cross-over traffic, making it critically important to identify an appropriate methodology for allocating the through revenue on non-issue traffic using the selected route between the SARR and the lines of the residual incumbent.

The Board has proposed to apportion the revenue from cross-over traffic between the on-SARR and off-SARR portions of the movement in a SSAC case “based on the revenue allocation methodology used in Full-SAC proceedings.” *EP 646 NPRM*, slip op. at 13. The Board is currently considering the issue of the appropriate cross-over traffic revenue allocation methodology to apply in Full-SAC cases in Ex Parte No. 657. In that proceeding, the Board is proposing to use an “Average Total Cost” (“ATC”) approach for allocating cross-over traffic revenues in lieu of the Modified Straight-Mileage Prorate (“MSP”) approach that had been applied in some recent SAC cases. *Major Issues in Rail Rate Cases*, Ex Parte No. 657 (Sub-No.1), slip op. at 19-20 (served Feb. 27, 2006) (“*EP 657 NPRM*”).

As BNSF explained in its comments in Ex Parte No. 657, cross-over revenue allocations could differ depending on how the Board conceptualizes a SARR with cross-over traffic.⁷ A SARR using cross-over traffic could be seen as a new market entrant that handles only part of a through movement. As a partial entrant in a contestable market, the SARR could expect to obtain revenues on cross-over traffic equal to the avoided costs of the defendant. Alternatively,

⁷ In order to have a complete record in this docket on the question of the proper approach to the calculation of revenues on cross-over traffic without burdening the Board with a repetition of the arguments and evidence presented in Ex Parte No. 657 on this issue, BNSF is including a CD as an Appendix with the comments and expert statements submitted by BNSF in Ex Parte No. 657 that address this important issue.

the use of cross-over traffic could be seen as a simplification device that allow the SAC analysis to be simplified while approximating the results of a SAC analysis done without cross-over traffic. Under this view of cross-over traffic, which appears to be the Board's position, the appropriate revenue allocation methodology is the ATC methodology, which properly accounts for the effects of density on relative on-SARR and off-SARR costs.

The same considerations would apply in SSAC cases as in Full-SAC cases on the proper calculation of revenues on cross-over traffic. Therefore, the Board should apply the same revenue allocation methodology in SSAC cases that it adopts in Ex Parte 657, as the Board has proposed. Both the avoidable cost and ATC methodologies are fairly straightforward and simple to apply in a SSAC case. Under the avoidable cost approach, the SARR's revenue for a cross-over movement is set at the level of the incumbent railroad's URCS costs for the portion of the movement that is on-SARR. Since the defendant must already calculate operating costs for each movement using a modified version of URCS, it would be relatively simple to apply this avoided cost methodology.

With respect to the ATC approach, BNSF has looked into the issue of how difficult or complex it would be to apply the ATC methodology in a SSAC case and has determined that application of ATC in such cases would not involve significant burdens. As explained in detail in the attached Verified Statement of Mr. Klick, BNSF would be required to gather most of the information that would be used to calculate cross-over traffic revenues under the ATC methodology in the process of identifying the movements in the traffic group and developing the operating and equipment costs necessary to carry out a SSAC analysis in the first place. To the extent the necessary information was not already collected in that process, it would be readily available from BNSF's databases.

D. Construction Costs (RPI)

The Board proposes to simplify the road property investment (RPI) calculation for the SSAC process by limiting the configuration of the SARR to the existing infrastructure on the route selected by the complainant (*EP 646 NPRM* slip op. at 11) and by using the rolling average of the RPI costs from prior Full-SAC cases wherever possible to determine the unit costs for the major RPI categories. *Id.* at Appendix A, 39-40. BNSF believes that the use of a rolling average of RPI costs from prior SAC cases would perpetuate the unrealistic, low costs that have been developed in those SAC cases, but BNSF is willing to accept the Board's RPI proposal as a less than optimal element of an overall simplification approach. However, some flexibility needs to be applied in assessing RPI costs in SSAC cases to account for major differences between the SARRs posited in the prior Full-SAC cases and the SARRs likely to be posited in SSAC cases.

BNSF has explained on numerous prior occasions that the Board's virtual disregard for the "feasibility" standard for SAC cost evidence has produced cost estimates for SARRs in Full-SAC cases that do not begin to reflect the costs net of entry barrier costs that would be incurred to construct a major railroad. In recent SAC cases, BNSF has presented evidence of the real world costs to construct rail lines based on evidence from recent actual construction projects. For example, in the WFA/Basin case, BNSF's Assistant Vice President of Engineering Services explained that any attempt to replicate the Orin Line – which has been a part of all recent PRB SAC cases – or any major portion of it would cost at least \$2.5 million per track mile.⁸ These costs do not include any significant entry barrier costs that would be excluded in a SAC analysis. But the cost estimates for the construction of SARRs in recent SAC cases have fallen far short of this amount. See *EP 646 NPRM*, slip op., at Appendix A, Table A-1 at 39.

⁸ See *Western Fuels Association et al. v. BNSF Railway Company*, Docket No. 42088, Reply Evidence and Argument of BNSF Railway Company at III,F-4-5 (filed July 20, 2005).

As BNSF has explained, a major problem with prior SAC cost estimates is that complainants develop their cost estimates by cherry picking low unit costs for individual components of RPI costs. In many cases, the cost of individual items is unrealistically low, particularly in light of other assumptions made by complainants to reduce construction costs, like the assumed construction schedule. The aggregation of hundreds of low cost items produces a substantially understated estimate of the total cost to construct the SARR. The Board has never examined whether the result of this aggregation process produces a realistic estimate of a feasible SARR. A comparison of recent SAC construction cost estimates with real world costs indicates that the process used in past cases does not produce realistic cost estimates.

To determine road property investment costs for a SARR under the SSAC methodology, the Board proposes to eliminate the development of costs for individual components and instead to rely on the findings from prior Full-SAC cases. Specifically, it proposes to derive an average unit cost for each major RPI category (land, grading, track, bridges, signals, buildings/facilities, and public improvements) by first deriving an average cost per unit of measure for each category (e.g., "per acre" for land, "per track mile" for track) from the six most recent Full-SAC cases and applying the average of those costs to the simplified-SARR. Under this approach, to the extent the underlying costs in the Full-SAC cases are understated, the SSAC average unit costs will also be understated and thus will perpetuate the understatement of the RPI costs in SSAC rate reasonableness proceedings.

The Board should be particularly concerned about the understatement of construction costs now, when rail capacity is constrained on nearly all major routes, demand is rising across commodity groups, and the railroads are budgeting huge capital expenditures just to keep pace with demand. The Board asserts that its SSAC methodology adequately addresses railroads'

need for revenues to make new capital investments by “incorporat[ing] . . . new capital investments . . . and ensur[ing] . . . a reasonable return on the replacement cost of those investments.” *EP 646 NPRM*, slip op. at 11. However, if the new capital investments are underpriced in the application of SSAC, railroad revenues will fall short of real world capital needs.

At a minimum, the Board needs to apply its rolling average methodology with some flexibility to account for differences between the SARRs that have been posited in recent SAC cases and the SARRs likely to be posited in SSAC cases. Full-SAC cases have typically included the infrastructure requirements of a network designed primarily to haul coal. Thus, use of those costs in SSAC proceedings involving lines that handle commodities in addition to coal, without some adjustments, may result in a further understatement of the investment costs for specialized facilities required for non-coal traffic. The Board should afford railroads the opportunity to introduce evidence on necessary adjustments.

For example, the Board has proposed a “per ton of traffic” unit cost for the buildings and facilities category based on its conclusion that there is a correlation in the Full-SAC cases between total costs for that category and total tons of traffic. *EP 646 NPRM*, slip op. at 46. But there is no reason to believe that such a correlation will hold true for other types of traffic requiring substantially different facilities. Unlike the coal routes in the Full-SAC cases, a SSAC route is likely to carry a mix of traffic types that yield different tonnages and require substantially different facilities, such as intermodal terminals and autoramps. While the track investment for these types of facilities are covered by the Board’s proposal, significant costs for pavement, fencing, security, lighting and other critical elements of these specialized facilities are missing. Similarly, a large bridge or other specialized structure for crossing a major navigable

waterway or exceedingly difficult terrain, although not related directly to traffic mix, will still require investment that is incremental to that derived from prior proceedings.

Another example is land costs. The costs per acre for residential and commercial property set out in Appendix A of the Board's NPRM reflect costs for land in the relatively small urban areas located along the predominately rural coal routes. Those unit costs clearly would not be proper surrogates for land values on potential SSAC routes traversing large urban areas such as Dallas, Chicago or Los Angeles.

Likewise, certain assumptions underlying the unit costs in Full-SAC cases may not be valid in SSAC cases. For example, the unit costs for the track construction category in Appendix A of the Board's Decision were calculated based on construction specifications that assumed in many instances that only a portion of the traffic handled in the real world by the incumbent would be handled by the SARR. Since the traffic densities were lower for SARR lines, the construction specifications used in the Full-SAC proceedings were in some cases below the standards of the incumbent. There is also a tendency in the Full-SAC proceedings for shippers to avoid the more expensive cutting-edge technology being deployed by railroads to improve capacity or reduce track maintenance time. But if the SARR in a SSAC is expected to handle all of the traffic of the incumbent as efficiently as the incumbent, the proponent of the SARR may not be able to avoid some of the costly construction items or specifications used in the real world.

Finally, in the Board's September 25, 2006 Decision in this proceeding denying NITL's request for the work papers underlying the unit costs in the tables in Appendix A of the NPRM, the Board invited comments on whether "the confidentiality of the information underlying the prior Board findings set forth in Appendix A poses a problem for future litigants seeking to use a

simplified procedure.” Sept. 25 Decision at 2. BNSF does not believe that there is any need or justification for any party to a SSAC case to rely on confidential information used in the prior SAC cost calculations. The assumptions used in prior SAC cases are adequately explained in the Board’s decisions. Moreover, it would severely undermine the objective of simplification for the parties in future SSAC cases to examine the confidential information in prior Full-SAC cases in order to verify or adjust the average unit costs determined in prior cases. Such a practice would only result in costly, time-consuming analyses that would not significantly improve the accuracy of cost estimates in SSAC cases. If a unit cost calculated by the Board appears to be erroneous, the parties could simply point out their concerns to the Board and ask the Board to verify its calculations. The Board and its staff are capable of determining whether there has been a technical error in their calculations.

E. Operating Costs

1. URCS Costs

The Board correctly noted in the NPRM that one of the issues in Full-SAC cases that has been highly contentious and the source of substantial litigation costs and delays is the calculation of operating expenses for a SARR. Since the SARR in most Full-SAC cases does not precisely replicate the defendant’s rail lines or handle the same traffic as the defendant, it has been necessary to identify the operating costs for a hypothetical rail carrier with different characteristics than the defendant. Indeed, most SARRs have been single-commodity railroads operating in discrete geographical areas, often handling significantly less traffic than the incumbent. The Board’s practice in those cases is to determine operating costs from the ground up.

The Board’s proposal that the SARR in a SSAC proceeding replicate the existing lines of the defendant and handle the same traffic as the defendant on those lines provides an opportunity

to simplify the calculation of SARR operating expenses. Since the SARR will not be different from the replicated portion of the defendant, the defendant's operating costs can be used as a proxy for the SARR's operating costs. The defendant's operating costs are readily calculated using URCS. In order to use the defendant's URCS costs to estimate the SARR's total operating expenses, the Board proposes to modify the values produced by URCS to reflect total, rather than variable, operating expenses and to exclude certain RPI expenses that are calculated separately under the one-year analysis in the SSAC. *EP 646 NPRM*, slip op. at Appendix B at 49-52.

