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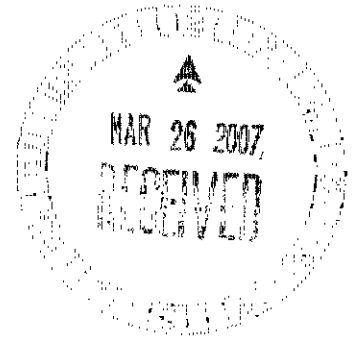
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March 26, 2007



Via HAND DELIVERY

The Honorable Vernon A. Williams
Secretary
Surface Transportation Board
395 E Street, S.W.
Washington, DC 20423

Re: **Western Fuels Association, Inc. and Basin Electric Power Cooperative v. BNSF
Railway Company, STB Docket No. 42088**

Dear Secretary Williams:

Enclosed are an original and ten copies of the Reply Second Supplemental Evidence of BNSF Railway Company ("BNSF"). Also enclosed are three DVDs containing electronic workpapers supporting BNSF's filing. The electronic workpapers should be treated as Highly Confidential subject to the protective order in this case.

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

Sincerely,

Carolyn D. Clayton
Counsel for BNSF Railway Company

Enclosures

cc: Counsel for Complainant



**BEFORE THE
SURFACE TRANSPORTATION BOARD**

STB Docket No. 42088

**WESTERN FUELS ASSOCIATION, INC. AND
BASIN ELECTRIC POWER COOPERATIVE**

v.

BNSF RAILWAY COMPANY

**REPLY SECOND SUPPLEMENTAL EVIDENCE OF
BNSF RAILWAY COMPANY**

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March 26, 2007

**ATTORNEYS FOR
BNSF RAILWAY COMPANY**

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

Docket No. 42088

**WESTERN FUELS ASSOCIATION, INC. AND BASIN ELECTRIC POWER
COOPERATIVE, INC. V. BNSF RAILWAY COMPANY**

REPLY SECOND SUPPLEMENTAL EVIDENCE OF BNSF RAILWAY COMPANY

In its November 8, 2006 Order ("*November 8 Order*") in the above captioned proceeding, the Surface Transportation Board ("Board") ordered the parties to submit supplemental evidence needed for the implementation of the Stand-Alone Cost ("SAC") methodologies adopted by the Board in its October 30, 2006 Decision in Ex Parte No. 657 (Sub-No. 1) ("*October 30 Decision*").¹ The *November 8 Order* instructed the parties (1) to submit revised variable-cost and jurisdictional-threshold calculations for the issue traffic using unadjusted Phase III URCS costs; (2) to develop revenue allocations for cross-over traffic using the Average Total Cost ("ATC") methodology; and (3) to calculate the variable costs for all movements in the SARR traffic group using the URCS Phase III movement costing program for use in applying the Maximum Mark-up Methodology ("MMM") to determine maximum rates. WFA/Basin filed their Opening Second Supplemental Evidence ("WFA/Basin Op. Second Supp. Evid.") on February 22, 2007. In accordance with the schedule set out in the Board's November 22, 2006 decision, BNSF Railway Company ("BNSF") hereby submits its Reply to WFA/Basin's Opening Second Supplemental Evidence.

¹ See *Major Issues in Rail Rate Cases*, STB Ex Parte No. 657 (Sub-No. 1) (STB served Oct. 30, 2006).

BNSF has reviewed WFA/Basin's implementation of the methodological changes adopted in Ex Parte No. 657. For the most part, WFA/Basin have followed the procedures established by the Board and BNSF accepts WFA/Basin's evidence, with the exception of a few instances where WFA/Basin's calculations and methodologies are erroneous or inappropriate, as discussed below.

I. URCS SYSTEM-AVERAGE VARIABLE COSTS AND THE JURISDICTIONAL THRESHOLD

In their supplemental evidence, WFA/Basin calculated the variable costs of the issue traffic movements for the fourth quarter of 2004, the only historical period in this case, using BNSF's unadjusted 2004 URCS costs and the Board's URCS Phase III program, as directed by the Board in its *November 8 Order*. As stated in their narrative, WFA/Basin used in the URCS Phase III program the inputs previously agreed upon by the parties for loaded miles, cars-per-train and tons-per car. WFA/Basin Op. Second Supp. Evid. at 10-11. WFA/Basin developed the variable costs and jurisdictional-threshold R/VC ratios for BNSF coal movements separately for the five origin/destinations pairs used by the issue traffic: Dry Fork to WFA/Basin's Laramie River Station ("LRS"); Eagle Butte to LRS; Cordero to LRS; Caballo Rojo to LRS and Jacobs Ranch to LRS. *Id.* at 12. WFA/Basin indexed the 2004 URCS variable costs to the appropriate levels for 4Q04. *Id.* at 13.

