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October 24, 2006

Via HAND DELIVERY

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

ENTERED
Office of Proceedings

OCT 24 2006

Part of
Public Record



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

Dear Secretary Williams:

Enclosed are the original and twenty copies of the Opening Comments of the Association of American Railroads ("AAR") submitted in response to the Board's decision served July 28, 2006, in the above-captioned proceeding. Please date stamp the extra copy of this letter and return it with our messenger.

Sincerely,

A handwritten signature in black ink, appearing to read "Samuel M. Sipe, Jr.".

Samuel M. Sipe, Jr.
Counsel for Association of American
Railroads

Enclosures

cc: Parties of Record

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

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

SIMPLIFIED STANDARDS FOR RAIL RATE CASES

OPENING COMMENTS OF THE ASSOCIATION OF AMERICAN RAILROADS

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OPENING COMMENTS OF THE ASSOCIATION OF AMERICAN RAILROADS

I. Introduction

The Association of American Railroads (“AAR”) respectfully submits these Comments as a party of record in accordance with the Board’s notice of proposed rulemaking in Ex Parte No. 646 (Sub-No. 1), *Simplified Standards for Rail Rate Cases* (served July 28, 2006) (“NPRM”). The AAR is a trade association representing the interests of North America’s major freight railroads, and often presents comments and testimony in STB proceedings. The AAR recently submitted comments in *Major Issues in Rail Rate Cases*, STB Ex Parte No. 657 (Sub-No. 1), which raises underlying policy issues related to those involved here.¹

This is an important proceeding which has significant implications for the economic well being of AAR’s members. AAR participated in earlier stages of this proceeding in 2003 and 2004.² Among other positions, AAR advocated the development of appropriate standards and procedures for cases involving truly small shippers.

¹ Comments of the Association of American Railroads (filed May 1, 2006) (“AAR 657 Comments”).

² Written Statements of Association of American Railroads, filed July 16, 2004, and oral testimony at the related July 21, 2006, hearing; Letter to Chairman Roger Nober, filed August 4,

AAR believes that the Board's proposed rules represent a significant positive step in the process of making small rate cases more accessible to shippers who believe they require protection from unreasonably high rates. Whatever the validity of such beliefs may be, it is in the interest of railroads and shippers alike to establish procedures to address rate claims efficiently where the cost of litigating a full SAC case is not justified. AAR supports in concept the approach that the Board identified in its NPRM, including the establishment of the categories of medium-size and small rate disputes.

In developing modified standards for smaller rate cases, the Board should maintain a sharp focus on two particular objectives of the statutory Rail Transportation Policy ("RTP"). First, rate regulation should be consistent with the railroads' need to earn their cost of capital, particularly given the current, pressing need for additional investment in rail infrastructure. Second, the Board's approach to rate regulation should foster private resolution of disputes. It should not promote litigation and become a vehicle for reregulating the industry.

II. Sustained Revenue Adequacy and the Promotion of Additional Investment

The nation's freight railroads have been consistently revenue inadequate over the quarter-century since the Staggers Act became law. In the last few years, industry financial performance has improved, but the goal of sustained revenue adequacy for the industry has not been achieved. To fulfill their potential in transporting the nation's freight, railroads need to earn their cost of capital over the long term so that they can justify the investments required to meet the growing demand for surface transportation capacity. It would not be in the public interest for the industry to reach the revenue adequacy threshold but then fall back again to a level of return that will not justify capital investment.

2003; Letter to Chairman Roger Nober, filed June 23, 2003; Written Testimony of the Association of American Railroads, filed April 16, 2003.

