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November 30, 2006

VIA E-FILING

The Honorable Vernon A. Williams
Secretary
Surface Transportation Board
1925 K Street, N.W.
Washington, DC 20423-0001

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

Dear Secretary Williams:

Pursuant to the Surface Transportation Board's decisions issued on July 28, 2006 and September 15, 2006 in the above captioned proceeding, The Kansas City Southern Railway Company ("KCSR") hereby files, via e-filing, its "Reply Comments" in the above captioned matter. If there are any questions concerning this e-filing, please contact me by telephone at (202) 663-7823 or by e-mail at wmullins@bakerandmiller.com.

Sincerely,



William A. Mullins

Enclosures

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

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

SIMPLIFIED STANDARDS FOR RAIL RATE CASES

REPLY COMMENTS OF THE KANSAS CITY SOUTHERN RAILWAY COMPANY

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Dated: November 30, 2006

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

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

SIMPLIFIED STANDARDS FOR RAIL RATE CASES

REPLY COMMENTS OF THE KANSAS CITY SOUTHERN RAILWAY COMPANY

On October 24, 2006, The Kansas City Southern Railway Company ("KCSR"), as well as many other parties, submitted opening comments in this proceeding. In its "Opening Comments," KCSR provided its views with respect to the Surface Transportation Board's ("STB") notice of proposed rulemaking as issued in Ex Parte No. 646 (Sub-No. 1), *Simplified Standards for Rail Rate Cases* (served July 28, 2006). As noted therein, KCSR does not ordinarily participate on an individual basis in STB proceedings regarding stand alone cost methodologies or the use of the Uniform Rail Costing System ("URCS"), but KCSR believes that the Board's proposals raise sufficient concerns to warrant KCSR's participation. Having reviewed the opening comments filed by others, KCSR's concerns remain valid, and in fact, other parties have raised additional issues that warrant these further "Reply Comments."

The Board has proposed two basic methods applicable to rate complaint cases involving small shipments: (1) Simplified-SAC; and (2) the "Three Benchmark" method. Both of these methods depend upon the use of URCS. In fact, the proposed rules call for the use of URCS cost information to calculate the Maximum Value of a Case in order to determine eligibility for use of either the Three Benchmark methodology (for small cases) or Simplified Stand Alone Cost

(“SSAC”)(for medium cases); to determine under both methodologies whether rates for challenged services exceed the jurisdictional threshold of 180% of the variable costs of providing that service; to develop operating and equipment expenses for the Stand Alone Railroad (“SARR”); and to prescribe future rates. In using URCS, parties are prevented from making “movement-specific” adjustments to URCS.

KCSR has already expressed its three concerns regarding the various uses of URCS in rate reasonableness proceedings for small shipments. First, the proposed rules unfairly presume that all carriers are sufficiently well-versed in URCS and have systems configured to provide necessary data inputs to be able to respond quickly to rate cases that turn upon URCS analysis. Second, the URCS methodology disadvantages rail systems that have shorter lengths of haul and a higher proportion of expenses derived from switching, pickup, and delivery of freight. Finally, KCSR is concerned that the Board’s proposal imposes a disproportionate impact on KCSR and other similarly-situated carriers because URCS does not accurately reflect cost allocations for such carriers.

Having reviewed the opening comments, it now appears that all carriers share KCSR’s concerns regarding the disproportionate share of the discovery burden and the timing involved in producing URCS-based information and responding to the Board’s disclosure requirements. KCSR reiterates its concerns and requests that the Board make changes in its proposed rules regarding the timing and scope of discovery responses consistent with the carriers’ comments and KCSR’s Opening Comments.

The opening comments also establish that other changes in the Board’s rules are needed. The comments of Canadian Pacific (“CP”) and Canadian National (“CN”) raise issues regarding cross-border traffic that are also relevant to KCSR. A number of shippers opening comments

suggest an increase in the threshold for determining the maximum value of the case so as to bring more traffic under the proposed rules, a suggestion that KCSR believes is ill-founded due to the admitted inaccuracy of the methodologies proposed by the Board in this proceeding. Accordingly, KCSR hereby files these Reply Comments to further elaborate on why unadjusted URCS would be inappropriate to use in SSAC and Three Benchmark proceedings involving KCSR or other similarly-situated carriers; and to support CP and CN's concerns regarding cross-border traffic

I. THE USE OF UNADJUSTED URCS WILL DISADVANTAGE SMALLER RAIL SYSTEMS LIKE KCSR AND WILL PREVENT THOSE CARRIERS FROM ACHIEVING LONG TERM REVENUE ADEQUACY

Due to the inputs that go into URCS, which are derived from railroads' R-1 reports and the STB's Waybill Sample, and the way in which URCS allocates those inputs among the various costing categories, KCSR is concerned that application of unadjusted URCS in the context of a rate complaint against carriers with shorter hauls, like KCSR and others, including Class II and Class III carriers, would produce inaccurate results and would result in rate prescriptions that would not allow KCSR and other carriers to recover their fully allocated costs. This is in part because the URCS methodology does not accurately account for the costs of shorter hauls and switching, pickup, and delivery of freight. This is also due to the fact that URCS underestimates the cost of capital for KCSR and others by using an industry-wide average cost of capital based upon the four large U.S. based Class I carriers whose cost of capital are lower than those of KCSR and other similarly-situated carriers. Finally, because the allocation methodologies and regression formulas within URCS may not accurately reflect costs associated with a particular movement, application of unadjusted URCS would not produce accurate results in cases where rail rates are challenged.

