

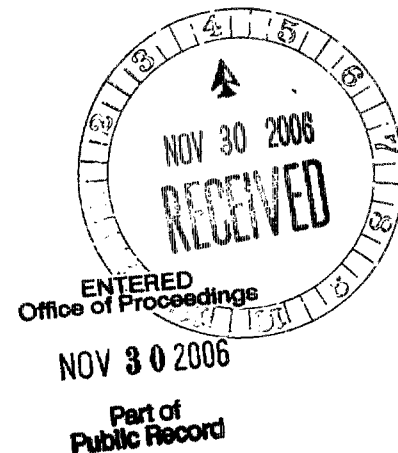
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November 30, 2006



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-referenced proceeding are an original and twenty copies of BNSF Railway Company's Reply Comments. Also enclosed are three CDs containing the text of this filing in Microsoft Word format.

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

Sincerely,

A handwritten signature in black ink, appearing to be 'Anthony J. LaRocca'.

Anthony J. LaRocca
Counsel for BNSF Railway Company

Enclosures

cc: Parties of Record



**BEFORE THE
SURFACE TRANSPORTATION BOARD**

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

SIMPLIFIED STANDARDS FOR RAIL RATE CASES

**REPLY COMMENTS OF
BNSF RAILWAY COMPANY**

**ENTERED
Office of Proceedings**

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**Part of
Public Record**

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**BEFORE THE
SURFACE TRANSPORTATION BOARD**

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

SIMPLIFIED STANDARDS FOR RAIL RATE CASES

**REPLY COMMENTS OF
BNSF RAILWAY COMPANY**

I. INTRODUCTION

BNSF Railway Company ("BNSF") submits these Reply Comments in Ex Parte No. 646 (Sub-No. 1), *Simplified Standards for Rail Rate Cases*, pursuant to the Notice of Proposed Rulemaking issued by the Board on July 28, 2006 initiating this proceeding ("*EP 646 NPRM*") and a September 15, 2006 decision modifying the schedule for submission of comments. BNSF filed Opening Comments on October 24, 2006. These Reply Comments respond to the comments submitted on opening by shippers, shipper associations government agencies and several other railroads.

BNSF supports the Board's efforts to simplify and make more predictable the determination of rate reasonableness in cases where a traditional SAC presentation is not justified. The proposals set out in the Board's July 28, 2006 NPRM pursue these objectives while attempting to remain true to the maximum extent possible to the principles and policies set out in the *Coal Rate Guidelines* and the governing statute. The Board's proposal to adopt different standards for small and medium-sized cases and to link eligibility for the different standards to a shipper's expected litigation costs are generally appropriate in BNSF's view. BNSF has urged the Board to make some important changes in the proposed methodologies for small and medium-sized cases, but it accepts the basic approach that the Board has proposed.

The shippers reject the Board's proposed approach and they offer no constructive suggestions for advancing the Board's simplification objective consistent with the legal and economic framework established by the *Coal Rate Guidelines* and the governing statute. Instead, the shippers seek a regime of expanded rate regulation that would virtually guarantee widespread rate prescriptions. The objective of the shippers' comments is not to improve access to the Board for small shippers who cannot justify the expense of SAC litigation. The shippers seek to have the Board substantially expand the group of shippers entitled to use the Board's proposed three-benchmark approach. But the primary beneficiaries of the approach shippers contemplate would be shippers of substantial quantities of freight by rail who seek to increase their profits at the expense of the Nation's railroads. The shippers' interest is in a revenue transfer, pure and simple.

The shippers reject the Board's proposal to apply different standards in small and medium-sized cases and they reject the Board's proposal to link the availability of the various alternative standards to expected litigation costs. They seek to expand the coverage of non-SAC approaches to rate regulation with no affirmative rationale for doing so. The few concrete proposals advanced by the shippers and their consultants are fundamentally at odds with the principles of Constrained Market Pricing ("CMP") that have provided the framework for maximum rail rate regulation for more than two decades.¹ The Board and ICC have repeatedly recognized that CMP establishes standards to govern rail rate regulation consistent with the economic realities of railroad markets, primarily the need for differential pricing to ensure the financial viability of the railroad industry. The shippers' rejection of simplified SAC and their

¹ In 1985, the ICC described CMP as "an appropriate regulatory framework that will meet our dual objectives of providing railroads the real prospect of attaining revenue adequacy while protecting captive coal shippers from 'monopolistic' pricing practices." *Coal Rate Guidelines, Nationwide*, 1 I.C.C.2d 520, 524 (1985).

plea for vastly increased eligibility thresholds would make the three-benchmark approach applicable to the vast majority of traffic potentially subject to regulation; it would marginalize CMP, making it the exception rather than the rule in rail rate regulation.

CMP gives railroads maximum flexibility to set rates based on perceived market conditions, with regulation only where individual shippers are asked to pay for facilities from which they derive no benefit or where they are asked to contribute more revenue than needed for the railroad to provide efficient service or to achieve revenue adequacy. The three-benchmark approach has only a tenuous connection to CMP. It does not evaluate the reasonableness of rates based on the principles of contestability and differential pricing that are at the heart of CMP, but rather compares challenged rates to average rates paid by other shippers on supposedly comparable traffic, with an adjustment to account for the defendant railroad's revenue needs. The three-benchmark approach is admittedly crude. It could be justified only in that small category of cases where the need for simplification outweighs the loss of accuracy. Applying it to broad categories of traffic as the shippers propose would violate the statute.

The shippers' desire to expand the scope of the three-benchmark approach is also contrary to the strong deregulation policy that informs the existing statutory scheme. The governing statute limits rate regulation to cases where there has been an abuse of market power. But the three-benchmark approach assumes that a rate is unreasonable merely because the rate exceeds an adjusted average rate for a group of supposedly comparable traffic. If this approach were expanded to cover the majority of rail shippers potentially subject to regulation – including, as shippers suggest, traffic that is currently exempt from regulation – it would amount to broad price regulation. Such a regime of broad price regulation would conflict with the clear intent of Congress in the Staggers Act and ICCTA to let market forces establish rail rates to the maximum

extent possible. It would also be unwise as a matter of policy. It would be particularly dangerous to establish an intrusive regime of price regulation now, at a time that new investments in railroad infrastructure are required to meet increased demand for surface freight transportation. Price regulation interferes with the market signals that prompt new investments during times of increasing demand. Broadly expanded regulation of rates in the rail industry could severely constrain new investment at the very time that it is badly needed.

No evidence has been presented in this proceeding of widespread abuses of market power that would justify a broad reregulation of railroad rates. In fact, the primary potential beneficiaries of the expanded rate regulation sought by the shippers are large companies whose economic power dwarfs that of the railroads. Shippers like Cargill, CF Industries, Chevron Phillips, Dow Chemical, DuPont and Occidental have vast resources at their disposal to deal with any abuses of market power by much smaller railroads. Product and geographic competition are pervasive and effective in markets where these large shippers participate. While the Board does not consider evidence of product and geographic competition in market dominance proceedings, shippers with large networks of suppliers and customers frequently rely on those competitive forces to constrain rail rates. The instances in which there is a need for regulatory intervention on behalf of such large shippers to combat market abuse by railroads should be extremely rare.

In their zeal for expanded rate regulation, the shippers have lost sight of the Board's simplification objective and its focus on the protection of small shippers. The shippers make few concrete proposals, but where they do suggest methodological changes, their proposed changes would make the Board's proposed standards more malleable, more costly and more

unpredictable. For example, Gerald Fauth, a consultant to the Joint Shippers,² proposes that discovery procedures in a SSAC case be expanded to give complainants greater opportunities to manipulate the selection of a route for the simplified SARR. Joint Shippers' Op. Comments, Fauth V.S. at 37. Mr. Fauth also proposes that the group of traffic from which comparable movements are selected in applying the three-benchmark standard be expanded to include traffic outside the issue traffic's two-digit STCC code, thus increasing complainants' opportunities to manipulate the composition of the comparable traffic group, thereby increasing the cost and complexity of rate litigation. The Joint Shippers propose to allow complainants to expand the evidence that can be submitted by complainants in the three-benchmark approach to include unspecified evidence related to the Long-Cannon factors. See Joint Shippers' Op. Comments at 36-37.

The Board's proposal to establish different standards for small and medium-sized cases is an appropriate way to simplify rate reasonableness litigation in cases where the litigation costs of a traditional SAC analysis (referred to by the Board as "Full-SAC") cannot be justified while preserving CMP to the maximum extent possible. The Board should reject the shippers'

² The umbrella filing for the shippers is a set of comments filed jointly by the American Chemistry Council, American Forest and Paper Association, American Soybean Association, Colorado Wheat Administrative Committee, The Fertilizer Institute, Glass Producers Transportation council, Idaho Barley Commission, Idaho Wheat Commission, Institute of Scrap Recycling Industries, Montana Wheat and Barley Committee, National Association of Wheat Growers, National Barley Growers Association, National Corn Growers Association, National Council of Farmers Cooperatives, National Farmers Union, National Grain and Feed Association, National Sorghum Producers, The National Industrial Transportation League, National Oilseed Processors Association, National Petrochemical & Refiners Association, Nebraska Wheat Board, North American Millers Association, North Dakota Grain Dealers Association, North Dakota Public Service Commission, North Dakota Wheat Commission, Oklahoma wheat Commission, Paper and Forest Industry Transportation Committee, PPL EnergyPlus, LLC, South Dakota Wheat Commission, Texas Wheat Producers Board, USA Rice Federation, Washington Wheat Commission, Alliance for Rail Competition, and Consumers United for Rail Equity. BNSF refers to these comments as the "Joint Shippers' Op. Comments" and to the group of shippers as the "Joint Shippers."

proposal to eliminate the SSAC standard for medium-sized cases and to expand dramatically the coverage of a modified benchmark approach.

BNSF's Reply Comments follow the basic outline of BNSF's Opening Comments. These Reply Comments are supported by a verified statement of Mr. John Klick, who also provided support for BNSF's Opening Comments.

II. GENERAL ISSUES

A. Eligibility

BNSF continues to believe that the Board has sought to achieve an appropriate balance between the interests of expanded access to the Board and the preservation of market-based regulation by adopting a three-tiered approach to rate reasonableness litigation and by proposing eligibility thresholds that reflect reasonable estimates of litigation cost. The tiered approach implements the statutory directive to develop simplified procedures where the value of a case is not sufficient to justify the expense of traditional Full-SAC litigation while at the same time preserving the application of CMP principles to as many challenged rates as possible. Under the tiered approach, SSAC provides a middle ground that implements CMP principles, albeit in a simplified manner, for a broad spectrum of cases that are not sufficiently large to justify a traditional case. Only the smallest cases would be decided under the three-benchmark standard, which has only a tenuous relation to CMP.

Shippers take a very different view. They argue that the Board should entirely eliminate the SSAC procedure for medium-sized cases and apply the three-benchmark approach to as many cases as possible. *See* Joint Shippers' Op. Comments at 5. The Joint Shippers do not make any specific proposals about the eligibility criteria for use of the three-benchmark standard. They simply argue that the Board "should drastically revise upwards its eligibility thresholds for

the Three Benchmark standard. . . .” *Id.*³ But any significant expansion of the eligibility criteria for the three-benchmark standard would subject an inappropriately large portion of BNSF’s traffic to rate regulation under standards that have only a tenuous connection to CMP and the economic principles underlying the *Coal Rate Guidelines*.

To demonstrate the impact of adopting higher eligibility thresholds, BNSF witness Klick replicated the Board’s analysis from Table 2 of the *EP 646 NPRM* using the 2005 waybill data for BNSF. Mr. Klick’s calculations, described in his reply verified statement, show that following the Board’s approach, if the USDA thresholds were adopted, more than 80% of BNSF’s regulated traffic would be subject to rate challenges under simplified procedures, and nearly half of all rate challenges would fall under the three-benchmark approach.

Expanding the coverage of the admittedly crude three-benchmark approach to cover such a significant proportion of BNSF’s traffic would run counter to the Board’s express justification for adopting a cruder standard to test the reasonableness of rates. As BNSF pointed out in its Opening Comments, the Board has recognized that a crude approach would be acceptable in truly small cases only because the adverse effects of applying such an approach would be limited by the small volume of traffic to which it would apply. BNSF Op. Comments at 7. Since the adverse effects would be limited, it is appropriate for the Board to judge that the benefits of simplification outweigh the adverse impact of applying a standard that does not implement CMP principles. In the *EP 646 NPRM*, slip op. at 27, the Board reiterated this position.

³ The Joint Shippers attach a copy of comments they submitted in 2004, which contain eligibility proposals for the procedures under consideration at that time, but they make no effort to link the 2004 comments to the Board’s current proposals. Reply comments submitted by the Association of American Railroads, in which BNSF joins, address the shippers’ 2004 comments as well as proposals made by the U.S. Department of Agriculture in its opening comments. Various other individual commenters offer alternative eligibility standards, but provide no clear rationale for those standards. *See Occidental Chemical Corporation, Comments for the Surface Transportation Board Proposal Simplified Standards for Rail Rate Cases* at 3.