As AAR pointed out in its recent comments in *Major Issues in Rail Rate Cases*, differential pricing remains critical to achieving sustained revenue adequacy.³ In addressing the proper standards to apply to small shipper cases in 1996, the Board recognized that, “[b]ecause railroads serve a mix of competitive and captive traffic, a carrier cannot recover an equal or pro rata portion of . . . unattributable costs from all traffic.” *Rate Guidelines – Non-Coal Proceedings*, 1 S.T.B. 1004, 1007 (1996)(“*Non-Coal Guidelines*”). The Board explained that this economic fact led the ICC to adopt Ramsey pricing principles in accordance with which “a railroad should price its traffic differentially so as to recover a greater percentage of its unattributable costs from the traffic with a greater dependency on its service.” *Id.*⁴ In the context of simplified guidelines, the Board characterized its task as determining “whether the degree of differential pricing . . . is reasonable. We must be guided by Ramsey pricing principles and fundamental fairness in carrying out this regulatory task.” *Id.*

The Board should continue to adhere to these principles. The fundamentals of railroad economics that led the ICC to embrace differential pricing and to adopt CMP as the mechanism for establishing maximum reasonable rates have not changed. Indeed, it is the freedom to engage in differential pricing that has allowed railroads to make major strides toward revenue adequacy.

Rate regulation that impairs differential pricing would be counterproductive even if it were limited to medium and small rate cases. Table 2 in the Board’s NPRM suggests that approximately two-thirds of non-exempt rail traffic that moves at an R/VC ratio above 180%

³ See AAR Ex Parte No. 657 Comments, at 3-5.

⁴ Because of the complexity of calculating demand and marginal cost, the ICC implemented Ramsey pricing principles by adopting Constrained Market Pricing (“CMP”). As the Board acknowledged in the NPRM, “CMP . . . 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.” NPRM at 9.

would be covered by the procedures proposed by the Board. If the Board were to restrict the ability of railroads to continue to set differential prices for the covered traffic, the railroads' ability to cover their unattributable costs would be detrimentally affected, and negative financial consequences would follow.

The real-world benefits of revenue adequate railroads should be abundantly clear at the present time given the capacity constraints that confront the surface transportation sector. In its comments in *Major Issues in Rail Rate Cases*, AAR addressed the increased demands placed on the nation's rail infrastructure.⁵ Traffic has grown markedly over the last decade, and is projected to continue to grow for the foreseeable future. This growth in traffic has resulted in current capacity shortages, which the Board has acknowledged.⁶ The achievement of sustained revenue adequacy will permit railroads to make the continuing investments in necessary infrastructure to serve the expanding traffic base and benefit the national economy as a whole.

The Board's proposed simplified standards are being considered at a time when there is public recognition of some upward movement in rail prices for certain traffic, reversing a long trend of declining rates. It should be clear to the Board and other participants in this proceeding, as it is to AAR's members, that higher rates in the marketplace do not suggest that railroads are exercising market power or that a problem with the current regulatory framework exists. It is a well recognized economic fact that when demand rises, particularly where capacity is constrained, prices go up. *See, e.g., Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209, 232 (1993) ("If prices rise in response to an excess of demand over supply . . . the

⁵ AAR Ex Parte No. 657 Comments at 5-10.

⁶ In the NPRM, the Board stated: "Railroads no longer are burdened by substantial excess capacity; rather, the rail industry now faces the opposite situation. Rail capacity is strained, demand for transportation service is forecast to increase, and railroads must make capital investments to meet that demand." NPRM at 11.

market is functioning in a competitive manner”). This is exactly what is happening in many rail transportation markets today. Recent price increases in an environment of capacity constraints provide evidence that the market is working, not evidence of a problem in search of a regulatory solution.

III. Mandatory, Non-Binding Mediation

An additional constructive feature that AAR believes should be included in the Board’s rules for medium-sized and small rate cases is mandatory, non-binding mediation. AAR proposed mandatory, non-binding mediation earlier in these proceedings.⁷ The Board should revisit this proposal given the benefits that could be obtained from a mediation procedure. Mediation would encourage negotiated settlements, which in turn would reduce costs for both shippers and railroads and would also reduce the risk of poisoned relations between shippers and railroads that could arise from litigating rate disputes. Particularly given the size of the matters under consideration and the greater certainty with respect to outcomes that the Board is trying to introduce into the process, it is reasonable to expect that at least some cases would lend themselves to resolution through mediation. Requiring mediation in medium and small rate disputes would also be consistent with the similar requirement for full SAC cases.⁸

Specifically, AAR proposes that the mediation procedures would, at a minimum, have the following elements:

- **Timing.** A twenty-day period would be established for mediation. In both medium and small-sized cases, the mediation period could commence on the day the answer is due. Reply filings on eligibility would not be due until after the close of the mediation period. The Board should examine the overall

⁷ Written Testimony of the Association of American Railroads, at 4-8 (filed April 16, 2003).