BNSF accepts WFA/Basin's development of the variable costs and the origin/destination-specific R/VC calculations. BNSF also accepts their methodology for indexing costs to 4Q04, but notes that for the fuel component of Phase III variable costs, WFA/Basin used the AAR Fuel RCAF-component index, rather than using actual BNSF fuel costs taken from BNSF Investors' Reports to index fuel costs, as both BNSF and WFA/Basin had done in their previous filings in this case. *See* WFA/Basin Rebuttal Workpaper "BNSF04 Index Rebuttal.123. However, as the

switch in index has little impact on the development of 4Q04 costs, BNSF has not made any adjustments to WFA/Basin's calculations.²

II. REVENUE ALLOCATION ON CROSS-OVER TRAFFIC

In its *November 8 Order*, the Board instructed the parties to develop revenue allocations for cross-over traffic using the Average Total Cost (ATC) methodology. To implement ATC, the parties allocate revenues for cross-over movements based on the incumbent's relative average total cost per ton (ATC) for the on-SARR and off-SARR portions of the movements. See Notice of Proposed Rulemaking in Ex Parte No. 657 (Sub-No. 1) at 20 (Feb. 26, 2006) ("*NPRM*"). The mechanics of the methodology were described as consisting of three steps:

- First, the railroad's average variable cost (AVC) per ton to haul the traffic over each segment would be estimated using unadjusted URCS.
- Then to estimate the average fixed cost (AFC) per ton of traffic using the various segments, the railroad's system-average fixed cost per route mile would be calculated by dividing the railroad's URCS total fixed costs by the total route miles of track operated by the railroad. This system-average fixed cost per mile could then be combined with the route miles and traffic density of any particular segment of the railroad's network to estimate an AFC per ton associated with that segment.
- The ATC for any particular segment would be the sum of the AVC and the AFC for that segment.

Id. In its *November 8 Order* in this proceeding, the Board instructed the parties in this case to submit supplemental evidence implementing the ATC methodology.

² WFA/Basin did not explain why they switched to the AAR fuel index. The broader AAR fuel index accounts for the experience of multiple railroads, reflecting different fuel sources and practices, including hedging, which can vary substantially from one railroad to another. Thus, use of the AAR index does not capture BNSF's specific fuel cost changes, and switching from use of the BNSF-specific index to the industry-wide index produces distortions. The use of the BNSF-specific fuel index is a more accurate reflection of BNSF's actual fuel cost experience across its system, and thus is more consistent with the use of BNSF system-average URCS costs. If it is necessary to index fuel costs to later years, the BNSF-specific fuel index should be used.

As explained below, BNSF disagrees with WFA/Basin's implementation of the Board's instructions in three areas. First, in developing the variable cost portion of the revenue allocation methodology, WFA/Basin should not have included costs associated with hypothetical interchanges that the incumbent does not incur. Second, WFA/Basin used a flawed methodology in addressing fixed costs associated with BNSF's trackage-rights miles. Third, WFA/Basin incorrectly used a single average density for on-SARR and off-SARR line segments that include segments of varying density rather than calculating the fixed costs for each distinct density segment within the longer route. These flaws and BNSF's corrections to them are discussed below.

A. Inappropriate Inclusion of Variable Costs for Hypothetical Interchanges

WFA/Basin incorrectly include in their AVC calculation the cost of hypothetical interchanges between the SARR and the residual railroad. ATC seeks to allocate revenue on cross-over traffic in proportion to the *incumbent's* ATC on each segment of the movement. As the Board explained in its *NPRM*, the ATC methodology involves an estimate of "the average total cost *incurred by the railroad [i.e., incumbent]* to haul that traffic over the segment replicated by the SARR and over the segment of the residual railroad." *NPRM* at 20 (emphasis and brackets added). But the incumbent incurs no interchange cost on a movement that is treated by the complainant as a cross-over movement in the SAC analysis, so interchange costs should not be included in the ATC calculation.