To help KCSR assess its concerns with the Board's proposal, KCSR hired Mr. George Woodward to review the proposed rules and the URCS methodology. Mr. Woodward is the former Senior Vice President-Chief Commercial Officer at ALK Technologies, Inc. from 1991 to 2001. ALK is the repository of the STB Waybill Sample and has developed information systems that enable rail carriers to analyze traffic flows. Prior to joining ALK, Mr. Woodward was an Executive Vice President-Distribution Services at Southern Pacific Transportation Co. from 1987-91 and Vice President-Marketing with Conrail from 1978-87. As a result of his experience, Mr. Woodward is familiar with URCS and the Board's Waybill Sample. Mr. Woodward has also worked for KCSR in the past as an independent consultant, and is familiar with the nature of KCSR's traffic.

As explained in his attached verified statement, Exhibit A to these Reply Comments ("V.S. Woodward"), KCSR's concerns are indeed justified. URCS does not accurately reflect the costs for carriers with a significant number of shorter hauls and whose traffic mix includes a significant portion of general merchandise traffic. This inaccuracy occurs because the costs of handling such traffic are more time-sensitive than mileage-sensitive (that is, fewer miles are traversed per hour in this type of activity than in linehaul operations while labor, locomotive and other costs are largely time-based), while URCS allocates costs predominantly based on mileage.

To test this statement, Mr. Woodward, working with KCSR, costed sample traffic movements on KCSR and compared those cost estimates for those with URCS costing of the same sample movements. In so doing, he determined that URCS costing for short-haul moves can be as much as 30% *lower* than KCSR's estimated actual costs. V.S. Woodward at 23. Clearly, setting rates based on URCS when URCS significantly understates KCSR's costs on short-haul moves could unfairly impact KCSR and result in a violation of the ICC Termination

Act of 1995 by allowing rate challenges on shipments moving at less than the actual 180% revenue to variable cost ratio and even, potentially, in setting rates below that threshold. KCSR believes that other carriers that are similarly-situated to KCSR could suffer similar revenue shortfalls from the Board's proposed rules.

Because URCS primarily allocates variable costs as a function of line haul mileage, it does not accurately reflect time-related cost-intensive activities like switching, pickup, and delivery. V.S. Woodward at 22. For example, labor costs are allocated in URCS on a per mile basis, meaning that time-intensive activities, such as switching, pickup, and delivery are allocated less than their actual labor costs because there is a higher ratio of man-hours to miles for such movements than in running long-haul trains. URCS makes some attempt to recognize the time-dependent costs associated with such activities, and to some extent the higher costs will be reflected in the labor inputs, but the URCS cost inputs for these time-dependent elements including switching, locomotive time, terminal car time, equipment rentals, etc., are mostly based on out-dated allocation formulas. Thus, while the inputs themselves from the R-1's may be accurate, the way in which URCS uses those inputs and allocates costs among the various costing categories will produce inaccurate results, especially for carriers that have a large amount of time-intensive activities. This problem is further compounded by the fact that some of the URCS's inputs are not carrier-specific, such as the cost of capital, and thus do not accurately reflect the actual KCSR movement at issue in a rate complaint case.

KCSR and others, such as Class II and Class III carriers, have a lower percentage of long-haul traffic than larger Class I carriers. Because the lower-cost per unit line-haul operations are a smaller proportion of KCSR's overall operations than they are of the operations of larger Class I's, KCSR is unable to spread its time-intensive gathering and distribution costs over a high

percentage of longer haul traffic. Accordingly, the percentage of KCSR's system wide costs attributed to local and/or switching service is much higher than that of its larger Class I brethren, whose average line-haul move may be hundreds of miles longer than KCSR's.¹ URCS does not accurately account for this type of movement. V.S. Woodward at 22-23. The problem is compounded by the use of an industry-wide average for the cost of capital. As a result, short-haul movements on carriers like KCSR are not accurately reflected by application of unadjusted URCS and can understate the true costs to provide the service.

The failure of URCS to properly attribute KCSR's costs to some movements means that some rate complaints would be allowed to proceed under the Board's rules when those rates actually do not exceed the statutory threshold for bringing a rate complaint case. The statute and the proposed rules allow a complainant to bring a rate complaint case against KCSR if the complainant can establish, using URCS, that the KCSR movement at issue has an R/VC ratio above 180%. Congress established the 180% R/VC as a threshold for rate challenges in recognition that movements must be priced above variable costs to provide contribution to the carrier's fixed costs, overhead, and profit. But if the URCS allocation formulas and methodologies do not accurately reflect the true costs of short-haul movements on carriers like KCSR and others, then the Board cannot accurately assess whether the challenged rate exceeds 180% of R/VC.