The Board further made clear in the *EP 646 NPRM* that limited application of the three-benchmark approach offered protection against the D.C. Circuit's "concern that repeated application of a mean figure as the basis for a regulatory ceiling could have a feedback effect that could lower the mean for future cases."⁴ The Board concluded that since the three-benchmark approach would apply only to a small group of traffic, the "feedback effect" would be minimal and therefore acceptable. The Board also stated that limits on application of the three-benchmark approach would prevent unwarranted deviation from CMP principles:

[O]nly a small percentage of a carrier's traffic would likely be eligible to use the Three-Benchmark approach under our proposed eligibility criteria Thus, most traffic in the comparison group would likely be constrained (potentially or actually) by some form of the SAC test – either the Full-SAC or Simplified-SAC test. Therefore, while this Three-Benchmark approach would not replicate directly the results of a SAC analysis, it would import that constraint indirectly by comparing the challenged rate against rates for other potentially captive movements that are constrained by some form of the SAC test.

EP 646 NPRM, slip op. at 28. Obviously, if the Board were to "drastically revise" upward its eligibility thresholds for the three-benchmark approach, and do away with SSAC entirely, these justifications for the three-benchmark approach would no longer apply and the three-benchmark approach could not survive legal challenge.

The Joint Shippers challenge the Board's litigation cost assumptions without ever making it clear how litigation costs fit into their framework for establishing eligibility criteria.⁵ Their

⁴ See *Burlington Northern Railroad Co. v. I.C.C.*, 985 F.2d 589, 597 (D.C. Cir. 1993).

⁵ The Board's eligibility criteria for use of the three-benchmark standard are based on an assumption that if the value of a particular case justifies the litigation costs of a SSAC case, then the case should be brought under the SSAC standard. Only if the value of the case is less than the cost to litigate under the SSAC standard should a case be brought under the three-benchmark standard. Likewise, if the value of a particular case justifies the litigation costs of a Full-SAC case, then the case should be brought under the Full-SAC standard.

claims concerning the likely cost of litigating a SSAC case are wildly exaggerated. As Mr. Klick explains in his attached reply verified statement, the Joint Shippers' consultants have largely ignored the significant cost savings that would result from the simplifying assumptions used in SSAC as well as the savings for shippers of placing the burden of developing evidence on the railroad defendants. Similarly, Mr. Klick explains that the shippers have exaggerated the costs of Full-SAC litigation by ignoring the impact of the Board's recent rulings in Ex Parte No. 657 (Sub-No. 1) that will simplify SAC litigation. For example, eliminating disputes over variable costs by using unadjusted URCS should by itself substantially reduce litigation expenses. Costs will also be saved in Full-SAC cases as a result of the Board's recent methodological decision in Ex Parte No. 657 on the standards that apply to the revenue allocation methodology. A substantial portion of the record in recent SAC cases has been devoted to arguments and evidence relating to the proper methodology to apply in this area. In addition, the Board's decision in Ex Parte No. 657 on the treatment of productivity in the calculation of operating expenses will reduce litigation costs associated with SAC operating expenses.

The Joint Shippers also challenge the Board's proposal to assess the value of a case by reference to the maximum value of the case, which may not reflect the amount that shippers could expect to recover. According to the Joint Shippers, without some guarantee of a sizeable return to shippers who bring cases, the Board's simplification procedures do not represent meaningful reform. As they put it, "[t]he blunt fact of the matter is that no rational shipper will bring a rate challenge if it would recover merely the cost of the litigation, or even a little more, and thus, an eligibility standard *must* take into account a litigation risk factor." Joint Shippers' Op. Comments at 18.

The Joint Shippers miss the point. The Board's task in this proceeding is not to maximize the amount of rate litigation or to increase the likelihood of success for large firms who perceive low likelihood of recovery from rate litigation. Rather, the Board's purpose is to develop procedures that will give access to rate relief to those shippers who may be suffering from market power abuse but who do not have large enough claims to justify the expense of a Full-SAC proceeding. Raising eligibility thresholds does not accomplish this goal. Those shippers with small claims who face litigation uncertainty would still face the same trade-off between potential recovery and litigation cost even if the Board adopted higher eligibility standards. Raising eligibility thresholds would simply increase the size of cases that could potentially be brought under simplified procedures with less accurate results.

Moreover, it would be inappropriate for the Board to take account of likelihood of success in setting eligibility thresholds. Likelihood of success in litigation is an inherently subjective factor that cannot form the basis for rational regulatory policy. Shippers, not the Board, should be evaluating whether a case has sufficient merit to warrant litigation in the first place. Given the additional clarity the Board is attempting to bring to simplified standards in this rulemaking, it should be easier for shippers to conduct that analysis in the future, particularly after there is some experience with the new standards, and to avoid bringing non-meritorious cases.

Furthermore, there is a much more straightforward solution to the real issue the Joint Shippers have identified, namely that the maximum value of the case as calculated under the Board's proposal may overstate the maximum realistic value of the case. The direct solution to this issue would be to permit a shipper to specify what it believes the MVC of a case to be and to

limit the shipper's recovery to that stipulated MVC. The shipper may then bring its case using the simplified procedure available to it given the stipulated MVC.

Allowing shippers to stipulate an MVC would only be appropriate, however, if the Board applies the aggregation rules it has proposed. Those rules are properly directed at preventing shippers from manipulating the value of their cases in order to bring them under simplified and less accurate standards when the more costly and much more precise Full-SAC standard would be appropriate. The Board must be able to prohibit such abusive practices so that it can ensure that Full-SAC proceedings and their underlying CMP principles are employed whenever possible.

The Joint Shippers' criticism of the Board's proposed aggregation rules appears to be solely directed toward ensuring that as many cases as possible would be brought under simplified standards. Their rejection of the aggregation rule simply reflects their view that eligibility for simplified standards should not be tied to litigation costs. But the rationale underlying the aggregation rule is simple and consistent with the basic approach to eligibility – if the value of potential rate relief for a group of related movements justifies litigating the reasonableness of the rates for those movements under SSAC or Full-SAC, then those more accurate rate reasonableness standards should be applied. There is no reason to allow a shipper to disaggregate the rate challenges for those movements so that they may take advantage of a simplified but less accurate standard.

B. Jurisdictional Threshold

In its October 30, 2006 decision in Ex Parte No. 657 (Sub-No.1), *Major Issues in Rail Rate Cases* ("EP 657 Decision"), the Board modified its approach to calculating the jurisdictional threshold in SAC cases and decided to "limit the parties to the use of the unadjusted URCS Phase III movement costing program and disallow movement specific

adjustments other than those automatically made by URCS.” *EP 657 Decision*, slip op. at 60.

The Board concluded that “disallowing movement-specific adjustments other than those required by URCS brings us closer to what Congress intended for a procedure to expeditiously handle rail rate challenges.” *Id.* at 59. The Board further noted that the use of unadjusted URCS would “reduce the expense of litigating before the agency by as much as one-third.” *Id.*

In light of the Board’s decision to disallow movement-specific URCS adjustments in large rail rate cases in the interests of simplifying and expediting SAC litigation, the Board may be disinclined to permit movement-specific URCS adjustments in assessing the jurisdictional threshold in small and medium-sized cases where the Board’s concerns over simplification and expedition are even greater than in SAC cases. BNSF nevertheless continues to believe that there may be unusual cases where adjustments to URCS are critical to determining the actual variable costs of a particular movement so that it would be inappropriate to forbid such adjustments. On opening, BNSF gave the example of third-party payments, which have been routinely permitted by the Board and its predecessor and where the required adjustments to URCS can be easily made. The circumstances where such extraordinary adjustments should be made are not likely to be widespread. Therefore, BNSF urges the Board to leave open the possibility that adjustments will be considered in individual cases in circumstances where the adjustments can be easily made and the failure to make the adjustment would result in a patently incorrect determination of Board jurisdiction over a particular rate.

C. Exempt Traffic

The Board has proposed to make the SSAC and small rate case standards available to shippers of commodities that have been exempted from regulation under the Board’s class exemption authority at 49 U.S.C. 10502(a) through the device of a partial revocation of exemption. In its Opening Comments, BNSF pointed out that the simple and expedited

procedures proposed by the Board for addressing requests for revocation did not provide sufficient opportunity to consider the factors that must be considered in a proceeding to revoke an existing exemption. BNSF, AAR and others⁶ expressed concern that the revocation process proposed by the Board could become a back door for reregulating traffic, contrary to the intent of Congress and the public interest. BNSF Op. Comments at 13-15; AAR Op. Comments at 13. BNSF and AAR recommended that any request for revocation of an existing exemption should be addressed as a threshold matter, consistent with the statutory standards of §10502(d), with a decision on revocation preceding the initiation of a rate reasonableness proceeding. BNSF Op. Comments at 16; AAR Op. Comments at 14.

The shippers' opening comments generally support the Board's proposed simultaneous consideration of an exemption revocation request with a challenge to the reasonableness of a rate. Shippers argue that the revocation of existing exemptions should be facilitated because the tightening of capacity in all modes of transportation has left shippers of exempt commodities "increasingly . . . without effective transportation options." Joint Shippers' Op. Comments at 38. They further argue that a request for revocation of an existing exemption does not require consideration of any information that would not already be considered in a rate reasonableness proceeding because "the standards for market dominance under 49 U.S.C. §10701 are similar to the standards that would be required to show that the exemption should be revoked." *Id.* at 38-39. The shippers are wrong on both counts.

⁶ The United States Department of Transportation (U.S. DOT) cautions that in considering requests for revocation of class exemptions the Board must adhere to the statutory standards governing exemptions from regulation and the usual burden of proof in meeting those standards and that it would oppose any suggestion that the class exemptions "could be dispensed with on some other basis simply because they arise in the context of rate regulation." U.S. DOT Op. Comments at 2-3.

The shippers present no evidence whatsoever that capacity constraints have affected the competitiveness of most transportation markets that led the ICC to establish exemptions for many commodities. To the extent that shippers are claiming that tight capacity has led to higher prices, such a result is entirely consistent with the workings of competitive markets. Tight supply and increasing demand will naturally produce higher prices. If markets are allowed to function without interference, the higher prices will encourage expanded supply, through new entry or new capacity, necessary to meet the higher demand.

The shippers' claim that the standards for assessing market dominance are equivalent to the standards for assessing whether an existing exemption should be revoked is also wrong. An exemption under §10502 is based on a specific determination that railroads do not have substantial market power over the exempted traffic, and therefore there is no need for regulation to protect shippers from abuse of market power. Railroads lack market power over the transportation of exempt commodities because shippers of those commodities are able to use a range of competitive forces, including product and geographic competition, to restrain any exercise of market power. *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). But the Board's market dominance standards expressly disallow the parties to consider product and geographic competition. The market dominance inquiry in the rate reasonableness proceeding would not consider all of the competitive factors that would be relevant to the possible revocation of an existing exemption and for that reason a revocation proceeding must be separate and distinct from the market dominance inquiry in a rate reasonableness case.

III. SIMPLIFIED SAC

The Board's proposed rules are based on a recognition that the principles of CMP can be preserved for medium-size rate cases by applying the SAC test using a series of simplifying

assumptions. Thus, the Board has proposed a Simplified SAC (“SSAC”) approach. SSAC would entail some sacrifice of accuracy in the interest of simplification. However, the Board concluded that the trade-offs between simplification and accuracy were reasonable in cases where the costs of a Full-SAC analysis could not be justified. Therefore, SSAC should be used sparingly, that is, only in those cases where the value of the case does not justify a Full-SAC presentation.

BNSF agreed that the Board’s SSAC proposal was a valid means of applying CMP and the basic SAC principles in medium-sized cases, although it proposed some modifications to the Board’s specific methodologies. UP, and to a somewhat less enthusiastic extent, NS and CSX, also agreed with the basic framework set out by the Board for a simplified SAC analysis. UP further urged the Board to adopt only a SSAC approach as an alternative to Full-SAC proceedings and not to adopt the three-benchmark approach.

The Shippers reject the SSAC proposal in its entirety. They make two basic arguments. First, they argue that SSAC is inconsistent with the statutory mandate to develop a simple and expedited procedure, claiming that SSAC is neither simple nor expedited. The Joint Shippers claim that the SSAC procedure is too complex because it still requires the time-consuming identification of SARR assets, the identification of cross-over traffic and the calculation of operating expenses. Joint Shippers’ Op. Comments at 26. They further object to a time schedule of eighteen months, which they claim is even longer than the Board’s rules allow for Full-SAC cases, absent special adjustments to the procedural schedule. *Id.* at 31.

While the SSAC procedures are somewhat more involved than the three-benchmark approach, they are undeniably simpler and more expedited than Full-SAC procedures. Much of the time and costs associated with Full-SAC litigation relate to the traffic analyses, engineering

studies and operating plans that must be carried out when the complainant hypothesizes a SARR that handles a different traffic group than the incumbent. These tasks, and the time-consuming and costly discovery associated with them, are unnecessary in the SSAC methodology. In addition, the simplifying assumptions made in the SSAC methodology will expedite cases by avoiding the numerous and time-consuming disputes that have delayed the resolution of Full-SAC cases far beyond the time period specified in the Board's regulations.

The shippers' second and primary challenge to the proposed SSAC procedure is that it is inconsistent with CMP principles because it does not allow the complainant to address the supposed inefficiencies in current rail operations. According to shippers, SSAC's use of the incumbent's existing traffic, infrastructure, equipment mix and system average costs undermines a fundamental purpose of SAC, which is to determine the least cost at which an efficient competitor could provide the service for the issue traffic and any additional traffic selected by the complainant. Joint Shippers' Op. Comments, Crowley V.S. at 55.