⁸ See *Procedures to Expedite Resolution of Rail Rate Challenges to Be Considered Under the Stand-Alone Cost Methodology*, STB Ex Parte No. 638 (served Apr. 3, 2003).

schedule for both medium and small cases to ensure that mediation would not delay the ultimate resolution of the case if it continued on a litigation track.

- **Board Staff Mediator.** A Board staff member conversant with rail rate regulation issues would be made available to act as mediator. The Board staff member would be recused from participation in the underlying case if the mediation is unsuccessful.
- **Flexible Process.** The parties and the Board staff member would agree on mediation procedures for each mediation that would be most efficient and convenient for the parties involved. For example, in smaller cases the mediator and parties might agree to conduct the mediation by conference call to avoid the time and expense of travel.
- **Confidentiality.** The entire mediation process including material used or exchanged and positions taken would be treated as confidential and would not be disclosed to the Board or to third parties not participating in the mediation. Nothing arising out of the mediation could be used in evidence in the underlying case and the parties would not be bound by any statements made, or positions taken during the course of mediation. The protective order applicable to the underlying case would also apply to the mediation.

IV. Eligibility for Simplified Rate Standards

The Board's approach to establishing eligibility requirements based on the Maximum Value of the Case ("MVC") in relation to the expense of bringing a case is consistent with the statutory directive to establish simplified procedures for "determining the reasonableness of challenged rail rates in those cases in which a full stand-alone cost presentation is too costly, given the value of the case." 49 U.S.C. § 10701(d)(3). Likewise, creating two categories of simplified cases – medium-sized and small rate disputes – appears to be a rational and practical approach. AAR believes that it is reasonable to establish a two-tier system and that the MVCs that the Board has proposed for determining eligibility for medium sized and small rate cases should not be set any higher than the levels the Board has proposed.

It is crucially important that the eligibility categories for medium-sized and small rate cases not be overly broad.⁹ Both in the NPRM and in *Non-Coal Guidelines* the Board recognized that a full SAC proceeding is the preferred and most accurate approach to establishing maximum reasonable rates. AAR concurs in this view, and believes that the Board should be guarded in permitting departures from a full SAC presentation. In *Non-Coal Guidelines*, the Board recognized the dangers of applying simplified but cruder rate reasonableness standards and warned that “[b]ecause 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.” 1 S.T.B. at 1021. The inaccuracies and distortions that are unavoidably introduced by simplified maximum rate methodologies could have a negative effect on the ability of railroads to earn adequate revenues. As the Board already proposes to apply the simplified procedures to traffic representing a significant percentage of railroads’ regulated traffic, it is important that eligibility to use the simplified standards not be further expanded. The extent of potential negative impact on railroads is directly related to the amount of traffic subject to simplified proceedings.¹⁰ It is therefore critically important to restrict less accurate methods to those cases in which a full SAC presentation is not feasible, as the statute requires.

V. Discovery Burdens

AAR cannot determine in the abstract exactly what discovery burdens the Board’s proposals will impose on its members. The burdens will likely vary from carrier to carrier in

⁹ As noted above, the Board’s Table 2 indicates that as proposed approximately two-thirds of the railroads’ traffic that moves above an R/VC of 180 would be subject to one of the simplified procedures.

¹⁰ The Board acknowledged this linkage in 1996 when it endorsed the ICC’s view “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.” *Non-Coal Guidelines*, 1 S.T.B. at 1008.

light of differing information technology systems and data retrieval capabilities. AAR expects that member railroads will comment on their individual degree of burden as they relate to retrieval of their own data and other discovery tasks.