The higher cost structure of carriers that have shorter average lengths of haul and a higher ratio of time-intensive switching, pickup and delivery to linehaul mileage sometimes leads to those carriers actually needing average revenue levels greater than the 180% R/VC levels to

¹ BNSF and UP have an average lengths of haul of about 1200 miles, while CSX and NS each average 600+ miles per move. KCSR's average length of haul, by contrast, is only approximately 350 miles.

attain adequate revenue. This is not as much of a problem with carriers that have longer hauls as the absolute dollar margin from longer haul traffic can help offset the lower absolute dollar margin from short haul traffic. Since the time-related costs for a shorter haul move may not be accurately reflected in URCS, the carrier with a higher proportion of shorter haul shipments, like KCSR, is at a significant regulatory disadvantage in seeking to generate enough uncontested margin to cover its fixed costs, overhead and profit. As a result of the deficiencies in URCS, applying unadjusted URCS to assess the reasonableness of rates for many movements on KCSR and similarly-situated carriers does not provide enough uncontested margin for these carriers to gain enough revenues to cover their fixed costs.

Another problem with the Board's proposed use of unadjusted URCS is its application to joint-line movements involving carriers like KCSR, with a higher cost structure, and a larger Class I. Over 80% of KCSR's loaded mileage involves joint-line traffic, mostly with the larger Class I carriers. To challenge the rate for such a movement, a complainant is required to challenge the rate for the entire through movement. Even though each carrier's portion of the through movement would be separately costed under URCS, often a majority of that movement will occur on the larger Class I with the lower cost structure. Thus, the majority of the costing of the movement will be based on the larger Class I's lower cost structure due to its long haul, while only a minor part of the cost will be based on KCSR's cost structure, and even that is likely to be understated by URCS for many moves.² The end result will be that the Board would

² While the four largest Class I carriers may themselves have issues with how URCS calculates costs, as the Board has discovered in processing stand alone cost cases involving large carriers, the differential between unadjusted URCS costs and adjusted URCS, where movement specific adjustments have been made is to URCS, is within the 1-3% range. Major Issues In Rail Rate Cases, STB Ex Parte No. 657 (Sub-No. 1), slip op. at 53, (STB served Oct. 30, 2006)(“Major Issues”). This differential will likely be higher in a movement involving carriers with a significant amount of short-haul movements and can be as high as 30%. V.S. Woodward at 23.

prescribe a through rate based on costs that are even more inapplicable to the KCSR system than the already inaccurate results that one would obtain from looking only at the KCSR portion of the move under URCS. Thus, any rate prescription under SSAC or the Three Benchmark calculation will further reduce KCSR's revenues as KCSR is "punished" by the use of URCS.

One of reasons URCS does not accurately account for KCSR's costs is that fact that URCS understates KCSR's cost of capital. V.S. Woodward at 22-23. URCS uses an industry average cost of capital. That industry average is based upon a methodology and calculation that does not include KCSR. According to the Board's most recent cost of capital calculation,³ the rail industry had a cost of debt for 2005 of 5.36%. This is based upon the cost of debt for UP, BNSF, CSX, and NS, all of which have investment grade debt. Yet, KCSR's cost of debt and equity is higher than this industry average.

KCSR relies upon financing from its parent company, KCS. Recent debt issues by KCS suggest a KCS-specific cost of debt in the 7-8% range, although historically, KCS debt has been in the 10-11% range. V.S. Woodward at 24. KCS's cost of equity has been estimated to be in the 18-20% range, which is higher than that demanded of KCSR's larger Class I competitors. Combining its debt and equity, KCS's weighted average cost of capital is estimated to be in the 14-16% range,⁴ in contrast to the industry average of 12.2%. *Id.* As a result, applying the industry average cost of capital in a rate dispute involving KCSR, as URCS does and the Board's proposal allows, will understate KCSR's costs and provide a misleading picture of KCSR's revenue needs.

³ Railroad Cost of Capital - 2005, STB Ex Parte No. 558 (Sub-No. 9), slip op. at 11 (STB served Sept. 20, 2006)("Railroad Cost of Capital - 2005").

⁴ KCS's capital structure includes approximately \$1.7 billion in debt (45%) and \$2.1 billion (55%) in market equity. This capital structure is somewhat more leveraged than the overall U.S. rail industry, which averages roughly 30% debt and 70% equity. Railroad Cost of Capital - 2005.

Finally, a large part of why URCS does not accurately cost short-haul, labor and time intensive movements is due to the way URCS allocates the various inputs and assigns different weights to those allocations. V.S. Woodward at 23. For example, URCS uses three different methods to develop costing relationships: direct, engineering, and statistical. These three different methods are employed because each has advantages and is better suited than the other two techniques to measure some types of costs. Yet, URCS no longer generates accurate costing information in some cases, the Board's URCS calculations rely in part on switching studies conducted in the 1940's. As a result, application of unadjusted URCS in a SSAC or Three Benchmark case will not accurately assign KCSR's costs so as to provide KCSR with an opportunity to recover its fully allocated costs.