BNSF supports the Board's proposal to estimate the total operating expenses of the SARR in SSAC cases using modified, system-average URCS costs. This proposal is a logical part of the Board's overall package of simplifying assumptions, where simplification is made possible by assuming that the SARR replicates parts of the defendant's network.

However, the Board needs to address an important issue relating to the fact that under the Board's SSAC proposal, operating expenses and traffic levels will be drawn from different time periods. The Board proposes that the SARR's traffic levels be drawn from the four most recent quarters for which data are available. However, SARR operating expenses would be based on the Board's URCS calculations, and there is a significant time lag in the Board's calculation of a railroad's URCS costs. The time lag could produce distortions in the SAC calculations. For example, if the SARR's traffic and revenues are based on a recent time period where traffic levels are relatively high but the URCS-based operating costs are from an earlier time period where traffic levels were lower, revenues could be overstated relative to costs. When a railroad's lines are congested, operating costs tend to increase as the efficiency of operations declines. It is

therefore important to match the operating cost calculations as closely as possible to the period for which revenues are calculated.

In most instances, this time-lag issue can be adequately addressed by indexing the costs from an earlier period to the period corresponding to the traffic used in the SSAC analysis. In Full-SAC cases, the Board and the parties regularly use standard industry indices and procedures to adjust prior-year operating costs to more current cost levels. The Board should permit the parties to make such adjustments in SSAC cases. In addition, other adjustments might be required to address unique circumstances. For example, if a railroad engaged in fuel hedging practices in prior years, but did not engage in hedging in the more recent time period corresponding to the traffic group used in the SSAC analysis, the effects of hedging should be removed altogether from the URCS cost calculations. A special index would need to be developed to remove the effects of hedging from the URCS costs before applying an inflation index.

2. Equipment Expenses

The Board also asked the parties to comment on its proposed calculation of SARR equipment costs. Rather than relying on the current replacement cost of the equipment needed to provide service to the SARR shipper group, as in full SAC cases, or using the book value of equipment less depreciation, as in URCS, the Board proposes to use the historic book value of a railroad's equipment without any depreciation.

BNSF believes that the Board's proposal will understate the acquisition cost of new equipment for the simplified SARR by failing to account for the inflation in equipment prices from the time of the actual purchase to the current period. For example, many of the locomotives in the BNSF fleet were purchased in the 1990s, so the historic book values for these units are at 1990s price levels. The Board's proposal essentially assumes that locomotives today

could be purchased at the same 1990s price levels, thereby ignoring the substantial inflation in locomotive prices that has occurred in the intervening period.⁹

The Board justifies the use of historical book values with a citation to the Railway Accounting Principles Board (RAPB) that suggests that use of historical asset values in combination with the nominal cost of capital accounts for inflation in the asset value. The Board, however, misapplies the RAPB cite. While it is correct that the combination of historical cost and the nominal cost of capital provides for changes in prices during the time period over which an asset is owned, the nominal cost of capital does not account for inflation that occurred prior to the time the asset is assumed to be acquired by the SARR. In the case of the above example, applying the nominal cost of capital now would not account for price inflation from the 1990s to the current period.

BNSF therefore prefers the use of full replacement cost for equipment, which is consistent SAC practices in past cases. However, BNSF acknowledges the litigation costs that would be incurred in identifying the replacement cost of older locomotives, so BNSF accepts the Board's historical cost proposal as a valid part of the overall package of simplification measures.

F. DCF Analysis

As further simplification of the SAC methodology, the Board proposes to adopt a one-year DCF analysis. Under this approach, the Board would modify the current DCF model used in Full-SAC cases to compare capital recovery requirements and operating expenses (*i.e.*, SAC Revenue Requirement) to SAC revenues for a single year of the SARR's operations – the Test Year. This approach would allow parties to avoid the costs and burden of litigation over

⁹ It is possible that increases in the productive power of locomotives between the 1990s and the current period could offset some of the increase in locomotive unit prices, but it is difficult to quantify such changes.

forecasts of changes in traffic, revenue and operating costs into future DCF periods. Forecasts are inherently speculative, particularly as they relate to the later years of a DCF analysis, and these issues have been the subject of much contention in past SAC cases leading to substantial litigation expense.

Use of a one-year DCF comparison period would simplify SAC litigation, but it would also tend to overstate the amount of any overcharge found in a SAC analysis. In Full-SAC cases, the current practice is to net annual SAC overcharges and undercharges over the DCF period. Because of differences in the escalation patterns of costs and revenues, a SARR's revenues may exceed costs in early years, but in some future period the SARR may have costs in excess of revenues, and the excess would be used to reduce the overcharges from the early years. *See, e.g., Arizona Public Service Company and PacifiCorp v. The Atchison, Topeka & Santa Fe Railway*, 2 S.T.B. 367, 393 (1997). Use of a one-year DCF analysis would eliminate this netting effect. Moreover, use of a one-year DCF analysis with a five-year rate prescription requires that the basic SAC calculations be performed each year for five years, thereby increasing a defendant's litigation expenses. Nevertheless, BNSF accepts the Board's one-year DCF proposal as part of the overall package of simplification measures that the Board has proposed. Use of a one-year DCF analysis would simplify the presentation of evidence and make the proposed SSAC methodology more readily available to prospective litigants who cannot justify the expense of a Full-SAC presentation.

The Board also solicits comment on whether certain features of the DCF model should be simplified. Specifically, it asks whether it would be appropriate to further simplify the SSAC process by substituting for the detailed calculations now used in the SAC DCF model estimates for effective tax rates and interest during construction. On the issue of tax rates, the DCF model

includes a provision for computing state-specific income taxes whereby a weighted average statutory tax rate is calculated based on the number of miles traversed by the SARR in each state. Because tax rates can vary significantly by state, averages from prior proceedings may not reflect accurately the tax rates for the states traversed by the simplified-SARR. It is not particularly complicated to make state-specific tax calculations, so the current practice in Full-SAC cases should be maintained for SSAC cases. On the question of interest during construction, the DCF model automatically makes the required calculation so no simplification would be achieved by using data from prior SAC proceedings. In short, while the Board's DCF model contains sophisticated and complex formulas, its application is straightforward and no further simplification of the DCF calculations is needed.

G. Five-Year Rate Relief

As noted above, the Board proposes to analyze only the Test Year to determine whether an overcharge exists, but it also proposes to provide five years of rate relief for successful complainants. Specifically, if the rate is shown to be unreasonable in the Test Year, the Board would instruct the parties to apply the same method to determine the lawful rate for the other years in the five-year period. The Board suggests that the parties confer annually to recalculate the maximum lawful rate to reflect the actual changes in traffic volumes, revenues, and URCS costs. As noted above, such an approach expands the litigation burdens on railroad defendants, but BNSF accepts this approach so long as the Board also adopts the cost-sharing measures BNSF has proposed to discourage meritless claims.

In the subsequent year SSAC calculations, the Board should allow railroad defendants to modify RPI costs in appropriate circumstances to account for any increases in capacity on the SARR route that have occurred since the original SSAC calculations were made. Given the capacity constraints faced by the railroads today, and the significant capital budgets already

approved for future years' expansion, there could well be significant changes in facilities over a five-year period. It would be important to account for the costs of such capacity expansion since the expanded capacity may be responsible for any traffic increases that would be considered in the updated SSAC calculations. Such adjustments would ensure that the SSAC analysis allows the railroads to recover the costs of new capacity expansion.

H. Rate Reduction Methodology

The Board proposes to use the same rate reduction methodology for SSAC cases that it decides to apply to Full-SAC cases in the Ex Parte No. 657 proceeding. *EP 646 NPRM*, slip op. at 13. On October 4, 2006, BNSF filed supplemental comments in Ex Parte No. 657 that addressed why the Board's proposed rate reduction methodologies make even less sense now that they will be applied in both types of cases than they did when the apparent intention was to apply them only in Full-SAC cases.

BNSF explained at length in its Ex Parte No. 657 comments why the Board should reject the proposed rate reduction methodologies and should continue to use the established percent reduction methodology. As BNSF and its supporting witnesses explained, the Board's proposed methodologies would mark a return to the discredited and long-abandoned view that a railroad's shippers should pay uniform, cost-based rates to the maximum extent possible.¹⁰ Each approach proposed by the Board would cap rates at a cost-based average – MCM would use a uniform rate per ton-mile while MMM would use a uniform R/VC ratio. Either approach would have the effect of destroying the railroad's existing rate structure and virtually eliminating demand-based

¹⁰ The Board is aware of BNSF's position with respect to MCM and MMM and BNSF does not repeat those comments in the text of its comments here. However, to have a complete record on this issue in both proceedings where the MCM and MMM methodologies may be applied, BNSF has included in a separate electronic appendix included with this filing its Ex Parte No. 657 comments relating to the rate reduction issue and the statements of its expert witnesses who addressed the rate reduction issue in Ex Parte No. 657.

differential pricing among shippers. The obvious consequence would be a substantial reduction in revenue available to the railroad from the railroad's most demand-inelastic traffic, the group of traffic to which the railroad must look to achieve revenue adequacy.

As BNSF explained in its October 4, 2006 supplemental comments in Ex Parte No. 657, the flaws in the Board's proposed MCM and MMM approaches are magnified when they are considered in a SSAC case where the SARR would handle the full mix of different traffic types that traverse the relevant line segments on the defendant railroad. It would appear, based on the Board's own statements, that MCM could not even be considered for a SSAC case. According to the Board, MCM

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

EP 657 NPRM, slip op. at 13. The Board's own example of significant cost differences between chemical and coal traffic emphasize the problems that would result from the application of MCM in cases where multiple traffic groups are handled by the SARR. *See EP 657 NPRM*, slip op. at 16.

The flaws in the proposed MMM methodology are also highlighted when considered in the context of a SSAC case. MMM would reduce rates for a wide variety of traffic to a uniform R/VC ratio despite existing variations in the demand characteristics of the different traffic groups. BNSF showed in its October 4, 2006 supplemental comments that estimates published by a firm that offers rate analysis and negotiation support to rail shippers, Escalation Consultants, show average R/VC ratios by commodity varying from a low of 76.8% for "Forest Products" to a

high of 217.2% for “Ordnance or Accessories,” with wide variation between these two bounds: 146.5% for “Farm Products,” 160.3% for “Coal,” and 180.5% for “Chemical,” just to list a few.¹¹

R/VC ratios on traffic handled by a railroad engaged in differential pricing reflect variations in demand for transportation services.¹² MMM would eliminate variations in R/VC ratios by setting all but the lowest rated traffic to the same average R/VC ratio. BNSF’s witness Mr. Klick showed the impact of such a rate reduction methodology in a verified statement attached to BNSF’s rebuttal comments in Ex Parte No. 657.¹³ The same effect would be produced in SSAC cases, where rates would be driven to common R/VC ratios notwithstanding the substantial differences in demand among the various traffic groups handled by the SARR.