At a general level, AAR's member railroads are concerned that the Board's Simplified-SAC Method ("SSAC"), which requires the defendant railroad to identify traffic over the issue traffic route and develop modified URCS costs for that traffic, will impose a disproportionate share of the burden and costs of a medium-sized case on the defendant railroad. Not only is this unfair, but it is also likely to encourage litigation. If railroads bear most of the expense of preparing a medium-sized case, shippers may see little downside in pursuing litigation since it would cost very little to file a complaint, impose one-sided litigation costs on the railroad, and pursue a rate reasonableness claim on the chance that the Board will grant relief. To avoid creating incentives to litigate non-meritorious cases, the Board should require that the losing party pay all costs associated with discovery.

VI. Revised RSAM

The Board's proposal to calculate a new RSAM for small cases based on all of a railroad's traffic, rather than on a railroad's traffic with an R/VC ratio of greater than 180%, is inconsistent with *Non-Coal Guidelines*, fails to give adequate consideration to revenue adequacy needs, and is based on flawed reasoning. Whatever approach the Board adopts for determining maximum reasonable rates in small shipper cases, it should include the unadjusted RSAM as currently calculated to serve as a revenue-adequacy benchmark.

As defined by the Board in *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. The purpose of the RSAM calculation, the Board explained, was to serve as the only benchmark of the three benchmarks to be used in the rate reasonableness analysis that took account of a railroad’s revenue adequacy requirements. *Id.* at 1020. The unadjusted RSAM, as currently calculated, is linked to the revenue adequacy goal because it focuses on the revenues that need to be earned on relatively demand inelastic traffic (*i.e.*, traffic with R/VC ratios above 180%) on which it is reasonable to expect that differentially higher prices could be charged, thereby facilitating the goal of achieving revenue adequacy. Indeed, the Board explicitly noted that it was necessary to supplement the other benchmarks with the RSAM to properly account for a railroad’s revenue needs. *Id.* at 1036.

The Board’s new proposal to calculate RSAM based on all of a railroad’s traffic, both above and below the jurisdictional threshold of 180%, destroys the logic of the original calculation, which was intended to quantify the degree of differential pricing on relatively demand inelastic traffic that a railroad would need to achieve revenue adequacy. The proposed new RSAM might provide some information about how far a railroad is from achieving revenue adequacy, but it would say nothing about what revenues the railroad needs to obtain from demand inelastic traffic to satisfy its revenue needs. It was precisely this difficulty that led the Board in 1996 to reject including traffic with R/VC ratios of less than 180% in its calculation of the R/VC benchmarks used in small shipper cases. The Board stated that including such traffic “would be inconsistent with the statute . . . which contains an express legislative determination that no traffic with rates set below 180% is captive. 49 U.S.C. 10707(d)(1)(A).” 1 S.T.B. at 1026. The Board has not presented any compelling reason to believe that what was true in 1996 is no longer true today.

The Board contends in the NPRM, at 24, that inclusion of all traffic in the RSAM calculation is appropriate because railroads “have raised rates on competitive traffic as demand for rail transportation has increased.” The implicit assumption that railroads have market power over – and the concomitant ability to charge differentially higher prices to – their most competitive traffic is not economically sound. The fact that prices may rise (or fall) on competitive traffic as overall conditions of supply and demand fluctuate in surface transportation markets does not signify the emergence of new found market power. Prices on competitive traffic should rise as demand tightens, but rates on competitive traffic are still constrained by competitive alternatives. Railroads require the freedom to charge differentially higher prices on demand-inelastic traffic precisely because they lack market power over traffic with more elastic demand and therefore cannot recover significant portions of their unattributable costs from such traffic. It is inappropriate for the Board to presume that railroads have the power to charge differentially higher prices to shippers of such competitive traffic. Indeed, the Board acknowledges that “railroads presumably maximize profits on all their traffic, whether competitive or captive, such that there is no money deliberately ‘left on the table.’” NPRM at 24. With respect to competitive traffic, this means that railroads are already charging the market price and there is no basis for assuming that railroads could charge higher prices than those that the market permits.