II. THE BOARD SHOULD PROVIDE KCSR AND OTHER SIMILARLY SITUATED CARRIERS WITH AN OPPORTUNITY TO ENSURE THAT URCS ACCURATELY REFLECTS THEIR COSTS

Given the fundamental flaws in the URCS system with respect to calculating KCSR's costs (and the costs of similarly situated carriers), KCSR respectfully suggests that the Board should not embark upon a procedure that is clearly inaccurate and that can be used to compel carriers to transport shipments at inadequately compensatory rates. Indeed, because the URCS costing mechanism likely understates actual operating costs for many shorter-haul carriers, applying unadjusted URCS in a SSAC or Three Benchmark rate dispute involving KCSR (or other similarly situated carriers) would improperly permit some rate cases to proceed that should not be allowed to do so, and could also result in rate prescriptions that would recover less than a carrier's fully allocated costs and could, in actuality, be below the statutory threshold of 180% R/VC. The Board's proposed reliance on unadjusted URCS would thus impede KCSR's and

other similarly situated carriers' ability to become revenue adequate, contrary to the objectives of the Staggers Act and ICCTA.⁵

Reliance on a flawed URCS system in rate disputes, particularly where the guidelines contemplate no movement-specific adjustments, means that the Board's processes would cut against the statutory objective of allowing KCSR to achieve revenue adequacy. In short, the proposed guidelines, when applied to KCSR, run counter to the Board's statutory obligation to "make an adequate and continuing effort to assist those carriers in attaining [adequate] revenue levels." 49 U.S.C. §10704(a)(2). Moreover, application of the rules to KCSR would be contrary to numerous provisions of the Rail Transportation Policy, including 49 U.S.C. §§ 10101(1)-(6), (8)-(11), (13) and (15).

KCSR urges the Board to reconsider its reliance upon unadjusted URCS, in light of the potential adverse impact that could befall KCSR and others if the guidelines were to be adopted as proposed. Under a strict adherence to an unadjusted URCS methodology, KCSR not only would be exposed to otherwise avoidable and inappropriate litigation, but it could be faced with the prospect that a challenged rate incorrectly could be found to be unreasonable or that a rate prescribed at the statutory threshold would, in actuality, produce less revenues than Congress has designated by statute as reasonable. In either situation, KCSR would be thwarted in its efforts to become revenue adequate. The Board is mandated by statute not to let that happen. See Standards for Railroad Revenue Adequacy, 364 I.C.C. 803, 810 (1981) ("If railroads earn less than adequate rates of return because of inappropriate regulatory action, ... then the standards of [the statute] and the clear thrust of congressional policy will be thwarted").

⁵ See Railroad Revenue Adequacy – 2005 Determination, STB Ex Parte 552 (Sub-No. 10), slip op. at 3 (STB served Oct. 23, 2006).

A. The Board Should Consider Allowing Movement-Specific Adjustments To URCS

One way to remedy the shortcomings inherent in the application of URCS to short-haul/high cost movements is to allow KCSR and other similarly-situated carriers to make movement-specific adjustments to URCS in the context of SSAC and Three Benchmark cases. KCSR understands that its suggestion runs counter to the Board's proposal and to the recent decision in Major Issues. However, as the Board stated therein, "[t]he Board's responsibility is to exercise its own judgment on how best to carry out its charge from Congress." *Id.* slip op. at 4. While allowing movement-specific adjustments to URCS could increase the complexity of the cases, that possible additional burden is outweighed by the need for the Board to be certain that it avoids acting inappropriately by prescribing rates below the statutory threshold. These same concerns may be as true for other Class I carriers as they are for KCSR, but the errors are more pronounced for KCSR and other similarly-situated carriers, especially shortline and regional carriers, who collectively have preserved rail service from extinction on thousands of miles of lines in the past quarter century. The Board should not endanger the rail system or risk violating its statutory authority merely in the name of avoiding complexity and adopting simplicity.

As the Board noted in Major Issues, the Board has found that the differential between the unadjusted URCS costs and the movement-specific adjusted costs was only in the 1-3% range. Such a small differential, in the Board's view, did not justify the time and expense associated with making movement specific adjustments. However, given the real probability that URCS does not accurately account for costs associated with KCSR's (and others') route and operating structure, failing to provide for adjustments to URCS is likely to result in URCS misrepresenting KCSR's costs by as much as 30%. *V.S. Woodward* at 23. This is substantially more than the 1 to 3% range that the Board found from its experience with SAC cases with the larger Class I

carriers. Given that KCSR's financial situation is different than other Class I carriers, it would not be unreasonable for the Board to "exercise its own judgment" and allow KCSR and other similarly-situated carriers to make movement-specific adjustments to URCS in the context of a SSAC or Three Benchmark rate complaint case.