The URCS costing program assumes that every movement being costed has a cost associated with the beginning and end points of the movement, even if the movement is part of a larger, single line movement. Therefore, when URCS is used to develop the variable costs for two segments of a through movement – the on-SARR and off-SARR segments – it automatically inserts interchange costs on both sides of the supposed interchange between the on-SARR and

off-SARR segments. This is incorrect. Because the purpose of ATC is to determine the *incumbent's* relative costs of the line segments, and the incumbent does not incur those interchange costs, no interchange costs should be included. BNSF has corrected this error by removing the URCS variable interchange cost applied to the non-existent interchanges.³

B. Inappropriate Allocation of Fixed Costs on Trackage-Rights Segments

A second error in WFA/Basin's ATC calculations involves the treatment of trackage-rights miles in allocating system-wide URCS fixed costs. In determining BNSF's system-average fixed cost per route mile, WFA/Basin took BNSF's total fixed cost (total cost – total variable cost) and divided that by the total route miles shown in BNSF's 2004 Annual Report Form R-1, which included both owned miles and more than 8,000 miles operated via trackage rights. WFA/Basin Op. Second Supp. Evid. at 20. Next, WFA/Basin calculated the total fixed costs for the routes traversed by the cross-over movements by multiplying the fixed-cost-per-mile by the route miles. *Id.* at 21. Then, WFA/Basin calculated the fixed cost per ton by dividing the total fixed costs by the "weighted average annual density (net tons)" of the route.⁴ *Id.* When calculating the fixed costs per ton, however, WFA/Basin understated the densities for routes that include trackage-rights segments by ignoring the traffic moving over the trackage rights segments.⁵

³ BNSF Reply Second Supp. Evid. Electronic Workpaper "WFA EP657 PH3 2004 URCS_BNSF Rev.xls."

⁴ In the next section, BNSF discusses a separate error related to this calculation, namely that WFA/Basin's approach improperly ignores the differences in the density of individual segments that make up an entire on-SARR or off-SARR segment. By assuming that the entire on-SARR or off-SARR segment has a single average density, WFA/Basin substantially understates the costs on off-SARR segments and thereby distorts the ATC calculation.

⁵ As WFA/Basin did not include any trackage-rights segments in its SARR configuration, this flaw affects only WFA/Basin's fixed-cost allocations for the off-SARR portion of cross-over movements.

To develop the “weighted average annual density” for the off-SARR route, WFA/Basin divided the total ton-miles for the segments by the total miles. WFA/Basin work paper “BNSF_2004_Density.xls,” worksheet “Density Matrix,” column “DT.” Although the total miles covered the total route, including owned segments and trackage-rights segments, the ton-mile figures that WFA/Basin used accounted for only the traffic on BNSF’s owned segments.⁶ This resulted in an understatement of the ton-miles per mile ratio that serves as WFA/Basin’s average density for the route. By developing the total fixed costs for all miles, including trackage-rights segments, but dividing them by the understated density, WFA/Basin’s approach resulted in overstated fixed costs per ton.

In evidence filed recently by AEP Texas in Docket No. 41191 (Sub No. 1), AEP Texas took a different approach to developing fixed costs per ton for off-SARR routes that include trackage rights segments. As BNSF explained in its March 19, 2007 Reply Supplemental Evidence, AEP Texas assigned fixed costs only to BNSF’s owned segments. Such an approach would, at a minimum, require changing the calculation of the system-wide fixed-cost-per-mile described at the beginning of this section to exclude the 8,000 miles of trackage rights from the route-mile denominator so that the fixed costs per ton mile would be consistent with the number of miles to which those costs are assigned.

⁶ While the density reports that were recently provided to WFA/Basin did not include the tonnages for trackage-rights segments, other data in the record upon which WFA/Basin relied show the densities for these segments. See WFA/Basin July 14, 2006 Supplemental Rebuttal workpaper “2003 System Traffic Density Map.pdf,” identified in WFA/Basin workpaper index as “LRR July 14, 2006 Supplemental Rebuttal Section III Electronic Workpaper Index.xls.” BNSF used this workpaper to correct WFA/Basin’s calculations so that they include the ton-miles on the trackage rights segments. To obtain 2004 densities, BNSF adjusted the densities in the 2003 density map to 2004 levels by applying the system-wide change in gross ton-miles per route mile and the LRR gross-to-net ratio of 1.5. See BNSF Reply Second Supp. Evid. Workpaper “BNSF_2004_Density_BNSF Rev.xls,” worksheet “Missing Segments.”