The shippers' arguments are misplaced. The proposed SSAC standard is a valid simplification measure that makes reasonable trade-offs between the accuracy of Full-SAC calculations and the cost savings that can be achieved through the use of modest simplifying assumptions. While BNSF urges the Board to modify the SSAC proposals in certain ways – particularly to reject the use of the MMM methodology – BNSF nevertheless believes that the SSAC is an appropriate way to simplify SAC evidence in medium-size cases and thereby make CMP-based maximum rate standards available to a larger group of shippers.

A. SSAC Properly Implements CMP Within the Context of Simplification

SSAC preserves the basic competitive market principles of CMP. It is based on the principle that a railroad should have the freedom to set rates based on market conditions and perceived demand for service while ensuring that a challenged rate is not so high as to subsidize

other traffic. SSAC, like SAC, tests for cross-subsidy by evaluating the entry costs of a hypothetical new entrant in a market without entry barriers. Also like SAC, SSAC finds a challenged rate to be unreasonable only if that rate, along with rates on traffic that shares facilities with the issue traffic, generate revenues that exceed the new entrant's costs.

The difference between SSAC and Full-SAC is that SSAC makes simplifying assumptions that produce results that may be somewhat less precise than a Full-SAC analysis. This is a trade-off that it is reasonable for the Board to make in order to provide access to rate relief for shippers who have potential cases where the value of the case is not sufficient to justify the costs of a Full-SAC proceeding while preserving to the extent possible the principles of CMP that underlie SAC. Such access is possible only if litigation costs can be reduced, and litigation costs can be reduced only by identifying and modifying or eliminating the most costly elements of a Full-SAC proceeding. Because of the inaccuracies, SSAC should be used only when the more precise Full-SAC standard is not feasible given the costs of litigating SAC. If SSAC is limited to those circumstances, it is a reasonable approach.

There will always be trade-offs between simplification and accuracy of results, as the Board repeatedly acknowledged when it accepted the use of cross-over traffic in Full-SAC cases. The question is whether the trade-offs are reasonable in light of the benefits that flow from simplifying the presentation and evaluation of evidence. The simplifying assumptions in SSAC are for the purpose of expanding access to the basic SAC test for shippers with medium-sized cases who have not availed themselves of the Board's existing rate reasonableness standards. The benefits from this expanded access justify the modest impact on the accuracy of SAC calculations from the use of the proposed simplifying assumptions.

The critical simplifying assumption of the Board's SSAC proposal is the assumption that the simplified SARR handles the same traffic as the incumbent over the same routes used by the incumbent. The complainant's ability to select the traffic that is assumed to share facilities with the issue traffic is an important part of the Full-SAC test, but it is also the source of most of the complexity in Full-SAC litigation. When the SARR is assumed to handle significantly different traffic volumes, the SARR's facilities must be designed from the ground up, requiring extensive capacity studies and contentious engineering evidence. A new operating plan must be devised for the SARR, requiring complex models and numerous assumptions about operating conditions that would affect any railroad operating under the uncertainties that face railroad networks.

These complications can be avoided if the traffic group is assumed to be the same as the incumbent's traffic that uses the same facilities as the issue traffic. As Mr. Klick explains, this assumption allows complainants to obtain the benefits of traffic densities available to the incumbent. If the SARR traffic group consists of the traffic that in the real world shares the facilities at issue, it is reasonable to assume that the SARR would also use the same basic facilities as the incumbent and would incur the same basic operating expenses as the incumbent. There is no reason to believe that an efficient SARR would be able to provide service to the incumbent's traffic using substantially different facilities or with substantially lower operating costs. Indeed, most of the differences in past SAC cases between the SARR's facilities and operating costs and the incumbent's real-world facilities and operating costs have been attributable to the differences between the SARR traffic group and the real-world defendant's traffic, not to inefficiencies that the complainants have been able to identify in the incumbents' networks or operations. If the SARR's traffic group is the same as the defendant's, it is reasonable to expect that the SAC costs will be the same.

B. Shippers' Objections To The Board's Proposed Use Of Construction Costs From Prior SAC Cases Are Without Merit

The Board proposes to simplify the road property investment (RPI) calculation in SSAC cases by limiting the configuration of the simplified SARR to the existing infrastructure on the route selected by the complainant and by using the rolling average of RPI costs from prior Full-SAC cases whenever possible to determine the unit costs for the major RPI categories. *EP 646 NPRM*, slip op. at Appendix A, 39-40. BNSF in its Opening Comments pointed out that the use of the rolling averages would perpetuate the already low RPI costs determined in the Board's prior SAC decisions, which are based on unrealistic assumptions about production rates and unrealistically low unit costs. BNSF Op. Comments at 22-23. Nevertheless, BNSF supported the Board's proposal for the simplified calculation of RPI costs as part of the overall package of simplification measures, although BNSF urged the Board to retain some flexibility to address instances where the RPI costs based on all-coal routes would be clearly inapplicable to the predominantly non-coal routes more likely to be at issue in SSAC cases. BNSF specifically noted that there could be significant differences in land values, types of facilities, and construction specifications. *Id.* at 24-25.

While declining to address the Board's proposal in detail, the Joint Shippers raise three concerns about the Board's proposed approach to calculating RPI costs. First, they claim that the Board's approach fails to account for the differences in the costs of railroad construction in the Eastern and Western United States. Joint Shippers' Op. Comments at 57-58. AECC echoes that complaint and requests that the Board allow "stratification" of the data so that complainants can use data from either the eastern or the western Full-SAC cases depending on the specific case. AECC Op. Comments at 8. Second, the Joint Shippers' witness Crowley claims that average RPI unit costs from past SAC cases are not a good indicator of the true investment expense for

the simplified SARR since unit costs in some cost categories differ widely based on the SARR's characteristics. Joint Shippers' Op. Comments, Crowley V.S. at 58-59. Finally, the shippers claim that the SSAC procedure improperly relies on unverified data because the STB would not allow consultants to access the backup data. *Id.* at 60-61. Each of these objections is discussed below.

1. East v. West

The Joint Shippers' concern over the Board's alleged "failure to differentiate regional costs" is without merit. The Joint Shippers' witness Crowley notes the Board's acknowledgement in the *Duke/NS* decision that constructing railroads in the mountainous areas of the Eastern United States compared to the less mountainous areas of the West may have been a factor in the higher total cost per route mile in the Eastern cases. Joint Shippers' Op. Comments, Crowley V.S. at 57, n. 89. Mr. Crowley therefore concludes that the Board's proposal to use average RPI expenses from across all regions to develop RPI expenses in SSAC analyses is "highly questionable." *Id.* at 58. But the Board was clearly aware of the potential distortions in SSAC investment costs that could result from basing RPI costs merely on the average of the Full-SARR investment by railroad asset category from cases involving eastern and western SARRs, and it specifically rejected that approach. *EP 646 NPRM, Appendix A at 39.*

In its NPRM, the Board seeks to minimize any distortions resulting from the use of SAC results from eastern and western SAC cases by proposing to use average *unit costs* instead of averages per route mile or track mile for those asset categories most influenced by geography and topography – land, earthwork (cuts and fills), tunnels, bridges and culverts. While this approach places some additional burdens on the proponents of the SSAC test to develop the relative RPI quantities (as opposed to a straight track-mile approach), it goes a long way towards

accounting for the differences in construction costs between the East and the West. The investment costs associated with other construction categories that could be influenced by geography and topography – for example, other earthwork and public improvements (overhead and at-grade crossings) – represent a relatively small portion of overall SARR construction costs. Accordingly, the use of average unit costs from prior SAC cases involving both eastern and western SARRs is a reasonable simplification measure that does not unduly distort the RPI results while substantially simplifying the presentation of evidence.

Moreover, the unit cost information contained in the NPRM demonstrates that the unit costs are not systematically higher for eastern cases, contrary to Mr. Crowley's suggestion. For example, in Table A-2, both the highest *and* the lowest cost per acre of agricultural land were found in western cases. The cost per acre of industrial land in one western case was higher than one eastern case but lower than the other two eastern cases. Similarly, Tables A-3 (cuts and fills) and A-6 (bridges) show that the variations in unit costs developed from the six prior cases are not driven by regional differences. Table A-3 shows relatively little difference between cases, with no direct correlation to east or west. Table A-6 shows that the costs per foot for Type 2 bridges are slightly higher in the east, whereas the costs per foot for Type 3 bridges are slightly higher in the west. There is no clearly predictable difference in unit costs based solely on regional differences.⁷

2. Variation Within Investment Categories

Mr. Crowley claims that the Board's proposed approach to use the rolling averages of RPI costs from prior Full-SAC cases is inappropriate because of the wide dispersion of RPI

⁷ AECC's suggestion that complainants be allowed to cherry pick from the prior SAC cases is an invitation to complicate SSAC proceedings and make them far more contentious, contrary to the Board's goal of simplifying the presentation of evidence.

results within some investment categories. He claims that in certain cost categories, the dispersion of data from past cases is too pronounced to be used as the basis for a prediction of costs in a SSAC case. Joint Shippers' Op. Comments, Crowley V.S. at 58-60. BNSF agrees that in certain areas the unit costs from one case to another can vary significantly. But Mr. Crowley overstates the problem and overlooks obvious ways of addressing the issue of data variation within the basic framework proposed by the Board.

Mr. Crowley acknowledges that the costs in several important cost categories fall within relatively narrow ranges, including the cost per track mile for track construction, the cost per cubic yard for earthwork cut and fills, and the bridge cost per foot for bridge types 2 and 3. Accordingly, the Board's simplified approach is clearly appropriate in these areas. In other areas where Mr. Crowley alleges there is a substantial variation – other miscellaneous earthwork and public improvements without grade separation – the use of averages from past cases will have little impact on the overall RPI costs of a SSAR. As the Board pointed out in its NPRM, the total cost of miscellaneous earth work is “a relatively minor part of the overall RPI analysis, such that more precise estimates would have only a modest, if any, impact on the SAC analysis.” *EP 646 NPRM, Appendix A at 42*. Public improvements without separation is the smallest category of RPI, and as the Board pointed out, its most recent decisions estimate unit costs very close to the overall average. Thus, for most of the RPI cost categories, the problem identified by Mr. Crowley either does not exist or is so minor that it does not invalidate the Board's basic approach.

In areas where there remains a significant variation in the underlying data, that variation can be addressed without discarding the Board's basic approach. For example, while there are variations in costs relating to grade separation, the Board itself noted that one particularly high

unit cost from a past case was an obvious outlier and invited parties to comment on whether this observation should be excluded from the rolling average. While such an approach would address Mr. Crowley's concern, the Joint Shippers have not even asked that the outlier be excluded. Another cost category identified by Mr. Crowley as exhibiting wide variation in data is Signals and Communications. The Board proposed using a cost per route mile for total signals and communications, but it also noted that there could be a need for specialized costing for signaling if the railroad uses automatic block system (ABS) rather than centralized traffic control (CTC). In that instance, the parties would be expected to present evidence on both signal and communications costs rather than using the rolling average. A similar approach could be used in the area of land costs or Type-1 bridges, where there is a significant variation in results. Limited additional evidence in these areas could be presented to improve the accuracy of the cost calculations without significantly increasing the complexity of the SSAC methodology.

There is no reason to believe that the Board's rolling-averages approach would significantly distort the RPI costs for a simplified SARR, particularly if some flexibility is retained by the Board in applying the rolling averages. Therefore, the Board's proposal is a reasonable approach to simplifying the presentation of RPI evidence in medium-size cases where the costs to make Full-SAC calculations are not justified by the value of the case.

3. Unverified Data

The shippers also object to the Board's use of RPI data from prior SAC cases because their consultants will not have access to the underlying confidential data and work papers from those prior cases. As BNSF explained in its Opening Comments, there is no need for any party to a SSAC case to rely on confidential information used in the prior SAC cost calculations. The Board has conducted extensive analyses of the record in each SAC case and it has provided adequate explanation of the assumptions used in prior SAC cases. The record developed by the

Board should be sufficient for the parties to understand and comment on any particular issues raised in the development of road property investment costs using the prior SAC decisions. Moreover, if a party believes that a unit cost derived from a past SAC decision is erroneous, the party can ask the Board to revisit that calculation to determine whether it should be excluded from the rolling averages.

Given that there is no need for access to confidential information, the burdens and additional costs associated with the disclosure of that data to SSAC complainants, including the procedures that would be needed to address the underlying confidentiality of the data, would not be justified. The shippers' own consultants make it clear that access to the underlying data would significantly complicate and increase the costs of SSAC litigation. Mr. Crowley would like to carry out "detailed examination of the underlying unit costs for each Full-SAC case" to determine whether the deviations may be caused by outliers within each case's RPI unit costs. Joint Shippers' Op. Comments, Crowley V.S. at 60. Similarly, on the issue of culvert costs, where the Board has proposed to use a series of regression equations, Mr. Crowley claims that he may need confidential data from the prior cases to "run statistical tests around the results of linear regressions to test the robustness of the results." *Id.* at 61. The shippers clearly have lost sight of the Board's objective of simplifying the presentation of evidence. The marginal value of any additional evidence developed through analyses of the data underlying the past SAC cost calculations is outweighed by the costs and burdens of the expanded litigation.