The calculation of RSAM based on the universe of a railroad’s higher demand traffic tells how much, on average, the railroad would have to charge such higher demand traffic to achieve revenue adequacy. There is, of course, no guarantee that the railroad is going to be able to increase rates on higher demand movements to levels that will result in revenue adequacy because, as noted above, this higher demand traffic is likely already being charged profit

maximizing rates. But, as the Board acknowledges in the NPRM, “if a carrier is not currently revenue adequate, one can presume that the carrier is not (on average) charging its potentially captive traffic as much as the statute would permit.” NPRM at 26. The RSAM based on traffic with R/VC ratios over 180% is therefore meaningful as a measure of what the statute would permit if the railroad were able to increase rates on higher demand traffic.

As a consequence, in the context of a challenge to a rate that exceeds the RSAM average, the RSAM level as currently calculated is instructive as to the reasonableness of the rate. The proper group of traffic for inclusion in the unadjusted RSAM calculation, therefore, is the group of higher demand traffic with R/VC ratios over 180% over which the railroad may have some degree of market power.¹¹

The Board’s identification of a potential inconsistency between RSAM and $R/VC_{>180}$ calculations for a single carrier when that carrier had achieved revenues in the vicinity of revenue adequacy does not justify effectively disabling the only benchmark that takes account of a railroad’s revenue needs.¹² There are methods for dealing with this problem, such as identifying and addressing the source of inconsistencies between the two data sets, that are much less drastic and much less likely to impair railroads’ financial health than jettisoning RSAM as currently calculated.

¹¹ The Board should also continue to calculate $R/VC_{>180}$ rather than R/VC_{Total} . For the revenue-need adjustment factor to make sense, both the RSAM and the R/VC denominator need to be calculated based on the same group of traffic. Both the RSAM and the R/VC should be calculated for the railroad’s traffic with R/VC ratios over 180% because that is the only traffic as to which the railroad could be market dominant under the governing statute. Of course, the statute also makes clear that the fact that traffic produces an R/VC ratio in excess of 180% does not establish a presumption that the railroad has market dominance over such traffic. 49 U.S.C. § 10707(d)(2)(A).

¹² See NPRM at 22-23.

VII. Exempt Traffic

The Board suggests that it will consider partial revocations of class exemptions in the context of medium and small rate case complaints addressed to a movement of exempt traffic. NPRM at 17, 30. AAR is concerned that the medium and small rate cases covered in this proceeding could become a backdoor vehicle for reregulating exempt railroad traffic. Such a result would reverse longstanding congressional and regulatory policy and would be inconsistent with the governing statute. The Board must adhere to the statutory commands to minimize regulation, 49 U.S.C. § 10101(1), (2), and to exempt classes of traffic from regulation “to the maximum extent” where continuing regulation is not necessary to prevent abuses of market power. 49 U.S.C. § 10502(a).

The ICC and the Board have carefully considered the market conditions that apply to various types of traffic and have concluded that competition constrains railroad market power with respect to large segments of rail traffic, thereby justifying various exemptions. Moreover, it remains true, as the Board acknowledged in the NPRM, that “competition controls the rates for most of a railroad’s traffic.” NPRM at 12. The Board should not lightly backtrack on this history of deregulation based on speculation that some shippers of exempt traffic might want to pursue rate complaints. The standards for revoking exemptions should not be watered down by affording special treatment to shippers of exempt traffic in order to enable them to bring medium and small rate cases. To revoke an exemption, even in part, the Board must engage in the same type of searching inquiry that led to the original grant of exemption, taking account of both the National Rail Transportation Policy and all competitive constraints on railroad market power.¹³

¹³ In this regard, it is important to note that “market power,” the phrase used in 49 U.S.C. § 10501(a) is a broader concept than “market dominance,” the absence of which eliminates

As a procedural matter, if a rate complaint is accompanied by a petition for partial revocation of an exemption, the Board should address the revocation petition first. It should make a separate decision concerning the revocation of the exemption without truncating the revocation analysis before proceeding to assess the reasonableness of a challenged rate and before requiring a railroad to engage in discovery relating to the challenged rate.