Such an exception for KCSR and other carriers who are similarly-situated would not substantially reduce the benefits of simplified procedures as a whole. Given that KCSR and other similarly-situated carriers, such as the Class II and Class III carriers, are very rarely, if ever, the subject of a rate complaint case, it is highly unlikely that the exception of allowing such carriers to make movement specific adjustments to URCS will be used, i.e. the exception will not swallow the rule. Second, even if such carriers become involved in future rate cases so as to permit movement-specific adjustments to URCS, the proposed SSAC methodology still would eliminate most of the litigation costs because it eliminates the time, expense, and discovery burdens associated with producing detailed operating plans and operating statistics which were required in SAC cases and were the main factors that added substantial costs to such SAC cases. Finally, the Board can reduce the cost of litigating potential disputes relating to movement-specific adjustments to URCS costs by providing guidance regarding the types of adjustments that it will permit KCSR and other similarly-situated carriers to make in SSAC cases.

B. Alternatively, The Board Should, At A Minimum, Apply KCSR's Cost Of Capital In Any SSAC Or Three Benchmark Proceeding To Correct URCS

Absent the ability to make movement-specific adjustments, at a minimum, KCSR and other similarly-situated carriers should be allowed to apply their own cost of capital in any SSAC or Three Benchmark proceeding. Given the Board's proposed increased reliance on unadjusted URCS in both large and small rate cases, it is crucial that the Board at least ensure that URCS is as accurate as possible. To this end, if KCSR and other similarly-situated carriers are prevented

from making movement-specific adjustments to URCS so as to account for the unique problems with URCS, then KCSR requests the Board at least allow KCSR and other to use their own cost of capital in any SSAC or Three Benchmark proceeding.⁶

As noted, URCS uses an industry average cost of capital; that industry average is based upon a methodology and calculation that does not include KCSR and includes only the four large Class I carriers. Because the average cost of capital applied in URCS is significantly lower than KCSR's cost of capital, URCS will understate KCSR's true costs and the cost of other similarly-situated carriers. As a result, applying the industry average cost of capital in a rate dispute involving KCSR, as URCS does and the Board's proposal allows, will understate KCSR's costs and provide a misleading picture of KCSR's revenue needs.

If necessary, the Board could hold these rules in abeyance pending development of procedures that would allow KCSR and others to apply their own cost of capital calculations in a SSAC or Three Benchmark proceeding. Doing so would also be consistent with precedent. See Suspension of Car Hire Updates, Ex Parte No. 334 (Sub-No. 7) (ICC served Jan. 3, 1986). In that case, the agency suspended updating car hire rates until resolution of the broader car hire issues encompassed by *Review of Car Hire Regulation*, Ex Parte No. 334 (Sub-No. 6) (ICC decided April 4, 1985), 1985 ICC LEXIS 475. See also, Major Issues in Rail Rate Cases (suspending the processing of multiple pending coal rate cases cited therein) and Major Rail Consolidation Proceedings, STB Ex Parte No. 582 (Sub-No. 1) (STB served June 11, 2001)

⁶ There is another possible alternative to the problem. The Board could consider modifying its rules to provide that no rate prescriptions issued under SSAC or the Three Benchmark test for movements under 150 miles should be set at revenue-to-variable-costs lower than 240 R/VC to compensate for the inaccuracy of URCS costing on shorter movements. V.S. Woodward at 26. Allowing rates to be prescribed below this R/VC level for movements under 150 miles would not allow KCSR or similarly-situated carriers to obtain enough margin above variable costs to cover fully allocated costs; thus prohibiting such carriers from becoming fully revenue adequate.

(suspending, subject to a Board-imposed moratorium, the proposed consolidation of Canadian National Railway Company and The Burlington Northern and Santa Fe Railway Company pending changes to the Board's merger rules). It would be preferable, less prejudicial to the involved parties, and more legally supportable for the Board to suspend this rulemaking proceeding to allow the development of procedures allowing individual application of carrier specific cost of capital than to allow the new guidelines to take effect and subsequently suspend a rate complaint filed under the new guidelines in order to resolve this issue at that time.

III. APPLICATION OF THE PROPOSED RULES TO INTERNATIONAL THROUGH TRAFFIC WOULD ALSO BE INAPPROPRIATE

Another problem that the Board needs to consider further is adjusting the proposed rules to account for the problems associated with applying the rules to international through traffic. CP and CN have raised valid concerns regarding the use of URCS and the Waybill Sample to determine the reasonableness of an international through rate. While CP's and CN's concerns addressed international through movements between the U.S. and Canada, the same concerns exist with respect to through movements between the U.S. and Mexico. As the Board knows, KCSR is a sister corporation with KCSM. Both are wholly-owned railroad subsidiaries of Kansas City Southern, a non-carrier holding company. KCSM operates solely within Mexico. KCSR and KCSM interchange a significant volume of international traffic. While much of this traffic is rebilled at the border, KCSR and KCSM have begun to market and bill such interline traffic on an international through basis. To the extent traffic is rebilled at the border, the use of URCS to challenge the domestic portion of the move does not constitute a data collection problem, although as KCSR's comments indicate, there are significant other problems with the application of URCS to a KCSR move. However, to the extent KCSR and KCSM bill on an

international through basis, rate-setting for such a movement under the Board's proposed new methodology suffers from the very same problems discussed by CP and CN.