C. Operating Costs

Since the SARR would handle the same traffic as the incumbent over the same facilities as the incumbent, the Board proposes that the incumbent's operating costs, reflected in URCS, can be used as a proxy for the SARR's operating costs. The Board further proposes to modify URCS to reflect total, rather than variable, operating costs and to exclude certain RPI expenses

that are calculated separately under the one-year analysis in the SSAC. BNSF agrees that the Board's basic approach is a logical and appropriate part of the Board's overall package of simplifying assumptions. Other railroad commenters also agree with the Board's basic approach, although they identify a number of areas where the Board should allow adjustments to the URCS costs in identifying the simplified SARR's operating costs.⁸

The shippers say very little about the Board's proposal for calculating operating costs of a simplified SARR. Their primary argument on operating costs is the argument addressed previously that the SSAC methodology deprives the complainant of the opportunity to develop lower operating costs for an optimally efficient SARR. *See* Joint Shippers' Op. Comments, Fauth V.S. at 28. The Joint Shippers' witness Fauth points to a number of potential efficiencies that a hypothetical SARR might achieve, including the acquisition of an entirely new fleet of the fuel efficient locomotives, and the establishment of supposedly efficient crew arrangements. Mr. Fauth also proposes that the hypothetical SARR might be able to reduce operating expenses through the construction of new facilities that would be significantly superior to the existing rail infrastructure, citing the experience of Japanese North American automakers.

The mere possibility that efficiencies in rail operations might be achieved by a hypothetical SARR does not invalidate the Board's proposal to use URCS-based operating costs as a simplifying measure in SSAC cases. The Board's assumption that a SARR handling the incumbent's traffic would have the same operating costs as the incumbent is reasonable. Complainants in prior SAC cases have been able to demonstrate operating efficiencies in all-coal

⁸ *See* Opening Submission of Union Pacific Railroad Company at 28 (adjustments for costs associated with hazardous waste shipments); Comments of Canadian Pacific Railway Company at 13-14 (costs associated with hazardous waste and cross-border shipments). BNSF also urged the Board to address the time lag between the preceding four quarters revenues and the available URCS costs. BNSF Op. Comments at 27-28.

railroads where a SARR's operations would be vastly simpler than those of a railroad handling multiple types of traffic. For example, the SARRs' exclusive use of efficient unit-train operations in past SAC cases has allowed complainants in those cases to posit lower operating costs in areas like G&A and locomotive utilization. But where the SARR is assumed to handle all of the traffic of the incumbent railroad, there is no reason to believe that the SARR would achieve the efficiencies available to an all-coal railroad. Indeed, in the one SAC case that involved commodities other than coal, the *McCarty Farms* case, the complainant posited the same type of operating efficiencies available to all-coal SARRs and the Board found the operating plan to be infeasible due in part to more complex operations necessary to handle commodities other than coal. *McCarty Farms, Inc. et al. v. Burlington Northern, Inc.*, 2 S.T.B. 460, 476 (1997).

D. Five Year Rate Prescription

The Board proposed to analyze only a single Test Year to determine whether an overcharge exists but to allow rate relief for a maximum of five years by having the parties recalculate the lawful rate in each of the other four years. The Board would have the parties confer annually to update the traffic volumes, revenues and URCS costs and then determine the lawful rate for that year. BNSF did not oppose the Board's proposal for five-year rate prescriptions, where warranted, despite the additional litigation burdens imposed on the railroad, but it asked that the Board adopt a cost-sharing measure to discourage meritless claims. UP also did not oppose the Board's five-year rate proposal.

The Joint Shippers accept the use of a Test Year analysis, but they complain that reapplication of the SSAC procedures over a five-year period is time-consuming and costly. They also suggest that there is something unfair about the complainant having to file an entirely new complaint at the end of the five years. While their discussion of the issue is brief and

confused, the shippers apparently would prefer that the Board prescribe rates for 5, 10, or 20 years, without annual recalculations, to simplify the process. Joint Shippers' Comments, Fauth V.S. at 32-33. The shippers' proposal to prescribe rates for 5 to 20 years on the basis of one year's data is clearly contrary to the Board's concern that any rate prescription account for changes in traffic levels over the time period covered by the prescription. *See EP 646 NPRM* at 14. The Board's test-year approach with annual recalculations over a five-year period is a valid way to address changes affecting the railroad industry during the rate prescription period in the context of a simplified rate reasonableness methodology.

E. Procedural Schedule

The Board proposed an overall procedural schedule for SSAC cases of eighteen months, consisting of 360 days for the parties' submissions of three rounds of evidence and six months for the Board to issue a final decision. The first phase of the schedule includes 50 days for evidence and a determination on eligibility; phase 2 allows 130 days for discovery; and phase 3 provides 180 days for submissions of evidence on the merits. *EP 646 NPRM* at 16-17.

The shippers complain that this procedural schedule is not sufficiently expedited, noting that the schedule is longer than the schedule for Full-SAC proceedings under the Board's rules. Joint Shippers' Op. Comments at 31. But the shippers also acknowledge that Full-SAC cases have never been carried out in the amount of time contemplated by the Board's rules due to the many disputes over discovery and the presentation of evidence that arise in Full-SAC proceedings. The primary focus of the Board's SSAC methodology is to simplify the presentation of evidence in ways that will avoid the disputes that lead to delays in Full-SAC cases. In light of the proposed simplification of evidence, an eighteen-month schedule for a SSAC case is realistic, and it would substantially reduce the time needed for resolution of rate reasonableness cases under the Full-SAC standard.

On the issue of discovery, the shippers complain that the Board's proposal is too restrictive. According to the Joint Shippers' witness Fauth, complainants will have to choose a route for the SARR before they obtain "vital information" from the defendants in the Second Disclosure, such as the identification of all traffic over the selected SARR routes, movement information, operating cost calculations, revenue data and other supposedly essential information that can be used to "choose" a route. Mr. Fauth claims that without these data "the Board is proposing that shippers go into the route selection process blindfolded." Joint Shippers' Op. Comments, Fauth V.S. at 37.

Mr. Fauth's discovery concerns are unfounded. Complainants do not need discovery relating to the choice of a route for the SARR because they should not be permitted to game the SSAC process through the selection of a route. As BNSF explained in its Opening Comments, the Board should require that the complainant in a SSAC case use the predominant route actually used by the issue traffic. It would be inappropriate to allow complainants to try to shift issue traffic from real world routes of movement to potentially inefficient routes simply to take advantage of the economies of density on other lines of the defendant railroad not actually used by the issue traffic. Limiting the choice of a route to the predominant real-world route is therefore consistent with underlying SAC principles. It also advances the Board's simplification objective. Additional costs and complexity would result from the numerous disputes that would be spawned by complainants' route selections if complainants were given broad discretion to choose any route they wanted for inclusion in a SSAC case.

F. The Board Should Not Use the MMM Rate Reduction Methodology in SSAC Cases

On opening, BNSF commented on the Board's declared intent to apply the same rate reduction methodology in SSAC cases that it adopts for use in Full-SAC cases. BNSF Op.

Comments at 32-35. BNSF explained that both of the Board's proposed methodologies – MCM and MMM – were inappropriate for use in Full-SAC cases and that the proposed use of those methodologies in SSAC cases only highlighted their problems. The Board adopted MMM for use in Full-SAC cases in its October 30, 2006 *EP 657 Decision*, slip op. at 14. BNSF continues to believe that there is no rational basis to apply a rate reduction methodology that assumes, as MMM does, that it is sensible to assign a common average R/VC ratio to traffic with different demand characteristics. Since different traffic types have different demand characteristics reflected, in part, in widely divergent R/VC ratios, it would be inappropriate to apply that methodology in SSAC cases.

In its decision in Ex Parte 657, the Board sought to justify use of MMM through reliance on the statutory Long-Cannon factors, 49 U.S.C. § 10701(d)(2)(A)-(C). Although the Board devoted a single cryptic sentence to the implications of Long-Cannon in the *EP 657 NPRM*,⁹ the Long-Cannon factors became the central justification for MMM in the October 30, 2006 decision.¹⁰ The Board focused in particular on the second Long-Cannon factor, which it maintains “reflects a Congressional directive that shippers with fewer transportation alternatives . . . not bear a differentially larger share of the joint and common expenses until the carrier has charged its shippers with more competitive alternatives . . . as much of the unattributable costs as demand will permit.” *EP 657 Decision* at 18. The Board attempts to convert the second Long-

⁹ *Major Issues in Rail Rate Cases*, STB Ex Parte No. 657 (Sub-No. 1), slip op. at 12 (served Feb. 27, 2006) (“*EP 657 NPRM*”) (“Moreover, while Ramsey pricing represents the most efficient way to price above marginal cost, reliance on pure Ramsey pricing would not be consistent with the Long-Cannon factors of the statute because it would not maximize the revenue contribution from traffic with more-elastic demand (competitive traffic) before calling on traffic with less-elastic demand (captive traffic) to make a differentially higher revenue contribution”).

¹⁰ See *EP 657 Decision*, slip op. at 12-13, 16-19.

Cannon factor into a requirement that railroads “maximize the revenue contribution from traffic with more-elastic demand (competitive traffic) before calling on traffic with less-elastic demand (captive traffic) to make a differentially higher revenue contribution.” *Id.* at 16.

The plain language of the statute does not support the Board’s new interpretation. While the Board would read the second Long-Cannon factor expansively, the statutory language is very specific and limited:

(2) In determining whether a rate established by a rail carrier is reasonable for purposes of this section, the Board shall give due consideration to . . .

(B) the amount of traffic which contributes only marginally to fixed costs and the extent to which, if any, rates on such traffic can be changed to maximize the revenues from such traffic

49 U.S.C. § 10701(2). The second Long-Cannon factor speaks only of “traffic which contributes only marginally to fixed costs.” There is no rational basis to equate “shippers with more competitive alternatives,” or “competitive traffic,” with “traffic which contributes only marginally to fixed costs.” Whatever “marginal contribution” may mean, it cannot possibly encompass all of a railroad’s competitive traffic. Much of a railroad’s competitive traffic clearly makes more than a “marginal contribution” to covering fixed costs. Indeed, Congress itself has defined all traffic with an R/VC of less than 180% as competitive. 49 U.S.C. § 10707(d)(1).

There is no mechanism within MMM that distinguishes between traffic that contributes only marginally and traffic that makes a more significant contribution. Nor does MMM draw any distinction between “competitive” and “captive” traffic. Instead, MMM draws an essentially arbitrary line that is based on the characteristics of a particular SARR: all traffic that moves below the average R/VC that is necessary to cover the full costs of the SARR is treated as having its rate unchanged while all traffic that moves at or above the average R/VC is treated as having

its rates set to produce the average R/VC. Rates are not set based on whether traffic contributes marginally, but on which side of the average calculated for a particular SARR the rates fall.

Nor is MMM tailored in any way to further the statutory goal of assessing whether rates on traffic that “contributes only marginally to fixed costs” can be changed to maximize revenue contribution from that traffic. Even if MMM identified the set of traffic specified in the statute, it does nothing to determine whether the rates on that traffic maximize revenue contribution or what the effect would be on total revenues if the rates on that traffic were changed. MMM simply assumes that the rates on all traffic falling below an arbitrary level should be left alone, and all of the necessary reduction in revenues should be taken from traffic with R/VC ratios above the arbitrary break point.

Long-Cannon considerations also do not support the key characteristic of MMM, which is to completely eliminate differential pricing for all traffic with an R/VC above the average necessary for the SARR to cover its full costs. Long-Cannon speaks only to what the Board should consider with respect to the lowest-rated traffic that moves on a railroad; it says nothing about how rates should be set for higher-rated traffic or for traffic that might be considered captive. Eliminating differential pricing for higher-rated traffic is neither necessary nor related to maximizing revenues from traffic that contributes only marginally to fixed costs.

Using MMM to establish maximum rates is nothing less than an abandonment of the economic principles underlying CMP. When the ICC adopted CMP, it saw its task as the development of “an economically efficient and equitable methodology for determining the reasonableness of rates.” *Coal Rate Guidelines*, 1 I.C.C. 2d at 521. It settled on Ramsey Pricing principles as the most efficient mechanism for allocating unattributable costs. The Board

continues to acknowledge that “Ramsey pricing represents the most efficient way to price above marginal cost.” *EP 657 Decision* at 12.

The Board now contends that “there are good reasons to depart from Ramsey pricing principles in favor of a form of demand-based differential pricing principles that is more compatible with the statute.” *EP 657 Decision*, slip op. at 19. But there is simply no basis to contend that MMM is “more compatible with the statute” than the existing percent reduction methodology. MMM does not further the second Long-Cannon factor, which focuses on rates for an extremely small subset of a railroad’s traffic. Nor does MMM further economic efficiency in rate regulation because there are superior methods of allocating unattributable costs, namely through an approach that approximates Ramsey pricing. And the key feature of MMM – the complete elimination of differential pricing for a significant portion of a railroad’s traffic – is clearly inconsistent with the demand-based pricing principles underlying CMP and the governing statute. The elimination of differential pricing is not called for by Long-Cannon considerations, and it is clearly inconsistent with the Congressional directive that “competition and the demand for services” are to be the basis for reasonable rates. 49 U.S.C. § 10101(1).