While this approach would be one way of addressing WFA/Basin's failure to account for the ton-miles on trackage rights segments, it is not the most precise way of dealing with trackage-rights segments, as BNSF explained in its March 19, 2007 filing. Trackage rights segments clearly do not have the same fixed costs as owned segments. Only a portion of the railroad's fixed costs – *i.e.*, “above-the-rail” costs – are incurred on trackage-rights segments. But the trackage rights segments do have some fixed costs. Therefore, a straightforward alternative would be first to calculate the roadway (“below-the-wheel”) fixed costs to be applied only to owned segments, and second to calculate the above-the-rail fixed costs per mile to be applied to all segments (owned and operated via trackage rights). BNSF follows that approach here to correct WFA/Basin's erroneous treatment of trackage rights segments.⁷

C. Inappropriate Treatment of Density Segments in Calculating Fixed Costs for On-SARR and Off-SARR Portions of a Movement

For any given cross-over movement, the on-SARR and off-SARR portions of the movement may be comprised of individual segments of varying density. However, in calculating the average fixed costs for the on-SARR and off-SARR portions of a movement, WFA/Basin assume that there are only two segments – the on-SARR segment and the off-SARR segment – and that each segment has only one density – the average density for the entire route. Although WFA/Basin properly defined a “density segment” as a discrete segment of the SARR or residual BNSF system within which the traffic density is consistent,⁸ they ignored the individual density segments in their calculations of the average fixed cost per ton over the on-SARR and off-SARR portions of a movement. Instead, WFA/Basin simply use an average

⁷ BNSF Reply Second Supp. Evid. Workpaper “BNSF_2004_Density_BNSF Rev.xls.”

⁸ For example, a portion of the system that runs from point A to point C via point B, where A-B handles 10 million tons and B-C handles 8 million tons, would be comprised of two density segments. WFA/Basin Op. Second Supp. Evid. at 17, fn. 18.

density across the entire on-SARR or off-SARR portion of the movement. This approach understates the average cost per ton of the on-SARR and off-SARR portions.

The effect of this methodological error can be easily demonstrated. The hypothetical example below assumes that the off-SARR portion of a movement consists of two density segments, a high-density segment of 100 million tons and a low-density segment of 20 million tons. It also assumes that the fixed cost per route mile using URCS data (incumbent's total fixed costs divided by incumbent's total route miles) is \$100,000, which would be applied to the mileage for each density segments. It also assumes that the route miles of each of the two density segments are 30. The total fixed cost for each segment would be \$3,000,000 (\$100,000 x 30 miles). The fixed cost per ton for each segment would be calculated by dividing the total fixed costs by the density, resulting in a fixed cost per ton of \$0.03 (\$3 million divided by 100 million tons) on the high-density segment and \$0.15 (\$3 million divided by 20 million tons) on the low-density segment. The total fixed cost per ton for the entire off-SARR segment would be the sum of the two densities, or \$0.18.

The methodology used by WFA/Basin does not calculate the fixed cost per ton for each density segment, but rather uses the sum of the route miles of the high and low density segments (30 + 30 = 60 miles) and the average density of the two segments (100 million + 20 million divided by 2 = 60 million). It then calculates the fixed cost per ton by dividing the total combined fixed cost of \$6 million by the *average density* of 60 million tons to get a fixed cost per ton of \$0.10. This methodology understates the fixed cost per ton on the off-SARR movement, resulting in a greater revenue allocation to the SARR.

Table 1: Example of Fixed Cost Calculation by Segment

	Source	Using Individual Segments			Using One "Average" Segment
		High-Density Segment	Low-Density Segment	Total	

1. Fixed Costs per Mile	URCS Data	\$100,000	\$100,000		\$100,000
2. Route Miles	Segment Data	30	30		60
3. Total Fixed Costs	Row 1 x Row 2	\$3,000,000	\$3,000,000		\$6,000,000
4. Density	Segment Data	100,000,000	20,000,000		60,000,000
5. Fixed Cost per Ton	Row 3 / Row 4	\$0.03	\$0.15	\$0.18	\$0.10

In its Reply, BNSF has determined the fixed cost for each individual density segment within the on-SARR and off-SARR segments and summed those costs to develop the total fixed cost per ton for the entire on-SARR and off-SARR segments.⁹

The table below compares the revenues calculated by BNSF and WFA/Basin after the Ex Parte No. 657 adjustments are made. Some of the differences are attributable to methodological and factual differences discussed in prior evidence.