As described below in the discussion of the Board’s proposed approach to small-sized cases, the Board rejected approaches like MMM that would cap all rates at a uniform average when it adopted simplified procedures in 1996. The Board specifically rejected the use of averages as completely inconsistent with CMP and differential pricing, stating that an average “does not provide an appropriate regulatory ceiling.” *Non-Coal Guidelines*, 1 S.T.B. at 1022. Accordingly, both the Board’s 1996 procedures and its current proposal endeavor to retain some

¹¹ See “STB Rate Data Provides Valuable Rate Comparison,” in *Rail Business* (May 20, 2002). See also “How to Determine the R/VC Benchmark for Your Traffic,” in *Rail Business* (June 20, 2005) (showing R/VCs from 102.3 for “fresh fish or other marine products” to 233.0 for “ordnance or accessories.”).

¹² See, e.g., *Burlington Northern Railroad Co. v. United States*, 985 F.2d at 589, 597 (D.C. Cir. 1993) (“if a profit-maximizing railroad charges more for the issue traffic than for the benchmark traffic, that would seem to represent a judgment – by the party with the greatest interest in making it correctly – that the issue traffic either costs more to transport or has a less elastic demand”); *Rate Guidelines – Non-Coal Proceedings*, 1 S.T.B. 1006, 1034 (1996) (“We are satisfied that comparison of r/vc ratios (a markup expressed in terms of variable costs), while not a refined measure, gives at least a rough indication of relative degree of captivity”).

¹³ See Verified Statement of John C. Klick, Diagrams 2 and 3 (attached to BNSF’s June 30, 2006 rebuttal comments in Ex Parte No. 657).

degree of differential pricing through the R/VC_{COMP} benchmark, whereas adoption of MMM would effectively eliminate differential pricing. It would be both ironic and impermissible for the Board's crudest approach to rate regulation to provide a greater degree of differential pricing than the supposedly more precise SSAC procedure.

I. Procedural Issues

1. Discovery Schedule

The Board's proposed schedule for SSAC proceedings requires that on Day 170 (Railroad Second Disclosure) the defendant railroad produce data identifying all traffic that moved over the route selected, the operating characteristics for those movements, total operating and equipment costs for each of those movements, and the revenue allocations for any cross-over traffic on the route. *EP 646 NPRM*, slip op. at 17-18.

While this time frame may be sufficient in cases where the parties agree on a route, it would not be workable where they disagree. According to the schedule, in case of a dispute, the Board's final decision on the appropriate route would be made on Day 140. That would leave the railroad only 30 days to accumulate and process the data required for the Second Disclosure. Such a short deadline would be difficult to meet without extraordinary and costly efforts. Moreover, given the time and cost associated with the production of route-specific data, it would be a waste of resources for the railroad to begin gathering and developing data for a route that may not be used. Therefore, the Board should consider making an appropriate adjustment to the schedule in cases where there is a dispute over the route.

2. Protective Order

The Board's Decision makes no mention of a protective order. The data required to be turned over to complainants in the Railroads' First and Second Disclosures are commercially sensitive and confidential. In Full-SAC cases, these data are released only after a Protective

Order has been entered that limits access and use of confidential data to persons who have signed an undertaking to comply with the order, and further limits access and use of "highly confidential" data to outside counsel and consultants. BNSF urges the Board to incorporate into its SSAC proceedings the same level of protection by requiring the entry of the Protective Order and Signed Undertakings standardized in the Full-SAC cases prior to the release of any confidential data.

IV. SMALL RATE DISPUTES

The Board's 1996 *Non-Coal Guidelines* set out a rate reasonableness standard for small rate cases that used three benchmarks -- the RSAM, $R/VC_{>180}$ and R/VC_{COMP} -- to determine whether a challenged rate exceeds a reasonable maximum rate. However, the Board noted that these three benchmarks were only the starting point for the rate reasonableness analysis, and the *Non-Coal Guidelines* contained no formula or predictable methodology for using the three benchmarks in a particular case. As the Board explains in the EP 646 NPRM, this approach created uncertainty that, according to some, resulted in almost no small shipper cases having been brought under the *Non-Coal Guidelines*.

BNSF does not believe that the infrequency of small rate cases is attributable to uncertainty over the standards that the Board intended to apply under the *Non-Coal Guidelines*. Instead, the scarcity of cases is more likely due to the fact that there is no market dislocation that would justify rate regulation. There is no reason to believe that unreasonable rates are widespread in today's market. Nevertheless, BNSF acknowledges that it is appropriate for the Board to clarify its intended application of the three-benchmark approach to simplify and make more predictable the Board's rate reasonableness standards in cases where relatively small amounts of revenues are at issue.

BNSF believes that the basic methodology set out by the Board in the *EP 646 NPRM* accomplishes these objectives. BNSF agrees with the Board's proposal to use the adjusted R/VC ratios of comparable traffic to identify the maximum reasonable rate of an issue traffic movement, so long as the comparable group truly reflects demand characteristics that are comparable to those of the issue traffic. BNSF also agrees that it is appropriate to adjust the R/VC ratios of the comparable traffic by a revenue need factor in order to ensure that railroads have an opportunity to achieve revenue adequacy. However, BNSF opposes the Board's proposal to modify the calculation of the RSAM and to change the $R/VC_{>180}$ to an R/VC_{total} . Moreover, BNSF would substitute a standard deviation approach, which defines an appropriate range of rates, for the Board's proposed use of the mean. These issues are addressed further below.

A. Comparison Group

The Board proposes to use a final-offer procedure "to select a comparison group most similar in the aggregate to the challenged movement." *EP 646 NPRM*, slip op. at 19. Under the Board's proposal, the shipper and the railroad involved in the case will each tender to the Board a proposed comparison group. *Id.* at 20. After the parties have an opportunity to engage in a technical conference with Board staff and to submit a final comparison group, the Board will select one of the parties' final comparison groups to calculate the R/VC_{COMP} . *Id.*

As noted above, BNSF believes it is appropriate to use a comparison group for the smallest rate cases as a simplifying measure and it accepts the Board's proposed final-offer procedure for selecting a comparison group. However, BNSF urges the Board to make it clear that in selecting the most appropriate comparison group, the Board will focus on the demand characteristics of the issue traffic and of the traffic included in the proposed comparable group.

BNSF also urges the Board to address three other issues relating to the selection of a comparable traffic group and the calculation of the R/VC ratios for the comparable traffic.

The Comparison Group Must Reflect Comparable Demand: The Board has already noted the importance of demand characteristics in selecting a proper comparable group:

“Comparability would be determined by reviewing a variety of factors, such as length of movement, commodity type, terrain involved, and other factors *which could affect demand characteristics* and operating costs.” *EP 646 NPRM*, slip op. at 20 (emphasis added). Similarly, the Board recognized the need to consider demand characteristics when it established the R/VC_{COMP} benchmark in 1996. The *Non-Coal Guidelines* made it clear that the “[t]he R/VC_{COMP} benchmark provides a means of reflecting demand-based differential pricing principles.” *Non-Coal Guidelines*, 1 S.T.B. at 1034-35. While the use of comparable traffic is a crude way to measure the markup taken by railroads on traffic involving similar commodities moving under similar transportation conditions, the Board nevertheless concluded that this approach “is the only simple means available to obtain even a rough measure of” a demand-based rate. *Id.* at 1035.

The only way to ensure that demand-based pricing can be preserved under the Board’s comparability approach is to set a maximum reasonable rate for an issue traffic movement that is comparable to the rates charged to traffic with similar demand characteristics. *See* the attached Verified Statement of Mr. Klick. The Board should therefore make it clear that its decisions on a proper comparison group will account for demand-based pricing by requiring evidence that the traffic chosen for the comparison group shares similar demand characteristics with the issue traffic.

Inclusion of Other Carrier Movements in the Comparison Group: The Board's NPRM suggests that movements for carriers other than the defendant railroad might be included in the comparison group. This suggestion is made in footnote 45 where the Board states that "[i]f the comparison group included movements from different carriers, the appropriate RSAM [divided by] R/VC_{total} ratio for the carrier involved would be applied to each movement." *EP 646 NPRM*, slip op. at 25, n. 45. BNSF opposes the use of other carrier movements in the comparison group. A movement on a carrier other than the defendant carrier cannot possibly satisfy the requirement that the movement be comparable to the issue traffic movement. The other carrier has its own network and cost structure that differs from the network and cost structure of the defendant carrier. Since the Board intends to base the selection of a comparable traffic group in part on whether the traffic has comparable costs, the different cost structure of other rail carriers should disqualify use of traffic handled by those other carriers altogether. Moreover, use of other carrier movements is inconsistent with the practice in Full-SAC cases where the parties only use movements for the respondent carrier in the traffic group. Use of other carrier traffic also raises substantial confidentiality concerns, since the R/VCs of the comparable group would involve unmasked waybill revenues, thereby giving a railroad access to confidential rate information of another railroad. The attached Verified Statement of Mr. Klick further discusses this issue.

Inclusion of Contract Movements in the Comparison Group: The Board's proposal also suggests that contract movements may be eligible for inclusion in the comparison group. This suggestion is made at pages 32-33 where the Board describes the process for identifying waybill data for comparable movements: "Under our proposal here, once we find that a complainant is eligible to use the Three-Benchmark method, we would release to lawyers and consultants who

have signed the necessary confidentiality agreement all movements in the most recent Waybill Sample that have the same 2-digit STCC code as the issue movement and an R/VC ratio above 180%. Confidential contract revenue information would continue to be encrypted. . . . At the end of the proceeding, we would unmask revenue information only for movements within the comparison group selected by the Board.” *EP 646 NPRM*, slip op. at 32-33 (emphasis added).

BNSF opposes the use of contract movements in the comparison group. The rates negotiated in a contract are directly linked to a host of factors that are not generally present in common carrier movements, such as a binding term, a volume commitment, service requirements, and damage provisions, among other things. Accordingly, the conditions associated with contract movements are necessarily different from the conditions of common carriage. Further, the use of contract movements in the comparison group could create a disincentive on the part of a railroad to offer lower contract rates than rates for common carrier service. This could inhibit the use of rail transportation contracts.

Time-Lag Issue: The Board contemplates that the R/VC ratios for the comparison group will be determined based on the costed-waybill data. *EP 646 NPRM*, slip op. at 33. However, use of the costed-waybill data as the starting point for the identification of a maximum reasonable rate creates a time-lag problem because the costed-waybill data is one to two years older than the rate being challenged. As a result, the Board’s proposal would result in the setting of current rates based upon revenue and cost data that are one to two years old. This time-lag problem would be particularly acute in periods when rate levels are changing. For example, if rates have increased significantly over a prior one to two year period, the use of comparable R/VC ratios from the older waybill data could significantly understate the *current* comparable

rate level. While costs may have also increased, there is no reason to believe that the increase in costs would preserve the same R/VC ratios from the prior time period.

The time-lag issue can be addressed by updating the R/VC ratios from the waybill data using reasonably straightforward and publicly available indices. On the revenue side, for example, revenues could be updated using a defendant railroad's 10-Q reports. See the attached Verified Statement of Mr. Klick. If the commodity at issue is grain, for example, the costed-waybill revenue could be updated based upon the percentage change in revenues/unit for the defendant railroad's agricultural products reflected in the railroad's 10-Qs from the date of costed-waybill data to the effective date of the rate being challenged. On the cost side, the Board could update the costs of comparable movements using the same indices used to update URCS costs for purposes of estimating operating costs in SSAC cases.