The Board also contends that the *Coal Rate Guidelines* did not really adopt or endorse Ramsey pricing principles, but merely provided that some form of “demand-based differential pricing to recover the total SAC costs” must be used. *EP 657 Decision*, slip op. at 12-13. This revisionist interpretation cannot be reconciled with the actual language of the *Coal Rate Guidelines* decision. The ICC explicitly stated: “We are satisfied that the constraints and incentives CMP contains should lead to rates approximating Ramsey prices” 1 I.C.C. 2d at 527.¹¹ The ICC also stated that “carriers are expected to use the market demand which they

¹¹ See also 1 I.C.C. 2d at 534 (“our purpose in CMP is to approximate Ramsey pricing”).

observed as the basis for their pricing.” *Id.* Similarly, the ICC made clear that unattributable costs should “be allocated among the carrier’s shippers in accordance with Ramsey principles (i.e., on the basis of relative demand elasticities).” *Id.* at 547.

Accordingly, it would constitute clear error for the Board to adopt MMM as its rate setting methodology in SSAC cases. The Board should instead retain the percent reduction rate setting methodology.

IV. THREE-BENCHMARK APPROACH

On opening, BNSF explained that while it does not believe that the infrequency of small rate cases under the *1996 Non-Coal Guidelines* is attributable to uncertainty over the application of the benchmark approach set out in those *Guidelines*, it nevertheless supports the Board’s attempt to bring greater clarity and certainty to the basic benchmark approach described in the *1996 Guidelines* for use in truly small rate disputes. BNSF therefore accepts the basic methodology set out in the *EP 646 NPRM* for small cases, although it does not agree with the proposed modifications to the RSAM or the use of a mean in assessing the maximum reasonable rate.

Other railroads were less supportive of the Board’s three-benchmark proposal. The Canadian railroads expressed concern about the availability of data relating to cross-border movements. CSX and NS expressed concerns over the use of a formulaic approach that might sacrifice too much precision for the sake of simplification. And UP objected to any use of a benchmark approach as incompatible with the principles of CMP. While BNSF acknowledges these concerns, particularly UP’s concerns about the need to preserve CMP to the maximum extent possible in the regulation of rail rates, BNSF also believes that a simplified benchmark approach is an acceptable means of providing access to the Board for the lowest value cases. BNSF does not believe that unreasonable rates are widespread, but shippers with low value cases

should not be foreclosed from access to the Board merely because the value of any claim they might have for relief is exceeded by the cost to bring a rate case. The Board's proposed benchmark approach, with modifications, is an appropriate way to ensure access to the Board on behalf of small shippers, so long as that approach is strictly limited to the smallest cases.

The shippers argue that some version of the three-benchmark approach should be adopted as the only alternative to the Full-SAC standard. They further argue that eligibility for use of the three-benchmark approach should be "drastically revise[d] upwards." Joint Shippers' Op. Comments at 5. As explained above, the result of the shippers' proposed expansion of the three-benchmark approach would be to expose the vast majority of traffic potentially subject to regulation to rate standards that bear only a marginal relationship to CMP. Such a result would be unacceptable as a matter of both law and policy.

In addition to their attempt to expand the coverage of the three-benchmark standard, the shippers seek to complicate the proposed approach and to make it more malleable and less predictable. The Joint Shippers urge the Board to allow complainants to submit evidence relating to "individualized factors that make the rate unreasonable even if the rate is below the level that would be produced by the formula." Joint Shippers' Op. Comments at 37. They also urge the Board to allow complainants to submit evidence relating to the statutory Long-Cannon factors, although they never specify what types of evidence would be appropriate. *Id.* As noted previously, the Joint Shippers' attempt to expand the complexity of the three-benchmark approach runs counter to the Board's simplification objective. The three-benchmark approach is only appropriate for the smallest rate cases, and in those cases the submission of potentially complex evidence on "individualized factors" unrelated to the benchmark calculations or evidence on Long-Cannon factors could defeat the objective of cost effective rate cases. The

Board should reject the shippers' proposal to make the standard more amenable to manipulation by complainants and their consultants.

A. The Selection of a Comparable Traffic Group

The principal concern raised by the shippers about the application of the three-benchmark approach relates to the shippers' access to data from the waybill sample. Under the Board's proposal, shippers receive masked revenue data at the beginning of a case and obtain the unmasked revenue data only after the comparable traffic group is selected. The shippers claim that this approach puts them at a disadvantage in the process of selecting comparable traffic because the railroads have access to the unmasked data – since it is their own data – while for contract movements in the waybill sample shippers have access only to revenue data that has been masked.

The shippers' concern is unfounded. The only movements in the waybill data that have masked revenues are contract movements. However, as BNSF explained on opening, contract movements should not be included in any comparable traffic group because of the inherent differences between common carriage and contract movements. Since contract movements should be excluded from any comparable traffic group, the fact that revenues on contract movements are masked in the waybill data should have no effect at all on the application of the three-benchmark standard. In any event, as explained by Mr. Klick in the attached Verified Statement, the Board has made it clear that R/VC ratios are not supposed to be used as the basis for determining the comparability of traffic in the comparison group. Thus, the Board will choose the most appropriate comparability group set forth by the parties based on the demand and cost characteristics of the particular movements without reference to R/VC ratios.

Shippers also complain that they do not have access to any waybill data, masked or unmasked, prior to the filing of a rate case. But there is no valid reason to grant potential

complainants pre-complaint access to confidential waybill data. The Board's rules governing access to confidential waybill data are based on a recognition of the commercial sensitivity of the data reported to the Board for purposes of compiling the waybill sample and the need to restrict access to the data. The Board has repeatedly found that pre-complaint access to the data is not a proper use of the sensitive waybill data. *See e.g.*, March 10, 2006 letter from Leland L. Gardner to Messrs. DiMichael and Goldstein. Moreover, complainants are not prejudiced under the Board's proposed approach. While defendant railroads have access to the underlying data, they have no need to refer to the data and no use for the data before a complaint is filed. Complainants and defendants are on equal footing with respect to access to the waybill data – both parties have access to the waybill data as soon as a complaint is filed and the data become relevant to a pending dispute.

Finally, the Joint Shippers' consultant Gerald Fauth argues that the Board should not restrict complainants' data access to waybill records of movements with the same two-digit STCC code as the issue traffic movement. Joint Shippers' Op. Comments, Fauth V.S. at 56. Mr. Fauth suggests that complainants be given access to the full confidential waybill sample so that their choice of comparable traffic is not restricted to movements of the same commodity. Expansion of access to waybill data beyond the two-digit STCC code is not warranted. It is highly unlikely that different commodities would be sufficiently comparable to be included in a valid comparison group in any but the most unusual circumstances. Therefore, the chance that the benchmark analysis would be improved by including different commodities is far outweighed by the increased complexity and the inevitable disputes that would arise if complainants were allowed to expand the comparison group to include different commodities. The benchmark approach is supposed to simplify the rate reasonableness process and make it more widely

available to shippers with low value cases. Mr. Fauth's proposal would only complicate litigation and increase costs with little or no improvement in the accuracy of the results.

B. The Use of a Confidence Interval

The Joint Shippers' consultant Mr. Crowley argues that the Board should not use the upper boundary of a confidence interval around the mean of the adjusted R/Vs of the comparable traffic to establish the maximum reasonable rate under the three-benchmark approach. Mr. Crowley claims that the use of a confidence interval is unnecessary because the comparable traffic group is not a sample, but rather is the group of traffic that is considered to be most comparable to the issue traffic. A confidence interval is only necessary, according to Mr. Crowley, when dealing with a sample.

BNSF does not advocate the use of a confidence interval around the mean, as proposed by the Board. As BNSF explained on opening, any use of the mean of a group of traffic would be inconsistent with demand-based pricing, where some rates are set above the average and others are set below the average, depending on demand characteristics. Nevertheless, BNSF responds to Mr. Crowley's misleading discussion of the Board's proposal. As explained by Mr. Klick, Mr. Crowley ignores the obvious fact that the data population used to select the comparable traffic is itself a sample. Therefore, if use of the mean were justified, it would be appropriate to apply a confidence interval around the mean to account for the fact that the source data consist only of samples from a larger universe of movements.

C. Proposed Changes to the Calculation of RSAM

The shippers generally support the Board's proposed modifications to the calculation of the RSAM, but they present no arguments or evidence in support of the Board's proposal. BNSF explained on opening why it believes that the Board's proposed changes to the RSAM calculation are inappropriate, and BNSF does not repeat those arguments here.

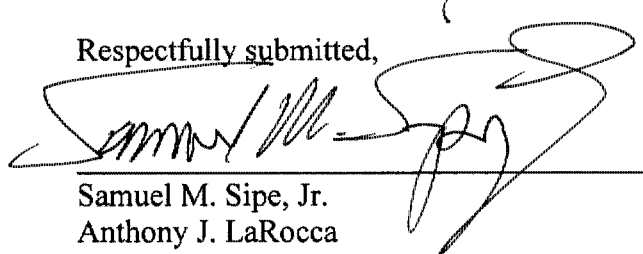
D. Procedural Schedule

Several shippers urge the Board to shorten the litigation period under the three-benchmark approach from 9 months to 6 months. But no commenting shipper presents any constructive suggestions on how the necessary evidence could be prepared, submitted and evaluated within such a constrained time period. Indeed, many of the shippers' suggestions, such as the Joint Shippers' proposal to allow the parties to submit information relevant to Long-Cannon factors, would further complicate the process and suggest the need for even longer litigation periods. There is no reason to modify the schedule as proposed by the Board.

E. Five-Year Rate Prescription

The shippers do not specifically address the Board's proposal for prescribing rates, where appropriate, for five years. As noted above, the Joint Shippers' consultant Mr. Fauth suggests generally that if the Board finds a challenged rate to be unreasonable, it should set a single rate for a multi-year period, either 5, 10, or 20 years. This proposal should be rejected since it ignores the Board's valid concern that any rate prescription should account for changes in market conditions over multi-year business cycles.

Respectfully submitted,



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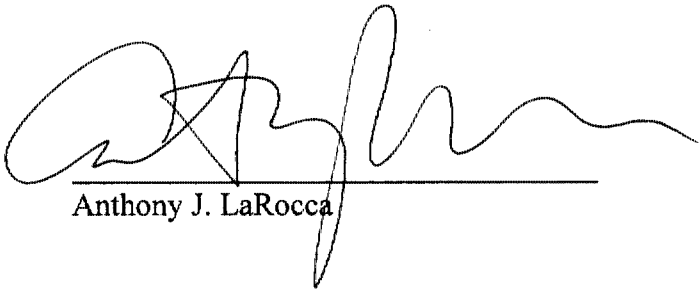
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November 30, 2006

ATTORNEYS FOR
BNSF RAILWAY COMPANY

CERTIFICATE OF SERVICE

I, Anthony J. LaRocca, hereby certify that on November 30, 2006, I caused a copy of BNSF Railway Company's Reply 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

SURFACE TRANSPORTATION BOARD

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

Simplified Standards for Rail Rate Cases

Reply Verified Statement

of

John C. Klick

Reply Verified Statement

Of

John C. Klick

My name is John C. Klick. I am a Senior Managing Director of FTI Consulting, Inc., and leader of FTI's economic consulting practice. My offices are located at 1201 Eye 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 (the "Interstate Commerce Commission" or "ICC"), arbitration panels and the Courts. A statement of my qualifications was attached as Exhibit No. ____ (JCK-1) to my opening verified statement in this proceeding.

I have been asked by BNSF Railway Company ("BNSF") to respond to the Opening Comments of the American Chemistry Counsel, *et al.*, including the attached verified statements of Thomas D. Crowley ("Crowley Opening VS") and Gerald W. Fauth III ("Fauth Opening VS"), which was filed on October 24, 2006.¹ I have been asked to focus on the following five issues:

- Eligibility, and the costs alleged in the *Joint Comments* to be associated with implementing the SSAC and three-benchmark standards proposed by the Board;
- Issues raised in the *Joint Comments* related to the Board's proposed aggregation rules;
- Criticisms raised in the *Joint Comments* with respect to the way the Board proposes to implement SSAC;

¹ Hereinafter referred to as "*Joint Comments*."

- Claims made in the *Joint Comments* with respect to certain issues related to implementation of the three-benchmark standard, including criticism of the Board's proposal to rely upon a confidence interval in calculating the mean R/VC ratio of the comparison group, and the shippers' alleged need for unmasked waybill sample data in order to select an appropriate comparison group; and
- Discussion of the extent to which MMM – adopted by the Board as the rate prescription methodology in the Ex Parte No. 657 (Sub-No. 1) ("X-657") proceeding – can reliably be used for this purpose in the context of medium-size rate disputes.

Before addressing these individual issues, it is appropriate to focus critically on a presumption that seems to underlie and cut across much of the shippers' opening testimony, *i.e.*, an expectation – divorced from any economic principle or rationale – that all small shippers paying relatively high rates are entitled to some form of rate relief, even though no rail carrier has yet achieved the long-term revenue adequacy that was a key goal of the Staggers Rail Act of 1980. For example, despite Mr. Fauth's observation that "density, density, density" is highly correlated with success in demonstrating that rates exceed SAC, the *Joint Comments* nonetheless complain that shippers on light-density lines are unlikely to achieve meaningful rate reductions under SAC or SSAC, as though the fixed-cost nature of the railroad business should be ignored altogether in small and medium-size rate disputes. An identical presumption underlies the shippers' complaints about the cross-subsidy test – arguing in essence that a cross-subsidy should be permissible if it is required to achieve a rate reduction on issue-traffic movements over light-density lines.