VIII. Calculation of the Jurisdictional Threshold

The Board's proposal to use unadjusted URCS to calculate the jurisdictional threshold in individual cases is clearly a trade-off between accuracy and the expense of a more precise calculation. AAR does not question the proposition that simplification is appropriate and necessary to enable small shippers to bring cases more efficiently. AAR believes, however, that it would be inconsistent with the Board's obligation to foster revenue adequacy to permit shippers to bring cases under simplified procedures in instances where there are clear reasons to believe that unadjusted URCS costs do not accurately reflect the true costs of service and where those true costs would result in an R/VC ratio below the jurisdictional threshold. The comments of a number of carriers in Ex Parte No. 657, *Major Issues in Rail Rate Cases*, identified particular situations where it would be appropriate to use adjusted URCS costs.¹⁴ The Board should retain sufficient flexibility in the calculation of the jurisdictional threshold to allow for adjustments in such cases.

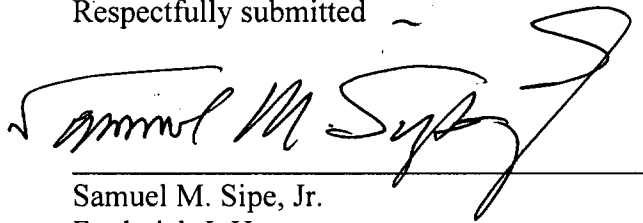
Board jurisdiction to regulate rates under 49 U.S.C. § 10707. *See Market Dominance Determinations – Product and Geographic Competition*, 3 S.T.B. 937 (1998), *aff'd*, 306 F.3d 1108 (D.C. Cir. 2002).

¹⁴ *See, e.g.*, Comments of BNSF Railway Company, at 64-65, 69 n.61 (filed May 1, 2006); Joint Comments of Norfolk Southern Railway Company and CSX Transportation, Inc., at 13-14 (filed May 1, 2006); Opening Submission of Union Pacific Railroad Company, at 37-40.

IX. Conclusion

AAR recognizes that the statutory scheme that the Board is charged with administering affords shippers protection from abusive pricing practices. The protections should be meaningful and accessible. The Board's NPRM represents a serious effort to grapple with the challenges of resolving rate complaints in those circumstances where a full SAC presentation is not justified. As the Board moves forward to implement its proposals, it must do so in a way that does not threaten railroad revenue adequacy or foster unnecessary litigation. At a time when demand for rail service, and investment in additional infrastructure, is high, it would be counterproductive to erect new regulatory barriers that would prevent railroads from fulfilling their role in meeting the nation's transportation needs. AAR encourages the Board to give full consideration to the right of railroads to earn adequate revenues over the long-term in developing standards and procedures to apply to small shipper cases. Moreover, while AAR supports the development of appropriate mechanisms for the limited instances in which smaller shippers may require rate relief, the Board must exercise caution to ensure that such procedures are limited to circumstances where they are necessary.

Respectfully submitted



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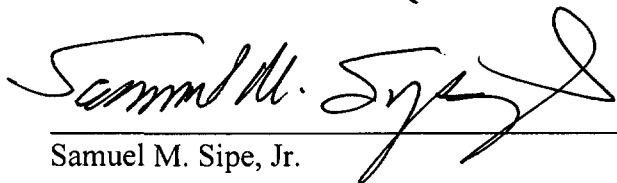
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CERTIFICATE OF SERVICE

I, Samuel M. Sipe, Jr., hereby certify that on this 24th day of October, 2006, I caused a copy of the Opening Comments of the Association of American Railroads to be served by first-class mail or a more expeditious method of delivery upon all persons identified on the Board's service list for STB Ex Parte No. 646 (Sub-No. 1).



Samuel M. Sipe, Jr.