B. Calculation of RSAM and R/VC total

The Board proposes to revise its calculation of the RSAM. The current RSAM reflects the R/VC ratio that a railroad needs to charge on average to traffic with R/VC ratios over 180% in order to earn adequate revenues. The Board proposes to calculate the RSAM using *all* of a railroad's traffic. Moreover, the Board also proposes to change the calculation of the $R/VC_{>180}$ to an R/VC_{total} , which would reflect the R/VC ratio charged on average to a railroad's entire traffic group.

BNSF opposes the Board's proposed revisions to the RSAM and $R/VC_{>180}$. The Board's new approach is inconsistent with the *Non-Coal Guidelines*. The Board's proposal departs without justification from the appropriate focus on a railroad's potentially captive traffic with R/VC ratios greater than 180% – the only traffic from which it is reasonable to expect that a railroad could obtain the higher level of contribution necessary to achieve revenue adequacy.

The Board should continue to use the unadjusted RSAM as currently calculated to properly account for revenue adequacy needs.

The Board explained the function of the RSAM benchmark in the *Non-Coal Guidelines*: “RSAM . . . calculates the average markup over variable cost that would be needed from all relatively demand-inelastic traffic (traffic moving at r/vc percentages in excess of 180) for the carrier to recover its total costs (including a reasonable profit component, as measured by the cost of capital for the railroad industry).” 1 S.T.B. at 1011. RSAM was calculated for “relatively demand-inelastic traffic” because that was the traffic for which railroads might expect to charge the differentially higher prices that are necessary to achieve revenue adequacy. The Board believed that including traffic that moves below an R/VC ratio of 180%, as it now proposes, “would be inconsistent with the statute . . . which contains an express legislative determination that no traffic with rates set below 180% is captive.” 1 S.T.B. at 1026. In other words, there is a statutory presumption that railroads lack the pricing power to establish differentially higher prices for traffic that moves at rates set below R/VC ratios of 180%.

Any RSAM calculation that fails to consider whether the revenue need identified by the RSAM factor is achievable would be illogical and unsupportable. As the Board stated in 1996, the RSAM is the only benchmark in the Board’s proposed formula that was intended to account for revenue adequacy needs. *Non-Coal Guidelines*, 1 S.T.B. at 1020. But the Board’s proposed new method for calculating RSAM provides no information on what rates a railroad needs to charge that traffic for which it has the ability to engage in differential pricing in order to become revenue adequate. Indeed, it is irrational to contend that the new RSAM reflects a railroad’s revenue adequacy needs when it is premised on the assumption that the railroad can increase its rates on non-captive traffic beyond the levels that have already been set by competitive forces.

The Board attempts to explain away this fundamental defect in the new RSAM measure by claiming, in essence, that railroads *do* have market power over non-captive customers. The Board argues that railroads “have raised rates on competitive traffic as demand for rail transportation has increased.” *EP 646 NPRM*, slip op. at 24. But the Board appears to have confused the normal operations of supply and demand with market power. In a properly functioning market, prices rise when demand increases or when capacity decreases. This is exactly what is happening in rail markets now where increased demand has actually caused capacity constraints in many areas. As demand increases, railroads have responded with rate increases. But competition has limited the amount of any rate increases, as evidenced by the fact that railroads continue to earn less than adequate revenues. To the extent revenues are inadequate today notwithstanding the higher demand for rail transportation service, this is strong evidence that the rates carriers such as BNSF can charge on traffic with relatively inelastic demand are also constrained by effective competition, or by regulation.

Fluctuations in market conditions cannot serve as an excuse for the Board to ignore long-established principles of railroad economics. Rising price levels for non-captive traffic may improve a railroad’s financial condition, but so long as a railroad remains revenue inadequate – as BNSF has been consistently – the only means by which a railroad could hope to become revenue adequate would be by setting even higher prices for those shippers where there is a degree of market power. Congress has determined that such shippers will be found only among those with R/VC ratios of greater than 180%. Therefore, it is appropriate and necessary for the revenue adequacy factor that is incorporated into the three-benchmark standard to focus only on that set of shippers, as the unadjusted RSAM currently calculated does. And since the revenue

need adjustment factor is based on a comparison of the RSAM to the R/VC ratio for the same group on which the RSAM is calculated, the Board also needs to retain the $R/VC_{>180}$ factor.

The existing RSAM is a useful indicator of how much, on average, a railroad would have to charge captive traffic to achieve revenue adequacy. Market conditions may prevent a carrier from raising its rates on such traffic to levels that will result in revenue adequacy, but the RSAM at least provides a target that is useful to the Board, railroads and shippers that indicates the level to which rates must move in order to achieve revenue adequacy – and *regulatory* constraints should not prevent railroads from assessing rates at these levels on traffic where they presumptively have some degree of market power. In contrast, the new RSAM calculation would be substantially below the 180% jurisdictional threshold. It would provide no information about the rate levels that would need to be charged to traffic that is presumed to be relatively demand inelastic in order to achieve revenue adequacy, thus frustrating an important purpose for developing the RSAM in the first place.¹⁴

Indeed, even as currently calculated, the RSAM significantly understates the revenue needs of revenue inadequate carriers because the calculation is based on the depreciated book value of a railroad's current assets. See the attached Verified Statement of Mr. Klick. As the Board has repeatedly recognized, the current high level of demand for rail transportation has given rise to an urgent need to expand rail capacity. New capacity is being added, but to justify widespread further expansion of the railroad infrastructure, railroads must be able to attract

¹⁴ The Board's perception that there is a supposed mismatch between the existing RSAM and $R/VC_{>180}$ for one carrier when that carrier had revenues approaching the level of revenues needed to achieve revenue adequacy does not justify wholesale abandonment of the current RSAM calculation. As explained by Mr. Klick in the attached Verified Statement, the supposed mismatch is caused by minor methodological differences in the data used to make the two calculations. There are clearly less drastic approaches to that issue that do not involve eliminating meaningful consideration of railroad revenue adequacy and the proper focus on a railroad's potentially captive traffic.

investment by offering a return on the value of the new investments equal to the cost of capital. New investments are being made at today's cost, not at the depreciated cost of the railroad's existing assets. But the Board's RSAM calculations assume that a railroad needs only to offer a return on the depreciated cost of existing assets, not on the cost to replace those assets today. Accordingly, the RSAM already understates the revenues that railroads need to address the capacity shortage in the rail network. The Board should not exacerbate that problem and undermine the RSAM calculations as a benchmark for determining the level of rates that a revenue inadequate railroad needs to charge by basing the RSAM calculation on a railroad's entire traffic group.

C. Use of an Average R/VC to Set the Maximum Rate is Impermissible

BNSF also opposes the Board's proposal to set maximum reasonable rates at the mean of the R/VCs for the comparison group. Such an approach is inconsistent with the Board's prior decisions, court decisions, and sound regulatory policy.¹⁵ The Board cites a 1991 decision concerning FERC regulation for the proposition that using an average is appropriate,¹⁶ but the Board completely ignores its own subsequent holding in 1996 to the contrary.

In the *Non-Coal Guidelines*, the Board stated with respect to the development of simplified procedures that "our regulatory task is to determine whether the degree of differential pricing . . . is reasonable. We must be guided by Ramsey pricing principles and fundamental

¹⁵ The Board devotes considerable discussion to the proposition that it will set maximum rates at the "upper boundary" of a 90% confidence interval around the mean of R/VC_{COMP} . 646 *NPRM*, slip op. at 26-27. All this means is that the Board acknowledges as a statistical matter that it cannot determine the precise actual mean of a distribution of rates based on a sample. The Board is therefore estimating the mean, but it is establishing a rate reasonableness standard that would strike down rates that are above the estimated mean.

¹⁶ *EP 646 NPRM*, slip op. at 27, citing *Tennessee Gas Pipeline Co. v. FERC*, 926 F.2d 1206 (D.C. Cir. 1991).

fairness in carrying out this regulatory task. . . . Our challenge is to reflect these economic and equitable principles, as best we can, in a practical, readily administrable test.” 1 S.T.B. at 1007. The Board properly found in the *Non-Coal Guidelines* that setting a maximum reasonable rate at an average R/VC for a comparison group did not fulfill these requirements because it failed adequately to address the need for differential pricing.

The Board addressed at length its concerns with the use of an average to set maximum rates in the 1996 decision. The Board explained:

We recognize the dangers inherent in relying on average numbers, and it is certainly not our intent to return to an era of rate equalization among different traffic. By its very nature, an average number, which is produced by combining numbers that are both above and below that level, does not provide an appropriate regulatory ceiling. That is why, as explained in the *1995 Decision*, the r/vc benchmarks can only provide the starting point for a rate reasonableness analysis, not the end result.

1 S.T.B. at 1022. Rather than set rates at an average level, the Board sought to identify a reasonable range of rates in order to preserve a semblance of differential pricing:

[T]he analysis that we envision would not presume that, simply because a rate produces an r/vc ratio above the average level, it is thereby unreasonable. The nature of an average number – which is produced by combining numbers that are both above and below that level – does not permit such a presumption. Rather, what we must consider is whether the resulting markup is within a reasonable range or zone.

1 S.T.B. at 1023 (note omitted). The Board must provide a reasoned basis for departing from its prior conclusions. It has not done so.

The Board does not squarely address the D.C. Circuit’s rejection of the ICC’s attempt to use the average R/VC ratio for a supposedly comparable group of traffic as a regulatory shortcut in *Burlington Northern*, 985 F.2d at 596-99. Instead, the Board asserts that using the proposed average should not undermine revenue adequacy because the level of the average R/VC ratio has

been adjusted upwards to account for a railroad's revenue needs. But this argument misses the point. The Board previously concluded that the use of an average for setting a maximum reasonable rate is fundamentally inconsistent with differential pricing, where some rates are set above the average and others below the average, based on relative demand characteristics. Even if the Board properly identified a railroad's revenue needs, the use of an average would not satisfy the Board's previously expressed concerns about the need to preserve differential pricing. The Board also suggests that the measure it uses does not matter because "only a small percentage of a carrier's traffic would likely be eligible to use the Three-Benchmark approach under our proposed eligibility criteria." *EP 646 NPRM*, slip op. at 28. In fact, however, the Board's own calculations indicate that 17% of a railroad's traffic that moves with an R/VC ratio greater than 180% "would be presumed eligible." *EP 646 NPRM*, slip op. at 37.

The Board also claims that, in any case, it has no reasonable choice but to use an average. The Board states that its task is to determine where in the range of R/VC ratios from the comparable shipper group a maximum reasonable rate falls. According to the Board, "[t]here are only two practical alternatives – the mean or the highest R/VC ratio in the comparison group – as there would be no reasoned basis for selecting a point in-between." *646 NPRM*, slip op. at 27. This unsupported contention is simply incorrect. As the Board recognized in 1996, its task is to determine whether a challenged rate is "within a reasonable range or zone" of differential pricing. There are precise and widely used statistical measures of the range or breadth of a distribution of values that would allow the Board to identify a zone of reasonableness, which is preferable to identifying a single point at which a rate becomes unreasonable.

The standard deviation is such a measure of the breadth of a distribution. As Mr. Klick explains in the attached Verified Statement, most values within the distribution (around two-

thirds) can be expected to fall within one standard deviation of the mean, while 95% fall within two standard deviations. Instead of setting the maximum reasonable rate at the mean of a group of comparable traffic, the Board should find that a challenged rate is unreasonable only if it is more than one standard deviation from the mean of R/VC_{Comp} . Such a rule would be much more consistent with the Board's stated goal of determining whether a given rate is within a reasonable *range* of differential prices. The rule would find rates to be unreasonable only where they vary substantially from the norm for rates charged to the comparison group. Such an approach would preserve differential pricing within the comparison group.