Similarly, the *Joint Comments* suggest that a shipper paying a rate that generates an R/VC ratio in excess of 325% should expect that rate to be a candidate for reduction.²

² *Joint Comments* at 9-10.

This position reflects a view that the rate reasonableness inquiry should be little more than a simplistic game in which all rates in excess of some arbitrary benchmark would be presumed “unreasonable,” without any meaningful consideration of the densities of the line segments required to handle that traffic, the fixed-cost nature of railroading, or the relative elasticities of demand exhibited by an individual shipper. In fact, the *Joint Comments* criticize the Board’s proposals for implying that small shippers be subjected to an “individualized” analysis of rate reasonableness, as though this is somehow inappropriate.

Missing from the *Joint Comments* is any notion that individual shippers have a responsibility to consider rate reasonableness in the context of the economics of providing railroad service, and in the context of the alternatives to rail service that may or may not be available to them. The *Joint Comments* appear concerned that shippers have failed to prevail in certain SAC proceedings undertaken to date, even though:

- (1) issue-traffic movements in several of these cases required diffuse, costly gathering operations (*McCarty*, *Duke Power*, *CP&L*);
- (2) complainants in some cases had to resort to cross-subsidies of the issue traffic in order to try to achieve rate reductions on movements that did not even cover their incremental economic costs (*PPL*); or
- (3) issue-traffic rates have not even exceeded the jurisdictional threshold.

The Interstate Commerce Commission held long ago that high R/VC ratios do not automatically indicate that rates are unreasonable.³ More recently, the DC Circuit made a similar observation in the context of reviewing an earlier ICC effort at implementing

³ Docket No. 37487, *Volkswagen of America, Inc. v. The Baltimore and Ohio Railroad Company, et al.*, 367 I.C.C. 493 (1983) at 500-501.

simplified standards for allegedly small cases.⁴ The Board is correct, in the context of this proceeding, in continuing to seek to minimize departures from the economic principles that underlie Constrained Market Pricing (“CMP”) and the traditional SAC test. Shippers – including small shippers – must understand that it necessarily follows from these economic principles that not all rates on high R/VC traffic should be eligible for a rate reduction.

CMP contemplates that railroads will set rates in the first instance in response to relative market demand, and that these rates will then be subjected to the SAC constraint. This means that shippers with fewer intermodal, intramodal, geographic and product options can expect to pay relatively higher rates in the first instance, and shippers who utilize relatively light-density segments of a railroad can expect proportionately less relief from the SAC constraint. Rate reasonableness determinations that are systematically divorced from these economic realities – which, as will become clear in this reply testimony, is what shippers appear to argue for here – are inconsistent with the Board’s expressed goal of adhering as closely as possible to the economic principles of CMP, and would cause a serious erosion in the rail industry’s revenues, and the ability of individual rail carriers to achieve revenue adequacy.

I. ELIGIBILITY

The *Joint Comments* are critical of the Board’s proposed eligibility requirements for two primary reasons. First, they argue that the Board has underestimated the costs of litigating a traditional SAC and SSAC case. Second, they argue that the “maximum value of the case,” or MVC, test should be replaced by an analysis of the “actual value of

⁴ See *Burlington Northern Railroad v. ICC*, 985 F.2d 589, 597 (D.C. Cir. 1993) (“*McCarty* decision”).

the case,” or AVC, as the “case value” that would be compared to the eligibility breakpoints. AVC would adjust MVC for the likelihood that shippers would achieve no rate reduction at all, and for the possibility that the reduction will not reduce the issue-traffic rate level to the jurisdictional threshold level (“JTL”) that is the starting point for the MVC calculation. I address these criticisms in this section.

A. Eligibility Breakpoints Proposed by the Board Appear to be Generally Consistent with the Costs to Conduct SSAC and SAC Studies

The Board’s eligibility breakpoints appear reasonable. Although the *Joint Comments* are correct in asserting that a certain flexibility on the Board’s part is necessary if the standards are to be meaningfully applied,⁵ it is nonetheless the case that the Board’s efforts to streamline standards for all three case sizes should substantially reduce the costs of undertaking a rate reasonableness proceeding. For example, while the *Joint Comments* suggest that the Board’s decision to use unadjusted URCS in rate reasonableness proceedings does not meaningfully reduce the cost of participating in the proceedings, the Board recently concluded that the variable-cost portion of a stand-alone cost proceeding costs approximately \$1 million when discovery and what is normally three rounds of evidence are taken into account.⁶

Similarly, the Board’s recent decision to rely upon ATC as the mechanism for attributing cross-over traffic revenues between the SARR and the residual incumbent will substantially reduce the cost of undertaking either a traditional SAC or a SSAC study, despite shippers’ claims to the contrary. In traditional SAC cases, the data required to

⁵ See, e.g., *Joint Comments* at 6.

⁶ STB Ex Parte No. 657 (Sub-No. 1) *Major Issues in Rail Rate Cases*, decided October 30, 2006, slip op at 51.

perform the ATC calculations are part of normal discovery, and defendants have routinely made density-based calculations for revenue-allocation purposes in the last several proceedings. The fact that ATC will be the *only* revenue-allocation mechanism used by the Board will substantially reduce other evidence that the parties have had to prepare. As I noted in my Opening VS in these proceedings, in SSAC cases the data required to perform ATC also are already part of the data that would be produced and/or developed for other aspects of the SSAC presentation anyway, so once again there is minimal additional effort required; and in the age of computers, increasing the number of point pairs and/or commodity groups for which the ATC calculations will be made under SSAC does not add significantly to the amount of work involved.

The *Joint Comments* also suggest that the Board's adoption of the "cross-subsidy test" in *PPL* and *Otter Tail* will substantially increase the burden of conducting SAC and SSAC calculations, particularly in small shipper proceedings. I strongly disagree. As I noted in my Reply and Rebuttal testimonies in the X-657 proceeding, the evidence BNSF filed in the *Laramie River* proceeding demonstrates that the stage 1 and stage 2 determinations contemplated by the Board in *PPL* and *Otter Tail*, respectively, can be made in the context of a single set of SAC calculations, thereby creating no additional burden on the parties. Furthermore, the Board's adoption of the cross-subsidy tests – which is eminently sound, from an economic point of view – will discourage rate complaints that should not be filed in the first place.

Mr. Crowley cites what he calls the evidentiary "arms race" as support for the proposition that SAC cases have become increasingly expensive to litigate, and he

suggests that this is largely the responsibility of the railroads.⁷ The obvious fact is that one cannot have an arms race without at least two participants, and much of the complexity (and resulting cost) can be laid at the feet of the shippers. Areas in which the shippers have unnecessarily increased the cost of traditional SAC cases include:

- (1) continued reliance on a “string program” for developing SAC operating expenses long after it had been repeatedly discredited by the Board (which led directly to many of the motions to strike that the Crowley Opening VS alludes to);
- (2) repeated insistence by shippers that it was appropriate to adjust line-specific road property and maintenance of way data for *high-density* lines by *system-average* variability percentages, in order to allegedly calculate line-specific variable costs – an approach that clearly understates the resulting variable costs for the high-density lines;⁸ and
- (3) efforts by shippers to overstate the rate reductions that would apply to issue traffic by constructing their SARR configurations in a manner that permitted them to cross-subsidize the light-density lines used by the issue traffic with revenues from traffic moving over high-density lines that did not traverse the light-density portions of the network.

Obviously, the Board also is concerned about the evidentiary “arms race.” While BNSF does not agree with all of the decisions made by the Board in the X-657 proceeding, it is clear that whatever procedures are ultimately adopted for use in SAC proceedings will have the effect of narrowing the areas in dispute and, thereby, reduce the cost of conducting SAC proceedings.

With respect to the procedures proposed for SSAC proceedings, it is clear that the Board’s proposals will result in substantial additional reductions in the cost of conducting a rate reasonableness proceeding, particularly in the areas of traffic selection,

⁷ Mr. Crowley’s suggestion ironically is belied by his own recognition that railroads have to a great extent simply been “contesting every evidentiary submission made by shippers,” which is what one would expect in an adversarial proceeding in which the shipper has the burden of proof, and tens of millions of dollars are at stake.

⁸ STB Ex Parte No. 657 (Sub-No. 1) *Major Issues in Rail Rate Cases*, decided February 27, 2006, slip op at 24-25.

development of road property investment, and calculation of operating and equipment expenses. While I agree with the *Joint Comments* that it may take two or three SSAC cases for the parties to reach equilibrium on these costs, I also note that most of the higher initial costs will fall on the Board – which will be developing the road property investment unit costs and the adjusted URCS unit costs for operating and equipment expenses – and on the railroads, which will have the burden of identifying the traffic moving over the SSAC route configuration and of developing the on-SARR and off-SARR operating statistics to which the unit costs developed by the Board will apply. While I concur that shippers’ consultants also will initially incur costs to review the efforts made by the Board and the railroads, with experience the need for doing such checks will decline substantially, and the efficiency with which the checks can be accomplished will increase significantly. While it is difficult to predict what costs will be once this “steady state” environment is achieved, the \$200,000 break point proposed by the Board is a reasonable approximation.

There is a second factor to consider in assessing the appropriateness of the \$200,000 break point that the Board has proposed between SSAC and the three-benchmark standard, and that is the fact that the SSAC approach is clearly more consistent with CMP principles than is the three-benchmark standard.⁹ While the *Joint Comments* argue that the Board’s SSAC assumptions are biased against shippers, they present no evidence that this is so. Clearly, the Board cannot and should not abandon a test for medium-size rate disputes that adheres more closely to CMP principles than does

⁹ I recognize that the *Joint Comments* take issue with this statement. Suffice it to say here that the *concept* of SSAC is clearly more consistent with CMP (and the SAC test) than is the concept of the three-benchmark approach. I address the criticisms raised by the *Joint Comments* of the Board’s implementation of SSAC below.

the three-benchmark proposal merely because shippers perceive that they will have a better chance of achieving rate reductions under the latter standard. Because the three-benchmark approach, as currently conceived by the Board, is incapable of accurately accounting for economies of density that are implicit in SAC and SSAC, it is important that its use be restricted to truly small cases.

Although the *Joint Comments* do not explicitly recommend alternative breakpoints, it is obvious that raising the breakpoints will increase the amount of traffic that would potentially be analyzed using a less-precise standard (SSAC) or a non-CMP-based standard (the three-benchmark approach). To illustrate the potential effect, I have analyzed BNSF's potential exposure under three scenarios.

As a baseline, I started with all BNSF traffic in the Board's Costed Waybill Sample for 2005 generating R/VC ratios in excess of 180 percent, including contract but excluding exempt traffic, and calculated MVC's using the Board's proposed eligibility standards. This approach suggests that 36% of BNSF's revenues for this traffic would be subject to analysis using traditional SAC procedures, 47% using SSAC, and 17% using the three-benchmark test.

Second, I conducted an identical analysis using the eligibility break points proposed by the USDA, *i.e.*, \$1.6 million between three-benchmark and SSAC and \$15.0 million between SSAC and SAC. Under these proposed break points, only 17% of BNSF's potential exposure would be subject to analysis using SAC, 34% under SSAC, and 49% (nearly *one-half* of the total) by the three-benchmark standard.

Finally, I selected break points between these two, *i.e.*, \$900,000 and \$9.25 million. This resulted in 25% of BNSF's potential exposure subject to analysis using SAC, 35% using SSAC, and 40% using the three-benchmark standard.

As the Board has explicitly recognized, the three-benchmark standard is not conceptually consistent with CMP. Nevertheless, the Board recommends that it be adopted for small rate disputes largely under the assumption that its application will be relatively limited. As my analysis demonstrates, however, even under the Board's proposed eligibility break points, 17% of BNSF's exposure would be analyzed using this standard. Under the USDA proposal, nearly one-half of BNSF's potential exposure would be subjected to this standard; and if the suggestion in the *Joint Comments* – that the SSAC approach be abandoned altogether – were adopted, more than 80% of BNSF's exposure would be analyzed under the non-CMP-based three-benchmark standard.¹⁰

When the proportion of total exposure that would be evaluated using the three-benchmark test increases to such an extent, the Board's rationale for this significant departure from CMP principles becomes attenuated, and the likelihood of adverse effects from downward "rate spirals" increases significantly. Such a result would be bound to have a devastating effect on the level of investment that is required to alleviate capacity constraints currently being experienced by the nation's railroads.¹¹ This is because the three-benchmark test inherently functions as a price-control mechanism by driving down

¹⁰ Even under the \$900,000/\$9.25 million eligibility break point analysis, 40% of BNSF's exposure would be evaluated using the three-benchmark test; and if SSAC were abandoned, this would increase to 75%, three-quarters of the total revenues potentially subject to analysis.

¹¹ STB Ex Parte No. 646 (Sub-No. 1) *Simplified Standards for Rail Rate Cases* ("X-646 NPRM"), decided July 28, 2006, slip op at 11.

prices that are set above the average for “comparable” movements in response to short-term shortages in capacity.

It is well-established that in properly-functioning markets, capacity constraints will engender rising prices, which in turn induce additional investment required to alleviate these constraints. A corollary of this is that price controls – which interfere with the proper functioning of markets – create significant disincentives to invest in capacity expansion, even when capacity shortages exist for long periods of time.¹² As a result, any increase in the amount of traffic to which the three-benchmark approach would apply would be particularly untimely now, when the need for investment in railroad capacity expansion is so critical.