As pointed out by CP and CN, any rate reasonableness challenge to an international through movement must involve a challenge of the entire charge for the overall movement. See Canada Packers, Ltd. v. Atchison, Topeka and Santa Fe Ry. Co., 385 U.S. 182, 183-84 (1966); Louisville & No. R.R. Co. v. Sloss-Sheffield Co., 269 U.S. 217, 234 (1925). Thus, if a through rate for a U.S. - Mexico movement is challenged, the rate reasonableness determination is based on the charge for the entire movement, including the portion of the through movement in Mexico. However, as with the concerns raised by the Canadian carriers, there are significant differences in the cost and revenue data available for domestic U.S. traffic versus that available for Mexican traffic. Neither the Board, KCSR, KCSM, nor KCS collect and maintain URCS data for the portions of rail movements in Mexico. Nor does the Waybill Sample collect data for the Mexican portions of a U.S. – Mexico through movement. Yet, the Board's rules with respect to the SSAC and Three Benchmark tests would require the application of URCS and the Waybill Sample movement records and volumes to the entire U.S. – Mexico through movement; something that simply can't be done under the existing data limitations.

The limitations associated with applying the rules to international traffic provides another reason for considering the need to hold the Board's rules in abeyance while this and other issues are resolved. If the Board rejects that recommendation and adopts the proposed new rules, it would not be appropriate to apply those rules to a KCSR-KCSM international through movement. If the Board rejects this alternative, KCSR requests that the Board at least allow movement-specific adjustments for URCS and make adjustments to the Waybill Sample as necessary to account for the specific problems associated with cross-border traffic.

IV. IN LIGHT OF THE UNDERLYING PROBLEMS WITH URCS, IF THE BOARD MOVES FORWARD WITH THE PROPOSED RULES, THE BOARD SHOULD DECLINE TO RAISE THE REVENUE THRESHOLDS

Finally, as the Board's decisions in this matter concede, the costing methodologies for rate cases covered by the Board's proposed rules are less accurate than the stand-alone cost, constrained market pricing approach. Without the ability to make movement-specific adjustments to URCS and given the increased reliance on URCS as proposed in the SSAC and Three Benchmark methodologies, these inaccuracies will only be magnified. This is particularly true with respect to costing movements on carriers that have, on average, shorter lengths of haul and a higher proportion of expenses derived from switching, pickup, and delivery of freight, such as KCSR and others.

Because, as shown herein, the use of URCS can produce significantly inaccurate results for the type of traffic that KCSR predominantly handles, the Board should resist various commentators' calls to expand the pool of movements subject to the rules. Even with the maximum value of the case thresholds set as they are, KCSR believes that a large segment of its traffic could be subject to the proposed rules and that applying URCS to KCSR's movements and to the similar movements of other carriers will produce significantly inaccurate results. As KCSR is revenue-inadequate and the rules as presently proposed will further prevent KCSR from obtaining rate levels that cover KCSR's fully allocated costs, the Board should not further expose revenues that KCSR needs for capital investment and expansion of its service capacity by raising the eligibility thresholds to expose even more KCSR traffic to a flawed ratemaking methodology process. At a minimum, the thresholds should remain as proposed.

CONCLUSION

In conclusion, KCSR was initially very reluctant to involve itself in this proceeding, given its limited exposure to and experience with rate complaint proceedings. However, now that KCSR has had an opportunity to more fully evaluate the proposed rules and the comments of other parties, KCSR is confident that its involvement is warranted. There are substantial problems with application of the proposed rate methodologies to a KCSR movement as well as to the movements of similarly-situated carriers. For the most part, these problems do not come from application of the rate complaint methodologies themselves, but rather from the way URCS calculates costs, from the underlying cost allocation formulae, and from the fact that URCS does not capture KCSR's actual cost of capital. As a result, URCS does not accurately account for KCSR's costs as well as the cost of similarly situated carriers. If the Board were to apply either the SSAC or Three Benchmark test to a KCSR move without further adjustments to URCS, the results would not accurately reflect KCSR costs and revenues and could result in the prescription of a rate substantially below what would be required to allow KCSR to recover its fully allocated costs and to achieve revenue adequacy.

To alleviate these problems, the best approach is to allow KCSR (and others, such as Class II and Class III carriers) to provide movement specific adjustments to URCS in the event KCSR is involved in a rate complaint proceeding. Absent this relief, the Board should develop a

procedure by which KCSR and others can apply their own cost of capital in a SSAC or Three Benchmark proceeding.

Respectfully submitted,

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Attorneys for The Kansas City
Southern Railway Company

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EX PARTE NO. 646 (SUB-NO. 1)

SIMPLIFIED STANDARDS FOR RAIL RATE CASES

REPLY COMMENTS OF THE KANSAS CITY SOUTHERN RAILWAY COMPANY

EXHIBIT A

VERIFIED STATEMENT OF GEORGE C. WOODWARD

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

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My name is George C. Woodward. I am an independent management consultant. I was formerly Senior Vice President-Chief Commercial Officer at ALK Technologies, Inc., from 1991 to 2001. ALK is the repository of the STB rail waybill sample and has developed information systems that enable rail carriers to analyze traffic flows. Prior to joining ALK, I was Executive Vice President-Distribution Services at Southern Pacific Transportation Co. from 1987-91 and Vice President-Marketing with Conrail from 1978-87. I have a B.S. in Physics from the Georgia Institute of Technology and an MBA with a major in Finance from the Wharton School of the University of Pennsylvania.