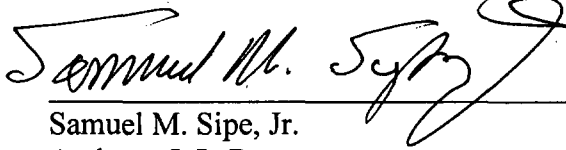
D. Five-Year Rate Relief

Finally, the Board proposes that relief in a small case will be available for 5 years if a challenged rate is found to exceed a reasonable maximum rate. *EP 646 NPRM*, slip op. at 33. However, the Board does not explain how the prescribed rate would be calculated after the first year. BNSF believes that the parties in a particular case would be in the best position to propose appropriate adjustment mechanisms, and the Board should allow them to do so in individual cases. For example, a party might propose to apply the same index used to index waybill revenues to current levels. While such an index is crude, it is simple to apply and it would capture general trends in the market so that prescribed rates can reflect overall changes in market conditions. Following the submission of the parties' proposals, the Board would select a method for adjusting any prescribed rate during the subsequent four years.

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Respectfully submitted,

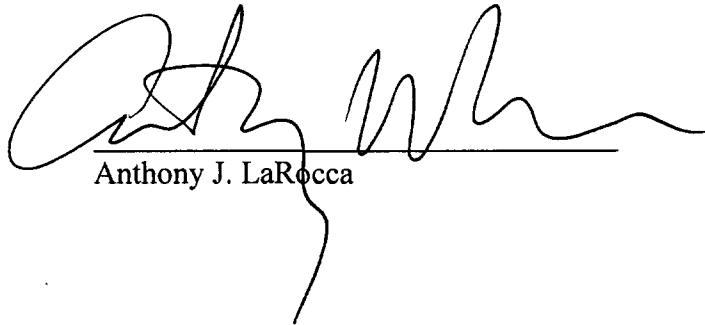


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CERTIFICATE OF SERVICE

I, Anthony J. LaRocca, hereby certify that on October 24, 2006, I caused a copy of BNSF Railway Company's Opening Comments to be served by first-class mail or a more expeditious method of delivery upon all persons who have filed a notice of intent to participate in STB Ex Parte No. 646 (Sub-No. 1).



Anthony J. LaRocca



KLICK

SURFACE TRANSPORTATION BOARD

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

Simplified Standards for Rail Rate Cases

Opening Verified Statement

of

John C. Klick

Opening Verified Statement

Of

John C. Klick

My name is John C. Klick. I am a Senior Managing Director of FTI Consulting, Inc., and head of FTI's economic consulting practice. My offices are located at 1201 I Street, NW, Suite 400, Washington, D.C. 20005. I have been engaged in financial and economic studies of railroad transportation since 1970, and many of these analyses have resulted in testimony before the Surface Transportation Board ("STB" or "Board"), its predecessor agency ("Interstate Commerce Commission" or "ICC"), arbitration panels and the Courts. A statement of my qualifications is attached as Exhibit No. ____ (JCK-1) to this verified statement

I have been asked by BNSF Railway Company ("BNSF") to respond to Board proposals set forth in a notice of proposed rulemaking in this proceeding served on July 28, 2006 (the "NPR"). In the NPR, the Board proposes to modify guidelines originally adopted in 1996 in *Rate Guidelines – Non-Coal Proceedings*, 1 S.T.B. 1004 ("*Simplified Guidelines*"), which were intended to "establish a simplified and expedited method for determining the reasonableness of challenged 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).

I. INTRODUCTION

The NPR has three principal features. First, it sets forth proposed "eligibility presumptions" that serve to categorize rate disputes as either "large," "medium-size," or

“small.” Second, it proposes to create a simplified stand-alone cost (“SSAC”) standard for use in assessing rate reasonableness in medium-size rate disputes, *i.e.*, disputes for which a traditional stand-alone cost presentation is too costly, given what is at issue in the medium-size cases.¹ Third, the NPR proposes modifications to the “Three-Benchmark” method adopted in *Simplified Guidelines* for use in small rate disputes in which even the SSAC approach proposed in the NPR would be too costly, given what is at issue. I am addressing issues related to the SSAC and three-benchmark standards.

My testimony is organized as follows. In Section II, I explain why the STB’s proposed Average Total Cost (“ATC”) approach is appropriate and feasible for use in allocating cross-over traffic revenues in medium-size rate disputes. In Section III, I address the Board’s proposed modifications to the Three-Benchmark approach for small rate disputes.

II. THE AVERAGE TOTAL COST (“ATC”) REVENUE-ALLOCATION APPROACH IS APPROPRIATE AND FEASIBLE FOR USE IN SSAC CASES

In this section of my verified statement, I discuss the Board’s stated intention to apply the same revenue allocation methodology in both traditional SAC cases and in SSAC cases, once a determination on the appropriate revenue allocation methodology is

¹ In the NPR, the Board uses the terms “full stand-alone cost” and “Full-SAC” to refer to the stand-alone cost presentations that are traditionally made in cases involving large volume movements, such as *McCarty*, *Xcel*, and *FMC*. This nomenclature is confusing – and potentially misleading – because in the Ex Parte No. 657 (Sub-No. 1) proceeding, the Board used the term “full SAC” in referring to traditional stand-alone cost presentations that do not rely on cross-over traffic and, instead, build *all* of the defendant’s facilities required to handle the issue and grouped traffic on an end-to-end basis. Ex Parte No. 657 (Sub-No. 1), February 27, 2006, at 17. To distinguish between these two very different concepts in this verified statement, I use the term “full SAC” the way the Board did in Ex Parte No. 657 (Sub-No. 1), and use the term “traditional SAC presentation” to refer to SAC studies that may rely on cross-over traffic that are routinely presented in large rate disputes.

adopted in Ex Parte No. 657 (Sub-No. 1). My reasons for supporting the STB's proposed ATC approach are set forth in my testimony in Ex Parte No. 657 (Sub-No. 1), an electronic version of which is appended to BNSF's Opening Comments in this proceeding. These reasons are equally supportive of its use in medium-size disputes. In this verified statement, I respond to recent claims made by shippers, filed in the Ex Parte No. 657 proceeding, regarding the alleged complexity of performing the ATC allocation.

As background, BNSF presented evidence in the Ex Parte No. 657 proceeding that explained that either the "avoidable cost" or ATC approach could be used to allocate revenues for cross-over traffic (for which the SARR does not serve the entire through movement service that is provided by the defendant). Developing allocations under those approaches is a relatively straightforward process – using either the incumbent's URCS variable costs for the "avoidable cost" approach, or separate variable and fixed cost components for ATC. On October 11, 2006, a group of shippers submitted a Reply to BNSF's Supplemental Comments filed in the Ex Parte No. 657 proceeding, in which the shippers criticize ATC as "far more complicated to implement" and a "time-intensive" exercise. In light of the STB's efforts to provide simplified procedures for medium-sized and small disputes in the instant proceeding, I examined how complicated it would be to apply ATC in a SSAC case, and have determined that doing so would not involve significant additional burdens. In fact, the information required to calculate ATC either is readily available or, as importantly, would be developed using the same information and processes that BNSF would otherwise need to gather or develop in SSAC cases, even if ATC were not to be used.

The Board's proposed disclosures require the railroad in a SSAC case to compile and provide a significant amount of information, including: (1) the identification of all traffic that moved over the routes replicated by the SARR, and (2) a calculation of the operating and equipment costs for that traffic.² This information already will contain the inputs and materials necessary to apply the ATC methodology and, using it, BNSF would be able to perform the ATC revenue allocation with relatively little additional effort.

Specifically, in the process of identifying the traffic that moves over the SARR in a SSAC case, BNSF will be required to identify the group of segments that comprise the route traversed by the issue traffic, and then determine which traffic moves over any of those segments. That process will involve a determination of the line segments each movement traverses and will serve to identify the specific BNSF segments – on-SARR and off-SARR – that are used by each cross-over movement in the SSAC traffic group. From this identification of the particular segments that are used by each movement, BNSF would then be able to identify the corresponding miles and densities by segment, and readily calculate the fixed costs for the on-SARR and off-SARR portions of each movement of cross-over traffic included in the SSAC analysis.

After identifying the movements in the SSAC traffic group, the railroads are required to calculate URCS-based costs for each movement to develop the SARR operating and equipment costs to be used in the SSAC analysis. This step requires the identification of nine inputs³ for each movement to develop the costs for the portion of the movement over the lines replicated by the SARR (*i.e.*, the “on-SARR” costs). In applying the ATC revenue allocation, railroads will be able to use the same nine inputs to

² 646 NPRM, slip op. at 18.

³ See, *e.g.*, 646 NPRM, slip op. at 18, for the nine inputs required to calculate URCS variable costs.

develop variable URCS costs for the on-SARR portion of each cross-over traffic movement, and seven of the nine to develop the costs for the off-SARR portion of each cross-over traffic movement.⁴ The two inputs that will not be the same for the on-SARR and off-SARR portion of the movements – the type of shipment (local, received-terminated, etc.) and the one-way distance of the shipment – are each readily available from BNSF's databases (and, importantly, also would be required to perform alternative revenue-allocation algorithms such as MSP). Thus, use of the ATC methodology – which BNSF strongly endorses – would require only a modest incremental effort to (1) compile the inputs not otherwise gathered for identifying the traffic, and (2) develop the operating and equipment costs.

III. COMMENTS ON THE PROPOSED STANDARDS FOR SMALL RATE DISPUTES

My discussion of the standards proposed in the NPR to be used in small rate disputes is broken into three issues. First, I discuss issues that relate to the selection of the comparison group. Second, I address the changes proposed in the NPR for calculation of the RSAM and the revenue need adjustment factor. Third, I discuss the methodology proposed by the Board for calculating the maximum reasonable rate.

A. Issues Associated with Selection of a Comparison Group

1. Parties Must Have an Opportunity to Submit Probative Evidence on Demand Elasticities

⁴ BNSF recognizes that ATC relies upon the standard URCS unit costs, and not those computed in accordance with the adjustments identified in Appendix B to the 646 NPRM to serve as the SARR operating and equipment costs. However, using the movement inputs to develop URCS costs for the ATC methodology, rather than operating and equipment costs for a SSAC case, requires modifying only the reference to the input URCS unit-cost file (referred to as the "E-table") in the cost processing program.

The methodology proposed in the NPR for application in small rate disputes is predicated on the ability to identify a “comparison group.” At page 20 of the NPR, the Board states that it will evaluate “comparability” of the traffic in the comparison groups (proposed, respectively, by the shipper and the rail carriers) to the issue traffic based on “a variety of factors . . . which could affect demand characteristics and operating costs.” The NPR also refers to a similar intent expressed in *Simplified Guidelines*, where the Board held that “properly selected comparison traffic will have a similar degree of demand elasticity.”⁵

While this language acknowledges the need for the comparison group to exhibit demand elasticities that are similar to those experienced by the issue traffic, the factors explicitly identified in the NPR (“length of movement, commodity type, terrain involved”) seem to relate much more closely to cost than to demand elasticity. In addition, the statement that “the analysis and arguments [related to comparability] must rely on publicly available information or on (non-rate) information provided in the Waybill Sample” may reflect an intent on the Board’s part to restrict the type of evidence most likely to bear on the issue of similar demand elasticities, such as evidence on the amount of product and geographic competition experienced by the issue traffic, on the one hand, and movements proposed for inclusion in the “comparison traffic group.”