B. Shipper Concerns about Alleged Differences between MVC and ATC Already are Appropriately Addressed in the Board’s Proposals

As noted in the introduction to Section I, the *Joint Comments* suggest that the “maximum value of the case,” or MVC, should be replaced by the “actual value of the case,” or what shippers call “AVC,” as the “case value” that would be compared to the eligibility breakpoints. As proposed by the shippers, AVC would adjust MVC for (1) the likelihood that the reduction ultimately achieved by the shipper will not reduce the issue traffic rate level to the JTL that is the starting point for the Board’s calculation of MVC, and (2) the possibility that in any given rate case the shippers would achieve no rate reduction at all.

The first of these concerns is already addressed by the Board’s proposals, which explicitly provide that shippers have the opportunity to show that the reduced rate

¹² See, e.g., “Insufficient Incentives for Investment in Electricity Generation,” The Cambridge-MIT Institute (March 19, 2004) and “Regulatory Impact Statement: Gas Access Regime – Greenfields Incentives,” Ministerial Council on Energy (Australia).

anticipated as a result of a rate proceeding will generate an R/VC ratio higher than 180%, thereby reducing the anticipated value of the case and increasing the chances of showing that it should therefore be litigated under either SSAC or the three-benchmark approach. The *Joint Comments* are dismissive of this flexibility, however, allegedly because it creates an additional burden on small shippers; but it seems clear that the real goal of this criticism is an effort to disconnect any notion of the potential value of a case from the decision that must be made concerning which standard to apply.¹³

The Board's proposals already address the possibility that shippers could seek to manipulate the MVC/benchmark comparison by under-forecasting volumes – in calculating MVC – in order to apply one of the less-precise standards, and then seeking to use the resulting lower rate on a much higher volume of issue traffic. To address this possibility in a reasonable fashion, the Board proposes to cap the volumes to which a reduced rate would apply at those levels initially assumed in the MVC calculation. A similar approach should logically apply if, in calculating the potential value of the case, a shipper were to take the position that the rate reduction likely to result from the proceeding would be significantly higher than an R/VC ratio of 180%. In such a case, in order to prevent a similar sort of manipulation by shippers, the rate reduction ultimately achieved clearly should be no lower than the rate level that would have been initially assumed for the purpose of calculating the case value.

In fact, the *Joint Comments* go in a different direction entirely, arguing that a bright-line test should be established based strictly on waybill revenues. For example, in their 2004 comments – sponsored here without any effort to update them – the Joint

¹³ Instead, the shippers argue that a decision about which standard should apply should be based strictly on total annual revenues. See *Joint Comments* at 5-6 and Appendix C

Shippers proposed that if annual revenues exceed \$7.2 million, the Board should rely upon SAC; if less than \$7.2 million, they would have the Board rely upon the three-benchmark standard (they would do away with SSAC altogether).¹⁴

By seeking to divorce the eligibility decision from the expected value of the case, the *Joint Comments* seek to sever any connection between what is actually at stake in a given rate dispute and the rate reasonableness approach that would be applied. This is bad public policy, and the Board's eligibility proposals rightfully force the parties to focus on this connection. Furthermore, by requiring shippers to be internally *consistent* between the assumptions employed in the MVC/benchmark comparison and the assumptions made in prescribing rate relief, a less precise rate reasonableness methodology will be authorized *only* when justified by a lower case value. An important by-product of this will be that shippers will be encouraged to think more realistically about what can be achieved under a regulatory solution, which should have the effect of promoting realistic negotiations between the parties.

Similar issues of appropriate public-policy incentives are at play in the arguments made, in the *Joint Comments*, concerning the need to adjust the eligibility standards for the likelihood that a shipper will not prevail in a given rate proceeding, what the *Joint Comments* describe as an adjustment for "litigation risk." First, the *Joint Comments* suggest that such an adjustment should have the effect of multiplying the cost-based eligibility break points *by a factor of three*.¹⁵ Any adjustment that has the effect of fully

¹⁴ See Appendix C to the *Joint Comments*.

¹⁵ The *Joint Comments* do not explicitly describe how these various proposed modifications would work together, but one can infer that the shippers seek (1) to increase the cost assumptions from \$3.5 million for SAC cases to \$4 million to \$7 million, and for SSAC cases from \$200,000 to \$400,000 to \$500,000; (2) to apply a multiplier of 3 to these higher cost levels – which would result in eligibility breakpoints of \$12 million to \$21 million for SAC cases, and \$1.2 million to \$1.5 million for SSAC cases; and (3) to reduce

compensating shippers for failing to prevail in individual rate cases creates perverse incentives, encouraging shippers to file rate reasonableness cases when they do not have a realistic expectation of achieving a rate reduction. This, in turn, discourages good faith negotiations in favor of regulatory litigation, and encourages parties to waste society's resources. Second, the shippers' proposal would have the practical effect of applying less accurate rate reasonableness procedures, even in large cases.¹⁶ There is simply no justification for off-setting bad litigation decisions made by either party. Shippers should file rate cases only when there is a realistic likelihood that they can demonstrate that the rates offered by the railroads in the context of rate negotiations are above a reasonable level.

Finally, I want to address the suggestion made by Mr. Crowley that railroads can manipulate the MVC calculation by artificially inflating the rate so as to increase the difference between the revenues and the MVC of the litigation. Of course the same could be said regarding the difference between revenues and AVC, or even if pure revenues were used as the eligibility requirement. In short, this possible concern – as remote as it may be – provides no basis for preferring one of the various ways of determining eligibility over another. The bottom line is that the Board's focus on what is at stake in a case (whether it involves MVC or, if a shipper provides appropriate evidence, AVC) is

the MVC calculation in any given case by some un-specified assumption about the extent to which the level of the proposed rate that ultimately is prescribed would exceed 180% of variable cost. Then, the *Joint Comments* argue that SSAC be abandoned altogether, which would have the effect of applying the three-benchmark approach to all movements with an annual AVC below \$12 million to \$21 million. As shown previously, such an approach would subject the vast majority of BNSF's traffic potentially subject to regulation to standards other than SAC.

¹⁶ Based on the figures shown in Mr. Crowley's Table 3, the MVC for the traffic at issue in the *Otter Tail*, *PPL* and *TMPA* cases each would have been below the \$21 million cut-off that appears to be the high end of the shippers' proposed eligibility breakpoint for SAC cases, suggesting there was not enough at stake, in those proceedings, to justify using the most precise SAC methodology.

both sensible as a public policy matter and consistent with the statutory basis for the development of simplified rate standards.

II. THE BOARD'S AGGREGATION RULES ARE APPROPRIATE

The *Joint Comments* stridently attack the Board's aggregation rules, suggesting that they are inappropriate and somehow act to the significant disadvantage of small shippers by potentially requiring shippers with minimal resources to engage in litigation that is more expensive because it ultimately would be conducted under a higher-cost test. The fact is that aggregation is a valid mechanism for policing potential abuses, and is unlikely to adversely affect truly small shippers.

Because CMP and the traditional SAC test are clearly the most economically defensible and accurate standards for regulating railroad rates, the Board is right to be concerned about efforts to manipulate the eligibility criteria in ways that would cause a disproportionate number of rate reasonableness proceedings to be conducted using second-best or third-best standards. This opportunity for abuse is of particular concern, given the potential for downward rate spirals that the DC Circuit was concerned would arise from use of a rate-comparison standard.¹⁷

Second, the shippers likely to be subject to the aggregation rule are most likely *not* the truly small shippers. Instead, they are the major chemical, grain and fertilizer companies – as evidenced by the identity of many of the companies that sponsored the testimonies of Messrs. Crowley and Fauth. Many of these companies are considerably larger than BNSF.¹⁸ These companies are major railroad shippers who already possess

¹⁷ *McCarty* decision at 597.

¹⁸ See Attachment No. 1.

significant bargaining leverage in rate negotiations because of the volume of business that they do with the railroads, and because of their ability to take advantage of geographic, product and intermodal competition.

Furthermore, because these companies are large and ship between major plant facilities and a wide variety of locations, they are well positioned to use the three-benchmark approach to create the downward spiral in rates. The opportunity for downward rate spirals arises from the use of the “average” adjusted R/VC ratio of the comparison group as the *maximum* rate standard. In its X-646 NPRM, the Board does not dispute that the potential for these effects is inherent in the three-benchmark approach. Instead, as I noted above, the Board argues that there is little danger that these effects would be widespread, because the universe of traffic to which the three-benchmark standards would apply is small.

For these reasons, it is clear that if the Board’s aggregation rules were withdrawn, the potential for abuse would increase exponentially, as major shippers would first seek to identify their highest R/VC movements, file rate complaints under the three-benchmark approach, reduce these highest R/VC rates to the average adjusted R/VC ratio of the comparison group, and then identify the remaining highest R/VC movements and repeat the process. The Board’s aggregation rules help to minimize these opportunities by forcing rate reasonableness determinations to be made under the more rigorous SSAC and traditional SAC approaches when a sufficient amount of traffic is truly at stake.

All of this makes clear that the companies supporting the *Joint Comments* are not concerned about the fate of truly small shippers, but about creating opportunities to abuse the three-benchmark standard that will be created if the Board could be convinced to

abandon its aggregation rules. For these reasons, the Board should continue to apply its aggregation rules in an effort to avoid abuse of the simplified standards by large shippers masquerading as small ones. It is critical that CMP principles, as reflected in the traditional SAC approach (and, to a less accurate extent, in the SSAC approach), be applied whenever the amount that is at stake justifies their application. The aggregation rules promulgated in these proceedings are an important tool in fulfilling that goal.

III. THE BOARD'S PROPOSED SSAC APPROACH IS A RELIABLE STANDARD FOR MEDIUM-SIZE RATE DISPUTES

The principal criticism leveled by the *Joint Comments* against the SSAC standard is that it is inconsistent with CMP principles because it allegedly does not rely upon a “most efficient” competitor. This criticism stems from the Board’s proposal that SSAC calculations utilize the issue traffic’s existing route and the facilities on that route, to serve all of the traffic currently handled by the defendant railroad over that route, and URCS-based costs described in Appendix B to the X-646 NPRM as the mechanism for estimating stand-alone operating and equipment expenses. From these facts, the *Joint Comments* conclude – without providing any evidence – that SSAC as proposed artificially inflates stand-alone costs and is, therefore, an inappropriate mechanism for evaluating rate reasonableness; as a consequence they argue that it should be abandoned in its entirety.

At the outset, it is important to make two points. First, as I suggested earlier, the issues raised by the *Joint Comments* relate to the implementation of the SSAC test, not to its conceptual consistency with CMP. As a simplification of the SAC test, the SSAC approach necessarily is less accurate than a traditional SAC test. As I discuss below,

however, there is no reason to believe such a simplification is systematically biased against shippers. Second, the shippers' recommendation to abandon SSAC altogether and to expand the quantity of traffic to which the three-benchmark standard would apply would be sensible only if the three-benchmark standard were somehow more closely aligned with CMP principles than SSAC or SAC, and the Board has already concluded otherwise. The Board should not abandon an approach for medium-size rate disputes that is conceptually aligned with the economic principles of CMP in favor of the three-benchmark standard, which cannot be shown to be consistent with the economic principles that underlie CMP.

Because it is a simplified procedure, SSAC requires the shipper to include *all* of the traffic that traverses the issue-traffic route. This is not an irrational approach; in fact, it is consistent with recent SAC complainants' preference for selecting traffic groups that are increasingly dependent on a variety of commodities, not just the issue traffic's.¹⁹ "Coal-only" traffic groups have presented sufficient densities for analysis in certain SAC cases where significant traffic sources are geographically concentrated and can be handled in high-volume, unit-train service, *e.g.*, the PRB and the heavy coal routes that extend from it. Such concentration is in contrast with other coal movements, as well as the typical smaller-volume, non-coal movements subject to SSAC analysis, where complainants will seek to include additional density. Given the importance of density in

¹⁹ In recent SAC studies assessing the reasonableness of unit-train coal rates, shippers often have recognized the necessity of handling a wide array of traffic in order to increase the densities on the SARR. See, *e.g.*, *AEPCO*, *Otter Tail*, *AEP Texas*. The Board's assumption – in the context of SSAC – that the SARR will handle all of the defendant's traffic is consistent with complainants' clear intent to layer on as much additional density to the SARR's lines observed in SAC studies. But the benefit of increased density that comes from including a wide variety of traffic is accompanied by more complex operating conditions that engender the sorts of G&A expenditures and facilities investment that are often deemed unnecessary in the context of traditional SAC cases focused on handling large volumes of a single commodity moving in unit-train service, such as coal.

a SAC, and SSAC, proceeding, it is reasonable to assume that the SARR will handle all of the incumbent's traffic, thereby increasing the density of the SARR's lines to the maximum extent possible. There is no basis for concluding that such an assumption would be inherently biased against a complainant.

If the SSAC system is going to handle all of the railroad's traffic, it is likely to require all of the defendant's real-world facilities. This fact has been borne out by traditional SAC studies in which the SAC proponents have included all of the defendant's traffic over portions of the SARR network. In developing its SAC evidence in the *AEPCO* case, for example, complainant's "operating and engineering experts developed track configurations and traffic-control systems for the [SARR] that virtually replicate the existing BNSF and UP facilities."²⁰ Given the economies of density that characterize the railroad industry, generally, there should be no bias created by requiring the SSAC analysis to take all the traffic and build all of the defendant's existing facilities. In any event, the Board's procedures permit shippers to modify this baseline assumption when they can show that existing facilities are not being utilized in the real world.