The purpose of my verified statement is to comment upon the Board's recent proposal to revise its smaller rate case guidelines, and, in particular, to discuss how the proposed guidelines' reliance upon unadjusted URCS will fail to accurately account for the actual costs of The Kansas City Southern Railway Company ("KCSR") and will thus lead to rate prescriptions that do not allow KCSR to recover its fully allocated costs so as to achieve revenue adequacy.

1) URCS Does Not Accurately Reflect KCSR's Costs Or Those Of Other Carriers Who Have A Shorter Haul Traffic Base With A Higher Proportion Of Interline, General Merchandise (Single-Car) Traffic.

As compared to the larger Class I carriers with which it is aggregated, KCSR handles a higher proportion of short haul, general merchandise (single car, local, interline forwarded and interline received). This type of traffic entails a higher proportion of handling and terminal capacity than do longer-distance hauls and unit train movements. Over 80% of KCSR's loaded volume is derived from shorter haul interline forwarded and received traffic. This is a problem for KCSR in relation to the STB's unadjusted Uniform Rail Costing System (URCS) because URCS primarily allocates direct and indirect variable costs based on line haul mileage. Although URCS attempts to recognize time-dependent costs associated with gathering and distribution of traffic, which is a larger relative portion of KCSR's overall service, the allocation formulas used to allocate the higher-cost inputs for these time-dependent elements (including switching time, locomotive time, terminal car time, equipment rentals, etc.) are out-dated and do not reflect carrier-specific costs.

For example, labor costs are allocated by URCS on a per-mile basis, meaning that labor-intensive activities, such as switching, pickup, and delivery are allocated less than their actual labor costs because there is a higher ratio of man-hours to miles for such movements than in running long-haul trains. KCSR's average length of haul is only approximately 350 miles, which is much shorter than those of other major carriers (for example, BNSF and UP average line hauls are over 1200 miles, while CSX and NS average line hauls exceed 600 miles). This means that KCSR's time-dependent gathering and distribution costs represent a much higher percentage of KCSR's overall service costs than URCS would allocate.

A large part of why URCS does not accurately cost short-haul, labor and time intensive movements is due to the way URCS allocates the various inputs and assigns different weights to those allocations. URCS uses three different methods to develop costing relationships: direct, engineering, and statistical. These three different methods are employed because each has advantages and is better suited than the other two techniques to measure some types of costs. Yet, URCS no longer generates accurate costing information because in some cases the Board's URCS calculations rely on switching studies conducted in the 1940's. As a result, application of unadjusted URCS in a SSAC or Three Benchmark case will not accurately capture KCSR's costs so as to provide KCSR with an opportunity to recover its fully allocated costs.

As a result of the way URCS measures and allocates inputs for short-haul, labor and time-intensive movements, such as those on KCSR or other similarly-situated carriers, the URCS costs for KCSR's predominantly shorter haul traffic do not accurately reflect KCSR's fully allocated costs. To test this theory, I costed certain KCSR traffic movements of roughly 150 miles in length. I also applied URCS costing to these same movements. In doing so, I discovered that URCS costing for these short-haul moves can be as much as 30% *lower* than KCSR's estimated actual costs. The same would likely be true of other carriers like Class II and III carriers, whose average lengths of haul are likely to be short relative to those of the largest Class I's.

2) URCS Does Not Accurately Reflect KCSR's Cost Of Capital.

As stated above, a large part of URCS' inaccuracy as applied to KCSR is due to the nature of KCSR's system and the way that the URCS formulas and regression analyses allocate the various R-1 inputs. But another problem with application of URCS to KCSR is that the cost of capital used by URCS is based upon the average cost of capital for the four largest U.S.-based

Class I carriers. As a result, URCS excludes KCSR and other carriers from the cost of capital calculations. Yet, because of KCSR's capital structure and return expectations, KCSR's cost of capital is significantly higher than those of the four largest Class I carriers. As a result, URCS significantly understates KCSR's capital costs.

KCSR's debt is secured through its parent corporation, Kansas City Southern ("KCS"). Accordingly, KCSR's cost of capital is reflected in KCS' overall cost of capital. Recent debt issues by KCS suggest a KCS-specific cost of debt in the 7-8% range, although historically, KCS debt has been in the 10-11% range.⁷ Likewise, KCS's cost of equity is higher than those of the four largest Class I carriers. KCS's cost of equity has been estimated to be in the 18-20% range. Combining its debt and equity, KCS's weighted average cost of capital has been estimated to be in the 14-16% range.⁸ This stands in contrast to the industry average of 12.2%.