In *Simplified Guidelines*, the Board explains that the R/VC_{COMP} is intended as “a means of reflecting demand-based differential pricing principles.” *Simplified Guidelines* at 1034. *Simplified Guidelines* explicitly provided that if particular traffic were not “truly comparable” to the issue traffic, the parties “can and should bring that to our attention in

⁵ 646 NPRM, slip op. at 20, citing 1 S.T.B. at 1035 n.90

an individual case.” *Id.* at 1034-1035. BNSF seeks a similar opportunity under the guidelines now being proposed by the Board in the NPR.

The three-benchmark approach is admittedly less precise in establishing a maximum reasonable rate than CMP or the SSAC approach. What is clear, however, is that the validity of the three-benchmark approach *hinges* on identification of a comparison group that exhibits demand elasticities that are *similar* to those exhibited by the issue traffic – if the comparison group is flawed in this regard, the rate-to-cost relationships of that group can tell us nothing about the appropriate rate-to-cost relationship (however adjusted) for the issue traffic, and the three-benchmark approach becomes completely divorced from the sound economic principles that underlie CMP.

In the *McCarty* decision,⁶ in which the D.C. Circuit reviewed I.C.C. efforts to apply simplified rate reasonableness procedures that also relied upon a comparison group of traffic with similar demand characteristics, the Court observed that:

[i]t is hard to discern any principle behind the choice of benchmark traffic. The Commission explained that it selected traffic with similar transportation and demand characteristics. *McCarty Farms*, 3 I.C.C.2d at 842. But if a profit-maximizing railroad charges more for the issue traffic than for the benchmark traffic, that would seem to represent a judgment – by the party with the greatest interest in making it correctly – that the issue traffic either costs more to transport or has a less elastic demand. If applied steadfastly, then, the R/VC method puts the Commission in the position of simply correcting (or purporting to correct) railroad management decisions as to what prices will most benefit the railroad. As it is hard to believe the Commission really thinks that would be a good allocation of its resources, it seems most probable that the transportation and demand characteristics of the two groups are in fact different. Thus though the outcome of the method depends critically on the choice of benchmark, the Commission’s statement of its criteria of choice seems not to fit its purpose in the exercise, leaving the true criteria obscure. *McCarty* decision at 597.

⁶ *Burlington Northern Railroad v. ICC*, 985 F.2d 589, 597 (D.C. Cir. 1993).

These same concerns persist in the procedures set forth in the NPR, and for this reason it is imperative that the Board allow the parties to submit probative evidence as to the comparability of the demand elasticity faced by the issue traffic, and those faced by the individual movements proposed for inclusion in the comparison group. As the Board recognized in its previous effort at simplified procedures, it is not possible to observe directly the demand elasticity of any individual movement. Nevertheless, the Board recognized that

[t]o be similar traffic, the comparison traffic should involve a similar commodity handled in a similar product (and perhaps geographic) market moving similar distances at an r/vc level above 180. The comparison traffic must involve a commodity that is not readily susceptible to transportation by another available mode (at least at the distances involved in the complaint).

Simplified Guidelines at 1035, n.90.

The relevance of product and geographic competition is not acknowledged in the NPR, yet consideration of these factors is critical to ensuring that the comparison group contains movements that are likely to exhibit demand elasticities that are similar to those exhibited by the issue traffic. The Board should clarify that it will entertain evidence on product and geographic competition, and any other evidence that is probative in establishing similarity in demand elasticities, including testimony from rail pricing officers and shippers about the nature of the markets in which the issue traffic and potential comparison traffic movements compete. Reliance exclusively on Waybill Sample data and other "publicly available" data (whatever the Board may mean by that term) may simply not be adequate to establish a reliable foundation for valid application of the three-benchmark approach.

2. An Adjustment is Needed to Account for the "Time Lag" Inherent in the Three-Benchmark Procedure

There is a significant time lag implicit in the application of the three-benchmark process. If undertaken today, the RSAM, RVC_{TOTAL} and the RVC_{COMP} factors relied upon by the three-benchmark standard would be based on 2004 data, which would be more than two years out of date (assuming average 2004 data is approximately comparable to mid-2004, which it may not be). To the extent rate levels have been rising overall – or for relatively demand-inelastic traffic – at a rate faster than increases in variable costs, such an approach could understate the rate that should be applied to the issue traffic under the theory underlying the three-benchmark standard. This would be true because the current R/V C ratios of the traffic in the comparison group would be higher than those identified from the historical Carload Waybill Sample (“CWS”) records, and use of the more current data would therefore produce a higher RVC_{COMP} factor for use in setting the issue traffic rate. On the other hand, if rates have increased more slowly than variable costs, the opposite might be true. What is clear is that setting 2006 rates based on 2004 data will not accomplish the objective of the Board to establish maximum reasonable rates that are comparable to rates paid by other shippers with comparable demand. The NPR is silent on how to address this problem.

In order to treat the time-lag between the historical rate levels of the traffic in the comparison group and the current level of the challenged rate, parties could rely upon publicly available indices. In particular, BNSF’s reports submitted quarterly to the SEC or STB present detailed information that could be used to address the disparity. For example, BNSF’s quarterly Investors’ Reports identify revenue information by commodity group that could be used to update the CWS revenues to more current levels. Similarly, to address the cost inflation that has transpired since the earlier time period of

the comparison-group records, the Board could incorporate the same indexing processes that it has previously employed in full-SAC cases and would similarly need to apply to update the URCS-based SARR costs in SSAC cases.⁷

3. Traffic of Other Carriers Should Not Be Included

It also seems appropriate, in the context of the simplified procedures the NPR proposes for small rate disputes, for the Board to limit the comparison group to traffic in which the defendant railroad participates. First, the Board's suggestion that other carriers' traffic might be included in the comparison group, on its face, contradicts the Board's stated objective of "comparability." Because carriers have different cost structures, it is highly unlikely that their respective movements could be demonstrated to be comparable across the "variety of factors," including "other factors which could affect . . . operating costs," as the Board proposes.⁸ Further, as the *McCarty* decision recognizes,⁹ an individual railroad sets its prices on the basis of the costs (and, implicitly, operating conditions) and demand elasticities that it observes in its markets to maximize the contribution generated overall by that mix of traffic. *McCarty* decision at 597. Under Ramsey pricing principles, a different railroad, operating with a different mix of traffic and different operating costs, will potentially make different pricing decisions even though it carries traffic with similar demand elasticities.

Second, there is the practical consideration that the parties are more likely to be able to offer qualitative evidence on product and geographic competition, and other

⁷ It is also true that this time lag affects the calculation of the RSAM and, thereby, the revenue need adjustment factor. Those calculations are also based on an earlier time period and therefore do not necessarily account for the current revenue needs of the defendant railroad. I am not aware, however, of a feasible or simple mechanism that can be used to update these calculations.

⁸ 646 NPRM, slip op. at 20.

⁹ *Burlington Northern Railroad Company v. Interstate Commerce Commission and the United States of America*, 985 F.2d 589, (D.C. Cir. 1993) ("*McCarty* decision").

factors that affect relative demand elasticities, when the comparison group is restricted to similar traffic handled by the defendant railroad. Finally, this constraint will prevent both parties to a small rate dispute from attempting to manipulate the outcome of the three-benchmark approach by searching far and wide for allegedly “similar” traffic – *i.e.*, movements of the same commodity that move a similar distance over similar terrain – that nonetheless move to very different markets and therefore have radically different demand elasticities.

B. The Changes Proposed in the NPR to the Calculation of RSAM and $R/VC_{>180}$ Should Not Be Adopted

The Board’s primary justification for changing the methodology for calculating the adjustment ratio reflects an incorrect conclusion drawn from what it deems to be an “erroneous relationship” it observed in the RSAM versus $R/VC_{>180}$ results for Norfolk Southern Railway Company (“NS”) for 2002 and 2004. The Board cites anomalies in the relationships of the RSAM and $R/VC_{>180}$ for NS that seemingly contradict the basic proposition that when a carrier is not revenue adequate under the Board’s annual calculations, its RSAM figure should be greater than its $R/VC_{>180}$, and vice-versa. Specifically, for 2002, the Board claims that the NS unadjusted RSAM was 216%, while the $R/VC_{>180}$ figure was 221%, suggesting that NS was revenue adequate. However, the Board’s revenue-adequacy determinations found NS was not revenue adequate. Conversely in 2004, NS’ unadjusted RSAM was 226% and its $R/VC_{>180}$ figure was 212%. While these metrics suggest that NS had not earned its target revenue in that year, the Board determined it had. To address this alleged “defect,” the Board proposes to alter radically its benchmark calculations (1) to reflect all traffic, and not just traffic priced

above the 180% R/VC level, and (2) to base the calculation of the benchmarks on publicly available data.¹⁰

The apparent anomalies in the RSAM and $R/VC_{>180}$ relationships observed for NS are created by minor methodological differences between the *URCS-based* calculations used to derive the RSAM and $R/VC_{>180}$, and the *Annual Report Form R-1 data* used in the revenue-adequacy determinations. For example, URCS normalizes certain expenses over periods of up to five years in an effort to mitigate swings in expenditures typical within business cycles. By contrast, the Board's revenue-adequacy determinations are based on data for only the current year. Likewise, while income tax liabilities within URCS are estimated by applying the pre-tax cost of capital to railroad net investment, the revenue-adequacy determinations are instead based on the actual taxes paid in each year.

Because of these and other computational differences, minor distortions in the RSAM relationships are likely to occur in situations where a carrier is relatively close to achieving revenue adequacy in a given year – either just below or just above as NS was in 2002 and 2004, respectively. However, such distortions – which have appeared for a single carrier in just two of the twelve years for which the Board has been publishing these benchmarks – are not evidence of a systematic flaw in the original RSAM or $R/VC_{>180}$ calculations, and do not justify the change to the benchmark calculations sought by the Board. The Board's proposed changes would alter the nature of RSAM, $R/VC_{>180}$, and the revenue need adjustment factor in a manner that is fundamentally at odds with differential pricing – seeking to spread the burden of making up the revenue-adequacy shortfall to traffic below the jurisdictional threshold, traffic whose rates are

¹⁰ 646 NPRM, slip op. at 23.

presumptively constrained by effective competition. For this reason, the Board should continue to publish the RSAM and $R/VC_{>180}$ as it has in the past.

The Board also must recognize that, as currently calculated, the original RSAM significantly understates the revenue needs of revenue inadequate carriers because the calculation is based on the depreciated book value of a railroad's assets. The current high level of demand for rail transportation is creating a widespread need to immediately expand rail capacity. New capacity is being added, but to justify this and future expansion of the railroad infrastructure, railroads must be able to attract investment by offering a return on the value of the new investments equal to the cost of capital, because these new investments are being made at today's cost. But the Board's RSAM calculations implicitly assume that a railroad needs only to earn a return on the depreciated cost of existing assets, not on the cost to replace those assets today – as is the case under both the traditional SAC approach, and under the SSAC proposal made herein for medium size rate dispute. Accordingly, the RSAM already understates the revenues that railroads need to address the capacity shortage in the rail network.