Similarly, there is no reason to expect that the URCS-based Appendix B methodology proposed by the Board systematically overstates operating expenses given the simplifying assumption that the SSAC analysis is based on transporting *all* of the defendant's real-world traffic. Obviously, the resulting operating expenses will be different than the operating expenses developed in a traditional SAC study for coal-only, or predominantly coal, SARRs, but that is because the traffic mix is significantly different. There is no reason to believe a SARR handling the defendant's real-world

²⁰ Complainant's Supplemental Rebuttal evidence (April 2, 2004), at III-B-9 to 10.

traffic on the same facilities as the real-world defendant would be able to operate with significantly lower costs.

In summary, there is no reason to expect *a priori* that the Board's SSAC assumptions will overstate stand-alone costs. As a result, SSAC is a reasonable simplification of the traditional SAC test that remains consistent with CMP principles and is appropriate for use in medium-size rate disputes.

IV. CERTAIN CRITICISMS SET FORTH IN THE *JOINT COMMENTS* REGARDING THE BOARD'S IMPLEMENTATION OF THE THREE-BENCHMARK APPROACH ARE NOT WARRANTED

This portion of my verified statement focuses on two criticisms that are made in the *Joint Comments* regarding the three-benchmark standard, on which BNSF concluded that expert opinion is warranted. The first relates to Mr. Crowley's claim that no confidence interval around the mean of the adjusted R/VC ratios for the comparison traffic is warranted; the second relates to the shippers' arguments that they need access to the confidential waybill file with unmasked revenues *before* they submit their comparison group selections.²¹

A. The Board is Correct in Employing a Confidence Interval

Mr. Crowley claims that use of a confidence interval is "unnecessary" and "statistically . . . would have no true meaning." He draws this conclusion based on the following logic:

²¹ In his Opening VS, Mr. Fauth suggests that it is the Board's intention to provide only data from the public use waybill file for the purposes of selecting the comparable traffic. BNSF does not read the Board's proposals this way. Instead, BNSF believes it is the Board's intention to provide data for movements of the same two-digit commodity code from the confidential costed waybill file, which would provide much of the information that Mr. Fauth seeks. As I discuss below, BNSF believes this information is more than adequate for the purposes of developing a meaningful comparison group.

The construction of the confidence interval implies that the sample was drawn randomly from the respective population. The STB's proposed Three Benchmark approach is far from being a random process, and is in fact the antithesis of randomness due to the direct selection of the comparison group movements by the parties to the case and the final offer selection by the STB. The creation of a confidence interval serves no purpose other than to artificially raise the reasonableness standard of a rate.

Crowley Opening VS at 48, footnotes deleted.

Mr. Crowley's reasoning is flawed, however, because it fails to take into account that the "population" from which the parties are identifying the potentially comparable movements is itself a random sample of movements drawn from the true population of total movements over the railroad system. Thus, a confidence interval is appropriate because the underlying waybill sample yields a random sample of supposedly comparable movements.

B. Shippers Do Not Need Access to Unmasked Revenues before the Comparison Group is Selected

The *Joint Comments* argue that shippers need access to unmasked revenues in advance of their making their first comparison group selection. First, the shippers do not need unmasked revenue because that revenue corresponds only to contract traffic that cannot legitimately be part of *any* comparison group. Rates on contract movements and, as a result, contract movement R/VC ratios, are affected by a host of contract terms and conditions that do not apply to common-carrier rates – including service commitments and penalties, volume discounts, multi-year commitments and loading requirements. As a result, contract movements reflect a relationship between the shipper and the railroad that is simply not comparable to common carriage. The Board should address the

shippers' concerns about unmasked revenues by simply eliminating from the data set provided to both parties any movements for which revenues are masked.

Second, shippers argue that receiving unmasked revenues initially is necessary in order to select a group of traffic movements that are comparable; but this can only be so if they concede that revenues are in fact relevant. Such a concession by shippers that rate levels and thus R/VC ratios are indicative of relative demand elasticities would reduce the three-benchmark test to a tautology in which the only appropriate movements for use in a comparison group would be movements with R/VC ratios comparable to those exhibited by the issue traffic.²² The more logical approach – as I noted in my Opening VS – is for the Board to seek qualitative evidence of comparable demand elasticities – such as information on product and geographic competition – as is contemplated in the *Simplified Guidelines* decision.

Another argument advanced by the *Joint Comments* in support of shippers' desired access to unmasked revenues is a claim that unless the shippers

²² In its *McCarty* decision, the DC Circuit raised the spectre of this tautology, noting 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.

have access to these data, the railroads will be free to “game” the masking process (by, for example, establishing masking factors that serve to reduce masked revenues on the high R/VC traffic and to increase masked revenues on the low R/VC traffic in order to induce the shippers into selecting comparison group movements that will have relatively high R/VC ratios once the unmasked revenues are disclosed). Setting aside the absurdity of shippers’ claim, if the Board did have any concerns that a particular railroad might be manipulating its masking factors in this way, it is fully capable of statistically evaluating that possibility and asking the railroad to adopt a different masking procedure – there is no need to widely release commercially sensitive contract rate data on the remote possibility the railroads are somehow seeking to manipulate masking factors to create an advantage when the three-benchmark test is applied.

V. USING MMM AS THE RATE PRESCRIPTION METHODOLOGY IS EVEN LESS DEFENSIBLE IN THE CONTEXT OF SSAC

BNSF’s evidence in the Ex Parte No. 657 (Sub-No. 1) proceeding demonstrated that the Board’s proposed MCM and MMM methodologies would be a radical departure from the principles of demand-based pricing – which have been the standard for rail rate regulation since the Staggers Act – that could not possibly be justified by any purported defects in the percentage reduction method (“PRM”) that the ICC and the Board have relied upon in every traditional SAC study since *Coal Trading*.²³ As BNSF noted in its

²³ The ICC found in *Coal Rate Guidelines* that: “[a]ny means of allocating [unattributable] costs among shippers other than actual market demand is arbitrary and may not permit a carrier to cover all of its costs.” *Coal Rate Guidelines – Nationwide*, 1 I.C.C. 2d 520, 526 (1985); and it explicitly rejected approaches, like MMM, that would establish uniform rates for shippers with different demand characteristics, even where the only shippers affected by the uniform rates were so-called captive shippers: “Setting all captive rates in the same proportion to marginal costs would be contrary to the principle of differential pricing, and could prevent a railroad from covering its total costs.” *Id.* at 533. Similarly, the U.S. Court of Appeals for the

supplemental filing in the X-657 proceeding, the lack of economic rationality in the Board's MMM approach is even more obvious when one contemplates its use in the SSAC process proposed in these proceedings for medium-size rate disputes. MMM starts from the premise that all traffic should pay a uniform allocation of SAC costs, and operates by reducing all but the lowest R/VC traffic in the stand-alone traffic group to a single, identical R/VC level, which cannot possibly reflect the wide range of demand for rail transportation that exists among *all* of the traffic that historically used any given portion of the defendant's issue-traffic route. Application of MMM would nonetheless reduce rates for all such traffic to a single R/VC ratio.

In its supplemental filing, BNSF included public data concerning variations in R/VC ratios (and hence demand as observed by railroads) which indicated that the variation is significant for different types of traffic, yet the effect of applying MMM would be to ignore these differences in demand by setting maximum reasonable rates across all of these traffic types at a single, identical R/VC ratio. Significantly, consistent with BNSF's views, the Board's 1996 *Simplified Guidelines* decision rejected approaches like MMM that would cap all rates at a uniform average because such approaches would be fundamentally inconsistent with economic principles underlying CMP, including the need for demand-based differential pricing.

The Board acknowledged that even the need for simplification did not justify a repudiation of differential pricing, noting that "[b]y its very nature, an average number, which is produced by combining numbers that are both above and below that level, does

D.C. Circuit struck down an attempt to set rates by reference to average R/VC levels, an approach similar to the Board's proposed MMM methodology, noting the "lack of any visible intellectual coherence in the R/VC method." *McCarty* decision at 599.

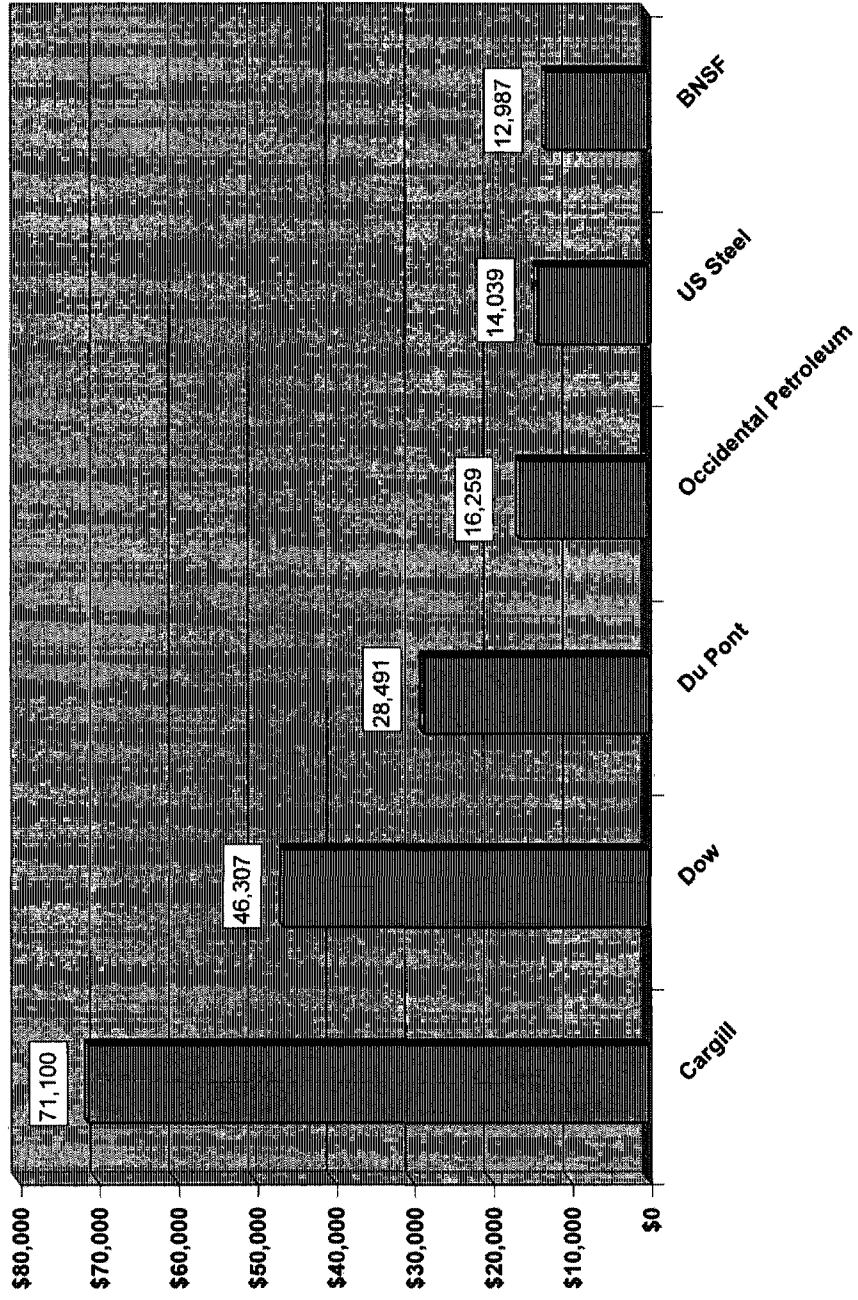
not provide an appropriate regulatory ceiling.” *Non-Coal Guidelines*, 1 S.T.B. at 1022.²⁴

The Board stated repeatedly that it did not intend “to return to an era of rate equalization among different traffic,” *id.*, and that it had no intention “to cap rates at an average level.” *Id.* at 1023. It specifically rejected any approach “premised on the general notion that a railroad can and should charge a single, uniform markup to all of its captive shippers. Such an approach is fundamentally inconsistent with demand-based differential pricing principles.” *Id.* at 1030.

The application of MMM in large and medium-size rate disputes would completely ignore differences in the demand characteristics of BNSF’s traffic. All traffic with an R/VC over a certain level would be forced downward to the same R/VC level, regardless of differences in demand. As a result, if the Board were to apply MMM in medium-size cases, the result would be that differential pricing would be preserved to a greater extent in small rate disputes than under either of the approaches that would exist for large and medium-size cases, which are designed to be much more consistent with the economic principles underlying CMP. Such an outcome would be economically irrational and not supportable as a matter of public policy.

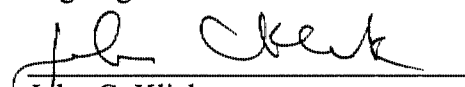
²⁴ See also *id.* at 1023 (“The analysis that we envision would not presume that, simply because a rate produces an r/vc ratio above the average level, it is thereby unreasonable. The nature of an average number – which is produced by combining numbers that are both above and below that level – does not permit such a presumption”).

Annual Revenue in Millions (FY 2005)



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

Executed on November 30, 2006



John C. Klick