Table 2: LRR Revenue Comparison

Period	SARR Revenues (\$ in Millions)		
	WFA Second Supplemental Opening (2-22-07)	BNSF Second Supplemental Reply (3-26-07)	Difference
4Q2004	\$55.0	\$48.5	(\$6.5)
2005	\$234.1	\$203.5	(\$30.7)
2006	\$246.2	\$216.0	(\$30.2)
2007	\$247.5	\$225.1	(\$22.4)
2008	\$248.3	\$226.3	(\$22.0)
2009	\$254.7	\$231.4	(\$23.3)
2010	\$257.1	\$233.7	(\$23.3)
2011	\$261.9	\$238.0	(\$24.0)
2012	\$267.3	\$243.1	(\$24.3)
2013	\$273.3	\$248.5	(\$24.8)
2014	\$277.9	\$252.7	(\$25.1)
2015	\$277.1	\$252.3	(\$24.8)
2016	\$284.1	\$258.9	(\$25.2)
2017	\$294.9	\$268.8	(\$26.1)
2018	\$305.7	\$278.7	(\$27.0)
2019	\$314.3	\$286.5	(\$27.8)

⁹ BNSF Reply Second Supp. Evid. Workpapers "LRR_2004_Density_BNSF Rev.xls" and "BNSF_2004_Density_BNSF Rev.xls."

2020	\$324.3	\$295.5	(\$28.8)
2021	\$335.1	\$305.1	(\$30.0)
2022	\$343.7	\$312.9	(\$30.7)
2023	\$353.3	\$321.5	(\$31.7)
1Q-3Q2024	\$272.9	\$248.4	(\$24.5)

III. MAXIMUM MARK-UP METHODOLOGY

The *November 8 Order* directs the parties to “calculate the variable cost for all movements (issue and non-issue movements) using the URCS Phase III movement costing program” to support the application of MMM to determine the maximum stand-alone rate. *Id.* at 4. WFA/Basin note in their supplemental evidence that the same variable costs developed for use in the ATC calculations can be used for MMM. WFA/Basin Op. Second Supp. Evid. at 24. BNSF agrees that the variable costs should be the same for both purposes, and thus BNSF uses the same variable costs for MMM as it uses for ATC.¹⁰

WFA/Basin also state that “the variable costs that WFA/Basin developed to calculate jurisdictional threshold costs under the Board’s Major Issues procedures can be used as MMM inputs.” *Id.* BNSF agrees and points out that in their supplemental evidence, WFA/Basin calculated the origin/destination-specific variable costs, consistent with BNSF’s multiple rate structure for the issue traffic. This is in contrast to WFA/Basin’s assertion in their previous filings that a single rate should be prescribed for all mine origins, which BNSF explained would be inappropriate. BNSF Reply Nar. at III.H-28 to 31. Should it be necessary to apply MMM in this case, the origin-specific variable costs should be used.

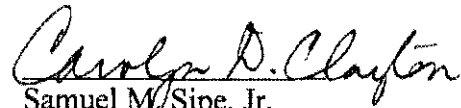
IV. CONCLUSION

In this Reply, BNSF has implemented the three methodologies adopted by the Board in Ex Parte No. 657 (Sub-No. 1), correcting the errors made by WFA/Basin in their implementation

¹⁰ BNSF Reply Second Supp. Evid. Electronic Workpaper “WFA EP657 PH3 2004 URCS_BNSF Rev.xls.”

of the ATC approach discussed above. The details of BNSF's calculations are set out in the workpapers BNSF submitted with this filing.¹¹

Respectfully submitted,



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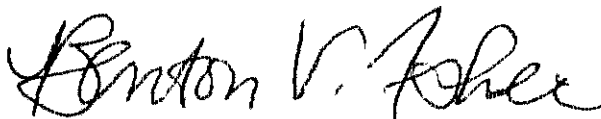
March 26, 2007

ATTORNEYS FOR
BNSF RAILWAY COMPANY

¹¹ BNSF Reply Second Supp. Evid. workpaper "BNSF RSS Workpaper Index.xls."

VERIFICATION

I, Benton V. Fisher, verify under penalty of perjury that I am the same Benton V. Fisher whose Statement of Qualifications appears in Part V of the Narrative Portion of the Reply Evidence of The Burlington Northern and Santa Fe Railway Company (now BNSF Railway Company) filed in this proceeding on July 20, 2005; that I am responsible for Sections I, II, and III of the foregoing Reply Second Supplemental Evidence of BNSF; that I know the contents thereof and that the same are true and correct; and that I am qualified and authorized to file this statement.

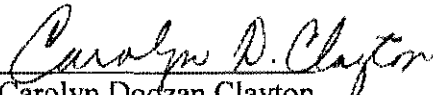

Benton V. Fisher

Executed on March 23, 2007.

CERTIFICATE OF SERVICE

I, Carolyn Doozan Clayton, certify that on the 26th day of March 2007, I caused a copy of the foregoing Reply Second Supplemental Evidence of BNSF Railway Company to be served by hand delivery on counsel for WFA/Basin, as follows:

John H. LeScur
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Carolyn Doozan Clayton