The Board should not exacerbate that problem and undermine the RSAM calculations as a benchmark for determining the level of rates that a revenue inadequate railroad needs to charge by basing the RSAM calculation (and the revenue need adjustment factor) on a railroad's entire traffic group. Instead, the Board must continue to calculate the adjustment ratio as it was formulated in *Simplified Guidelines*, i.e., as the ratio of RSAM, based on only traffic with R/VC ratios in excess of 180, to $R/VC_{>180}$.

- C. The NPR's View that It Should Set the Maximum Reasonable Rate on the Basis of the Average R/VC Ratio (Adjusted by the Ratio of RSAM to RVC_{TOTAL}) is not Defensible

The NPR proposes to set the maximum reasonable rate for the issue traffic at the mean of the adjusted R/VC ratios for the comparison group:

The question then is where in that range of the adjusted R/VC ratios the Board should look to determine the maximum reasonable rate for the issue movement. There are only two practical alternatives – the mean or the highest R/VC ratio in the comparison group – as there would be no reasoned basis for selecting a point in-between. Selecting the upper boundary of the comparison group would not be appropriate, however, as it would ignore all the other movements in the comparison group. As all movements in the comparison group should be similar to the issue movement, although not identical, there is no reason to presume that the movement with the highest R/VC ratio is any more probative of the proper maximum lawful rate for the issue movement than the movement with the lowest R/VC ratio.

Rather, the more reasoned approach is to use the average of the (adjusted) comparison group to determine the maximum reasonable rate. By using the average, we would accord equal weight to each R/VC ratio in the comparison group.
NPR at 27.

The Board seeks to buttress its view by (1) arguing that “it is well established that an average is ‘an obvious place to begin when there is no information that would incline the decision-maker to prefer one estimate over the other,’” citing *Tennessee Gas Pipeline Co. v. FERC*, 926 F.2d 1206, (D.C. Cir. 1991), and (2) minimizing the concern expressed by the D.C. Circuit, in its *McCarty* decision, that use of the average would over time force all rates to the lowest R/VC ratio in the comparison group.

There is an obvious deficiency with the first justification relied upon in the Board’s discussion. Under the Board’s logic, as expressed in the above-quoted paragraph, there is no rationale for favoring the mean over the highest R/VC ratio in the comparison group, the lowest R/VC ratio in the comparison group, or any other individual R/VC ratio in the comparison group; and this, in turn, is a function of an

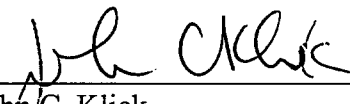
implicit assumption by the Board that all movements in the group are equally “comparable,” which is almost certainly not the case.

More fundamentally, the pervasiveness of railroad revenue inadequacy means that, overall, the railroad is not able to price its more demand-inelastic traffic at rates high enough to sustain the railroad over the long run. This, in turn, strongly suggests that *most* of the movements in the comparison group can be presumed to be priced at or below a reasonable level. As a result, it would be more consistent with the economic realities of the railroad business to establish the standard for a maximum reasonable rate for the issue traffic at a level higher than the mean of the (properly) adjusted R/VC ratios for the movements in the comparison group. One logical choice would be to select one standard deviation above the mean of the comparison group as the appropriate benchmark. Most values within the distribution (around two-thirds) can be expected to fall within one standard deviation of the mean, while 95% fall within two standard deviations.

Perhaps recognizing the inconsistency associated with forcing rates to the mean, the Board invokes a second argument, *i.e.*, that the three-benchmark test is not likely to be applied to a large proportion of a carrier’s traffic. But as the D.C. Circuit observed in its *McCarty* decision, this does not really address the problem substantively. The fact remains that this flaw has the potential to reduce rates for a *high proportion* of the traffic that *is* subject to this test, which means the test itself is fundamentally flawed for the traffic to which it would apply – it is meaningless for the Board to argue that the test is justified because it does not affect results for traffic to which it never intends to apply the test in the first place.

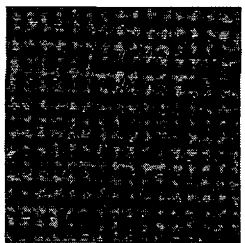
I declare under penalty of perjury that the foregoing is true and correct.

Executed on October 24 2006



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John Klick is a senior managing director and the practice leader of FTI's Economic Consulting practice and is based in Washington, DC. With 30 years of experience, Mr. Klick is widely recognized as a seasoned and effective expert witness on damages, economic costs, pricing of regulated services, mergers and acquisitions, and anti-trust matters.

Mr. Klick has provided expert testimony in cases involving economic damages; the public and private benefits of proposed mergers and acquisitions; the marginal, incremental and stand-alone costs of services provided by regulated network industries; and the pricing of access to network facilities. Much of this testimony has required Mr. Klick to analyze complex economic models and to effectively communicate his conclusions to decision-makers.

Mr. Klick has provided testimony before federal and state courts, arbitration panels, the Surface Transportation Board and its predecessor, the Interstate Commerce Commission, the Federal Energy Regulatory Commission, numerous state regulatory agencies, and mediators. He has assisted financial institutions in assessing potential investments in a variety of industries, and has served as a party appointed arbitrator in two complex contract performance disputes between Fortune 50 companies.

Mr. Klick has in-depth experience in a number of industrial sectors including telecommunications, energy, and transportation and has lectured on economic issues to various technical trade groups. In addition, he has taught a well-received Consulting Practicum as part of Georgetown University's MBA program.

TELECOMMUNICATIONS TESTIMONY

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John Klick

Alabama Public Service Commission

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John Klick

- November 9, 2001 Application No. 01-02-024. Joint Application of AT&T Communications of California, Inc. (U 5002 C) and WorldCom, Inc. for the Commission to Reexamine the Recurring Costs and Prices of Unbundled Switching in Its First Annual Review of Unbundled Network Element Cost Pursuant to Ordering Paragraph 11 of D.99-11-050. Declaration of John C. Klick in Support of Reply Comments of Joint Applicants Regarding Unbundled Switching Interim Proposal
- September 9, 2002 Rulemaking 93-04-003. Rulemaking on the Commission's Own Motion to Govern Open Access to Bottleneck Services and Establish A Framework for Network Architecture Development of Dominant carrier Networks. Investigation 93-04-002. Investigation on the Commission's Own Motion into Open Access and Network Architecture Development of Dominant Carrier Networks. Declaration of John C. Klick in Support of Proposal of AT&T Communications of California, Inc. (U 5002-C) and WorldCom, Inc. ("Joint Commentors") For Interim Unbundled Network Element Rates.
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- October 18, 2002 Application No. 01-02-024. Joint Application of AT&T Communications of California, Inc. (U 5002 C) and WorldCom, Inc. for the Commission to Reexamine the Recurring Costs and Prices of Unbundled Switching in Its First Annual Review of Unbundled Network Element Cost Pursuant to Ordering Paragraph 11 of D.99-11-050. Declaration of John C. Klick in Support of Joint Applicants' Opening Comments.
- August 6, 2004 Rulemaking 93-04-003. Rulemaking on the Commission's Own Motion to Govern Open Access to Bottleneck Services and Establish a Framework for Network Architecture Development of Dominant Carrier Networks. Investigation 93-04-003. Investigation on the Commission's Own Motion Into Open Access and Network Architecture Development of Dominant Carrier Networks. (Verizon UNE Phase). Declaration of John C. Klick in Support of Reply Comments of Joint Commentors.
- November 9, 2004 Rulemaking 93-04-003. Rulemaking on the Commission's Own Motion to Govern Open Access to Bottleneck Services and Establish a Framework for Network Architecture Development of Dominant Carrier Networks. Investigation 93-04-003. Investigation on the Commission's Own Motion Into Open Access and Network Architecture Development of Dominant Carrier Networks. (Verizon UNE Phase). Declaration of John C. Klick in Support of Rebuttal Comments of Joint Applicants.

John Klick

Public Utilities Commission of the State of Colorado

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- March 6, 1997 Docket No. 96S-331T. In the Matter of the Investigation and Suspension of Tariff Sheets Filed by U S WEST Communications, Inc., With Advice Letter No. 2617, Regarding Tariffs For Interconnection, Local Termination, Unbundling and Resale of Services, Pursuant to 47 U.S.C. Section 252 of the Telecommunications Act of 1996.
- March 26, 1997 Docket No. 96S-331T. In the Matter of the Investigation and Suspension of Tariff Sheets Filed by U S WEST Communications, Inc., With Advice Letter No. 2617, Regarding Tariffs For Interconnection, Local Termination, Unbundling and Resale of Services, Pursuant to 47 U.S.C. Section 252 of the Telecommunications Act of 1996.
- May 6, 1997 Docket No. 97M-063T. In the Matter of the Administration of the Colorado High Cost Fund and the Development of a Cost Model, Pursuant to 47 U.S.C. Section 252 of the Telecommunications Act of 1996.
- May 23, 1997 Docket No. 97M-063T. In the Matter of the Administration of the Colorado High Cost Fund and the Development of a Cost Model, Pursuant to 47 U.S.C. Section 252 of the Telecommunications Act of 1996.
- November 17, 1997 Docket No. 97M-063T. In the Matter of the Administration of the Colorado High Cost Fund and the Development of a Cost Model, Pursuant to 47 U.S.C. Section 252 of the Telecommunications Act of 1996.

Public Service Commission of the District of Columbia

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Florida Public Service Commission

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John Klick

Idaho Public Utilities Commission

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State of Iowa Department of Commerce Utilities Board

October 7, 1996 Docket No. ARB-96-3. In the Matter of the Interconnection Contract Negotiations Between AT&T Communications of the Midwest, Inc., and GTE Communications, Inc., Pursuant to 47 U.S.C. Section 252 of the Telecommunications Act of 1996.

October 21, 1996 Docket No. ARB-96-3. In the Matter of the Interconnection Contract Negotiations Between AT&T Communications of the Midwest, Inc., and GTE Communications, Inc., Pursuant to 47 U.S.C. Section 252 of the Telecommunications Act of 1996.

April 23, 1997 Docket No. RPU-96-9. Application for rehearing in part for purposes of Clarification and Correction, Pursuant to 47 U.S.C. Section 252 of the Telecommunications Act of 1996.

July 30, 1997 Docket No. RPU-96-9. . Application for rehearing in part for purposes of Clarification and Correction, Pursuant to 47 U.S.C. Section 252 of the Telecommunications Act of 1996.

Kentucky Public Service Commission

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Louisiana Public Service Commission

August 25, 1997 Docket No. U-22022. Review of cost studies submitted per Local Competition Regulations in order to determine the cost of interconnection and UNEs to establish reasonable, non-discriminatory, cost-based tariffed rates. U-22093. Review of tariff filing per Local Competition Regulations, which tariff introduces interconnection and unbundled services and establishes the rates, terms, and conditions for such service offerings, Pursuant to 47 U.S.C. Section 252 of the Telecommunications Act of 1996.

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John Klick

State of Maryland Public Service Commission

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Minnesota Public Utilities Commission

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May 26, 2000 Docket No. P-421/CI-99-1665 ;OAH Docket No. 12-2500-12631-2. In the Matter of a Commission Initiated Investigation into U S WEST Communications, Inc.'s Costs Related to Provision of Line Sharing Service

June 30, 2000 Docket No. P-421/CI-99-1665 ;OAH Docket No. 12-2500-12631-2. In the Matter of a Commission Initiated Investigation into U S WEST Communications, Inc.'s Costs Related to Provision of Line Sharing Service

Public Service Commission of Missouri

September 25, 1998 Docket TO-98-329. In the Matter of an Investigation into Various Issues Related to the Missouri Universal Service Fund.