URCS uses the industry average based upon the four large Class I carriers. URCS does not reflect KCSR's higher cost of capital. Because URCS does not reflect each carrier's individual cost of capital, current URCS data understates KCSR's true costs of doing business. This factor, combined with the existing deficiencies of URCS, will result in understating KCSR's true cost and will thus, in the context of a SSAC or Three Benchmark rate complaint case, prohibit KCSR from obtaining the revenues necessary to achieve revenue adequacy.

⁷ By contrast, according to the Board's most recent cost of capital calculation, the four largest Class I carriers had a 5.36% average cost of debt. Railroad Cost of Capital - 2005, STB Ex Parte No. 558 (Sub-No. 9) (STB served Sept. 20, 2005) ("Railroad Cost of Capital - 2005").

⁸ KCS's capital structure is somewhat more leveraged than its Class I peers, which average approximately 30% debt and 70% equity. See Railroad Cost of Capital - 2005, STB Ex Parte No. 558 (Sub-No. 9) (STB served Sept. 20, 2006). KCS, in contrast, consists of approximately \$1.7 billion in debt (45%) and \$2.1 billion (55%) in market equity.

3) Because Of The Deficiencies In URCS, Application Of The 180% R/VC And The Board's Rules To KCSR And Other Similarly-Situated Carriers Has A Disproportionate Impact.

Since application of unadjusted URCS to KCSR (and to other similarly-situated carriers) would not allow those carriers to recover their fully allocated costs, prescribing rates at or near the statutory margin threshold of 180% R/VC would impede KCSR's efforts to become revenue adequate. It should be noted that the 180% statutory threshold for rate reasonableness was developed as an *average* revenue-to-variable cost ratio derived largely from assumptions about carriers with much longer average lengths of haul. Over 80% of KCSR's loaded revenue and volume is shorter haul, interline forwarded and received traffic. This is the highest proportion of this type of traffic for any Class I carrier.

Since the URCS margin above variable cost contributes to the carrier's fixed costs, overhead and profit, a carrier with a higher proportion of shorter haul, lower revenue per car traffic will have less margin potential (in absolute dollars) to cover its fixed costs, overhead and profit. For a carrier with a comparatively higher length of haul, this is less critical since the absolute dollar margin from longer haul traffic can help offset the lower absolute dollar margin from short haul traffic. But because the time-related costs of a shorter haul movement appear not to be accurately reflected in URCS, carriers with shorter haul shipments, on average, would be hampered in generating enough uncontested margin to cover fixed costs, overhead, and profit if rates were prescribed at or near the 180% R/VC threshold.

Correcting the shortcomings of URCS by allowing KCSR (and similarly-situated carriers) to make movement-specific adjustments to URCS would be the best solution to enhancing the accuracy of the URCS calculations and avoiding the disproportionate impact on KCSR and others that will occur if the Board moves forward with its proposal in its current form.

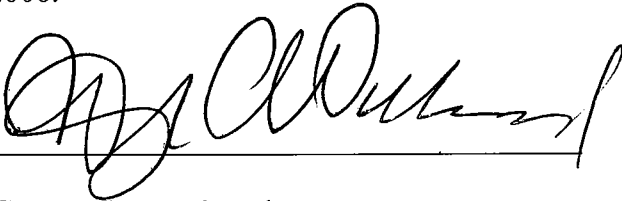
Alternatively, absent the ability to make movement-specific adjustments, at a minimum, KCSR and other similarly-situated carriers should be allowed to apply their own cost of capital in any SSAC or Three Benchmark proceeding. Applying the average cost of capital applied in URCS will understate KCSR's true costs and the costs of other similarly-situated carriers.

Another possible solution would be to exempt short-haul traffic from application of the rules altogether. This would not be altogether inconsistent with the Rail Transportation Policy as these types of movements are in substantial part considered truck competitive. In the alternative, to account fairly for the higher average per mile costs for shorter haul movements, the Board should consider modifying its rules to provide that no rate prescriptions issued under SSAC or the Three Benchmark test for movements under 150 miles should be set at revenue-to-variable-costs lower than 240% R/VC. Allowing rates to be prescribed below these R/VC levels for movements less than 150 miles would not allow KCSR or similarly-situated carriers enough margin above variable costs to cover their fully allocated costs, thus prohibiting such carriers from becoming fully revenue adequate.

VERIFICATION

I, George C. Woodward, declare under penalty of perjury that the foregoing is true and correct. Further, I certify that I am qualified to file this Verified Statement.

Executed this 30th day of November, 2006.

A handwritten signature in black ink, appearing to read "G. C. Woodward", is written over a horizontal line.

George C. Woodward

CERTIFICATE OF SERVICE

I have this day served a copy of the foregoing Reply Comments Of The Kansas City Southern Railway Company upon all other parties of record by depositing a copy in the U.S. mail in a properly addressed envelope with adequate first-class postage thereon prepaid, or by other, more expeditious means.

Dated: November 30, 2006

A handwritten signature in black ink, appearing to read 'William A. Mullins', with a long horizontal flourish extending to the right.

William A. Mullins

Attorney for The Kansas City
Southern Railway Company