Public Service Commission of the State of Montana

November 22, 1996 Docket No. D96.11.200. In the Matter of the Interconnection Contract Negotiations Between AT&T Communications of the Mountain States, Inc., and U S WEST Communications, Inc., Pursuant to 47 U.S.C. Section 252 of the Telecommunications Act of 1996.

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Nebraska Public Service Commission

October 18, 1996 Docket No. C-1400. In the Matter of the Interconnection Contract Negotiations Between AT&T Communications of the Midwest, Inc., and GTE Communications, Inc., Pursuant to 47 U.S.C. Section 252 of the Telecommunications Act of 1996.

New Jersey Board of Public Utilities

September 18, 1996 Docket No. TO 96070519. In the Matter of Petition of AT&T Communications of New Jersey, Inc. for Arbitration with Bell Atlantic - New Jersey, Inc., Pursuant to 47 U.S.C. Section 252 of the Telecommunications Act of 1996.

December 20, 1996 Docket No. TX 95120631. Notice of Investigation Local Exchange Competition for Telecommunications Services, Pursuant to 47 U.S.C. Section 252 of the Telecommunications Act of 1996.

October 20, 1997 Docket No. TX 95120631. Notice of Investigation Local Exchange Competition for Telecommunications Services, Pursuant to 47 U.S.C. Section 252 of the Telecommunications Act of 1996.

New Mexico Corporation Commission

November 22, 1996 Docket No. 96-411-TC. In the Matter of the Interconnection Contract Negotiations Between AT&T Communications of the Mountain States, Inc., and U S WEST Communications, Inc., Pursuant to 47 U.S.C. Section 252 of the Telecommunications Act of 1996.

January 20, 1997 Docket No. 96-411-TC. In the Matter of the Interconnection Contract Negotiations Between AT&T Communications of the Mountain States, Inc., and U S WEST Communications, Inc., Pursuant to 47 U.S.C. Section 252 of the Telecommunications Act of 1996.

June 13, 1997 Docket No. 97-35-TC. In the Matter of the Interconnection Contract Negotiations Between AT&T Communications of the Mountain States, Inc. and GTE Southwest, Inc., Pursuant to 47 U.S.C. Section 252 of the Telecommunications Act of 1996.

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November 21, 1997 Docket No. 96-310-TC; Docket No. 97-334-TC. In the Matter of the Implementation of the New Rules Related to the Rural High Cost Fund, and Low Income Components of the New Mexico Universal Service Fund, Pursuant to 47 U.S.C. Section 252 of the Telecommunications Act of 1996.

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State of New York Public Service Commission

- March 27, 1998 Case No. 95-C-0657. In the matter of Wholesale Provisioning of Local Exchange Service. 94-C-0095. In the matter of the Continuing Provision of Universal Service and Developing a Regulatory Framework for the Transition to Competition in the Local Exchange Market. 91-C-1174. In the matter of Comparably Efficient Interconnection Arrangements for Residential and Business Links, Pursuant to 47 U.S.C. Section 252 of the Telecommunications Act of 1996.
- October 31, 2003 Case 03-C-0980. Proceeding On Motion Of The Commission As To The Rates, Charges, Rules And Regulations Relating To The Provisioning Of Direct Current Power By Verizon-New York Inc. For Use In Connection With Collocation Spaces
- November 24, 2003 Case 03-C-0980. Proceeding On Motion Of The Commission As To The Rates, Charges, Rules And Regulations Relating To The Provisioning Of Direct Current Power By Verizon-New York Inc. For Use In Connection With Collocation Spaces

North Carolina Public Staff Utilities Commission

- December 15, 1997 Docket No. P-100, Sub 133d. In the Matter of the Determination of Permanent Pricing for Unbundled Network Elements, Pursuant to 47 U.S.C. Section 252 of the Telecommunications Act of 1996.
- January 30, 1998 Docket No. P-100, Sub 133b. In the Matter of Establishment of Universal Support Mechanisms, Pursuant to 47 U.S.C. Section 252 of the Telecommunications Act of 1996.
- February 16, 1998 Docket No. P-100, Sub 133d. In the Matter of the Determination of Permanent Pricing for Unbundled Network Elements, Pursuant to 47 U.S.C. Section 252 of the Telecommunications Act of 1996.
- March 9, 1998 Docket No.: P-55, Sub 133d. In the Matter of the Determination of Permanent Pricing for Unbundled Network Elements, Pursuant to 47 U.S.C. Section 252 of the Telecommunications Act of 1996.
- February 16, 2004 Docket No. P-100, Sub 133q. In the Matter of the Triennial Review Order – UNE-P

State of North Dakota Public Service Commission

- November 22, 1996 Docket No. PU-453-96-497. In the Matter of the Interconnection Contract Negotiations Between AT&T Communications of the Midwest, Inc., and U.S. WEST Communications, Inc., Pursuant to 47 U.S.C. Section 252 of the Telecommunications Act of 1996.
- February 14, 1997 Docket No. PU-453-96-497. In the Matter of the Interconnection Contract Negotiations Between AT&T Communications of the Midwest, Inc., and U.S. WEST Communications, Inc., Pursuant to 47 U.S.C. Section 252 of the Telecommunications Act of 1996.

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November 10, 1997 Docket No. PU-314-97-465. In the Matter of U S WEST Communications, Inc. Universal Service Costs Investigation, Pursuant to 47 U.S.C. Section 252 of the Telecommunications Act of 1996.

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Oregon Public Utility Commission

October 8, 1996 Docket No. ARB-5. In the Matter of the Interconnection Contract Negotiations Between AT&T Communications of the Pacific Northwest, Inc., and GTE Communications, Inc., Pursuant to 47 U.S.C. Section 252 of the Telecommunications Act of 1996.

February 24, 1998 UM 731, Phase 111. In the Matter of the Investigation into Universal Service in the State of Oregon, Pursuant to 47 U.S.C. Section 252 of the Telecommunications Act of 1996.

Pennsylvania Public Utility Commission

May 21, 1999 Docket Nos. P-00991648 and P-00991649. Petition of Senators and CLECs for Adoption of Partial Settlement and Joint Petition for Global Resolution of Telecommunications Proceeding.

South Carolina Public Service Commission

November 10, 1997 Docket No. 97-239-C. In the Matter of Intrastate Universal Service Fund, Pursuant to 47 U.S.C. Section 252 of the Telecommunications Act of 1996.

Public Utilities Commission of the State of South Dakota

November 20, 1996 Docket No. TC-96-184. In the Matter of the Interconnection Contract Negotiations Between AT&T Communications of the Midwest, Inc., and U S WEST Communications, Inc., Pursuant to 47 U.S.C. Section 252 of the Telecommunications Act of 1996.

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Tennessee Regulatory Authority

February 27, 2004 Docket No. 03-00491. In re: Implementation of requirements arising from Federal Communications Commission triennial UNE review: Local Circuit Switching for Mass Market Customers.

Public Utility Commission of Texas

February 27, 1998 Docket No. 18515. Compliance Proceeding for Implementation of the Texas High Cost Universal Service Plan, Pursuant to 47 U.S.C. Section 252 of the Telecommunications Act of 1996.

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Public Service Commission of Utah

April 23, 1997 Docket No. 94-999-01. In the Matter of an Investigation Into Collocation and Expanded Interconnection, Pursuant to 47 U.S.C. Section 252 of the Telecommunications Act of 1996.

Washington Utilities and Transportation Commission

October 28, 1996 Docket No. UT-960307. In the Matter of the Interconnection Contract Negotiations Between AT&T Communications of the Pacific Northwest, Inc., and GTE Communications, Inc., Pursuant to 47 U.S.C. Section 252 of the Telecommunications Act of 1996.

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March 26, 2001 Docket No. UT-003013. In the Matter of the Continued Costing and Pricing of Unbundled Network Elements and Transport and Termination, Part B.

Public Service Commission of the State of Wyoming

November 22, 1996 Docket No. 72000-TF-96-95/70000-TF-96-497. In the Matter of the Interconnection Contract Negotiations Between AT&T Communications of the Mountain States, Inc., and US WEST Communications, Inc. , Pursuant to 47 U.S.C. Section 252 of the Telecommunications Act of 1996.

February 6, 1997 Docket No. 72000-TF-96-95/70000-TF-96-497. In the Matter of the Interconnection Contract Negotiations Between AT&T Communications of the Mountain States, Inc., and U S WEST Communications, Inc., Pursuant to 47 U.S.C. Section 252 of the Telecommunications Act of 1996.

September 19, 1997 Docket No. 70000-TF-96-319/72000-TF-96-95. In the Matter of the Arbitration by the Public Service Commission of an Interconnection Agreement Between U S WEST Communications, Inc., and AT&T Communications of the Mountain States, Inc., Pursuant to 47 U.S.C. Section 252 of the Telecommunications Act of 1996.

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- November 14, 1997 General Order No. 81. In the Matter of the Investigation by the Commission of the Feasibility of Developing Its Own Costing Model for Use in Determining Federal Universal Service Fund Support Obligations in Wyoming, Pursuant to 47 U.S.C. Section 252 of the Telecommunications Act of 1996.
- November 21, 1997 General Order No. 81. In the Matter of the Investigation by the Commission of the Feasibility of Developing Its Own Costing Model for Use in Determining Federal Universal Service Fund Support Obligations in Wyoming, Pursuant to 47 U.S.C. Section 252 of the Telecommunications Act of 1996.

ENERGY TESTIMONY*Federal Energy Regulatory Commission*

- May 20, 1991 Docket No. IS90-21-000 et al. Williams Pipe Line Company.
- May 3, 1993 Docket No. RM93-11-000. Revisions to Oil Pipeline Regulations Pursuant to the Energy Policy Act of 1992.
- November 22, 1993 Docket No. RM93-11-000. Revisions to Oil Pipeline Regulations Pursuant to the Energy Policy Act of 1992.
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- October, 1999 Affidavit of John C. Klick Concerning Declaratory Order Petition of Colonial Pipeline Company
- April 17, 2000 Docket No. OR00-2-000. ExxonMobil Pipeline Company

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- January, 1980 Misc. No. 76-1. In the Matter of the Valuation Proceedings.

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- September, 1989 Deposition Testimony in Texas Utilities Company and Chaco energy Company v. Santa Fe Industries, Inc., et al., No. Civ-82-1419 C.

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- May, 1981 Finance Docket No. 30000. Union Pacific Corporation and Union Pacific Railroad Company -- Control -- Missouri Pacific Corporation and Missouri Pacific Railroad Company.
- February 22, 1983 Docket No. 37886S. Potomac Electric Power Co. v. The Baltimore and Ohio Railroad Co. et al.
- February 22, 1983 Docket No. 37834S. Ethyl Corporation v. Illinois Central Gulf Railroad, et al.
- May, 1983 Docket No. 38182S. Consumers Power Company v. Norfolk & Western Railway Company.

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June, 1986	Docket No. 36180. San Antonio, Texas, Acting By and Through Its City Public Service Board v. Burlington Northern Railroad Company and Southern Pacific Transportation Company.
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October 11, 1994	Finance Docket No. 32549. Burlington Northern, Inc. And Burlington Northern Railroad Company -- Control and Merger -- Santa Fe Pacific Corporation and the Atchison, Topeka and Santa Fe Railway Company.
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