ASSOCIATION OF AMERICAN RAILROADS

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Ms. Cynthia T. Brown
Chief, Section of Administration
Surface Transportation Board
395 E St., S.W.
Washington, DC 20423

Re: Ex Parte No. 715, Rate Regulation Reforms

Dear Ms. Brown:

Pursuant to the Board's Notice of Proposed Rulemaking served on July 25, 2012, attached please find the Comments of the Association of American Railroads for filing in the above proceeding.

Respectfully submitted,

Louis P. Warchot

Louis P. Warchot

Attachment

BEFORE THE
SURFACE TRANSPORTATION BOARD

STB Ex Parte No. 715

RATE REGULATION REFORMS

COMMENTS OF THE
ASSOCIATION OF AMERICAN RAILROADS

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October 23, 2012

BEFORE THE
SURFACE TRANSPORTATION BOARD

STB Ex Parte No. 715

RATE REGULATION REFORMS

COMMENTS OF THE
ASSOCIATION OF AMERICAN RAILROADS

Introduction

In a Notice of Proposed Rulemaking ("NPR") served on July 25, 2012, the Surface Transportation Board ("Board") proposed to modify its rules regarding railroad rate reasonableness proceedings. The Association of American Railroads ("AAR") respectfully submits these comments as a party of record in accordance with the Board's NPR.

The AAR is a trade association representing the interests of North America's major freight railroads, and often presents comments and testimony in STB proceedings. The AAR and its freight member railroads have a strong interest in this proceeding and ensuring that Board's rate reasonableness process conforms to the statutory directives of the Rail Transportation Policy ("RTP") and is consistent with the Board's established Constrained Market Pricing ("CMP") regulatory regime and sound economics.

The Board and its predecessor agency, the Interstate Commerce Commission ("ICC") have long rejected formulaic cost-based rate standards and recognized that railroads must be permitted to apply demand-based differential pricing in order to allow them the opportunity to recover their cost of capital. In adopting CMP as the guiding principles governing rail rate regulation, the ICC concluded that "the cost structure of the railroad industry necessitates differential pricing of rail services." *Coal Rate Guidelines - Nationwide*, 1 I.C.C.2d 520,526 (1985) ("*Coal Rate Guidelines*"), *aff'd sub nom. Consolidated Rail Corp. v. United States*, 812 F.2d 1444 (3d Cir. 1987).

Since the adoption of CMP in *Coal Rate Guidelines*, this sound economic principle has been reaffirmed by the ICC and STB, and approved by the courts, in numerous cases.[1] The application of demand-based differential pricing has helped the rail industry make progress toward improving its operating efficiency and financial health, by permitting railroads to make needed investments in physical capacity, in order to accommodate increases in freight volume, while at the same time offering competitive rates and providing improved service to shippers. In considering the issues raised in the Board's NPR, the AAR respectfully submits that the Board should take care to ensure fidelity to first principles of rail rate regulation, including sound, time-tested and judicially-approved principles of demand-based differential pricing. These principles are no less vital to the financial health and continued viability of the rail industry, and the essential service it provides to its customers, today than they were when CMP was adopted.

[1] *See, e.g., Consolidated Rail Corp.v. United States*, 812 F.2d at 1448-49; *Potomac Electric Power Co. v. ICC*, 744 F.2d 185, 193 (D.C. Cir. 1984) (in enacting the Staggers Act, Congress understood the "necessity of such differential pricing"); *see id.* at 194 (the "concept of differential pricing ... necessarily contemplates that the carrier will maximize its profits on traffic for which it has no competition so as to offset its lower earnings on competitive traffic"); *MidAmerican Energy Co. v. STB*, 169 F.3d 1099, 1106 (8th Cir. 1999) (affirming application of differential pricing to so-called "bottleneck" shippers; noting that the "Board has recognized that an important part of achieving revenue adequacy is differential pricing"); STB Docket No. 42072, *Carolina Power & Light Co. v. Norfolk Southern Ry. Co.*, slip op. at 33 (served Dec. 23, 2003) ("[d]emand-based differential pricing is essential in the railroad industry because railroads serve a mix of captive and competitive traffic"; non-demand-based cost apportionment methods do not necessarily permit carriers to recover costs) (reconsideration granted on other grounds in STB Decision served October 20, 2004).

Background

A. Constrained Market Pricing and Stand Alone Cost

The Board and the ICC have correctly concluded that the core regulatory principle in the rail industry is that a railroad must be able to engage in demand-based differential pricing to have the opportunity to earn adequate revenues. In *Coal Rate Guidelines*, the ICC rejected formulaic, fully allocated cost approaches to rate reasonableness that do not take account of demand conditions. The ICC held,

> a meaningful maximum rate policy could not be founded on a strictly cost-based approach. Because competition compels the railroads to price some of their services below an arbitrarily assigned 'cost', they must be able to price other services above their assigned 'cost' in order to compensate.

Coal Rate Guidelines, 1 I.C.C.2d at 523. As the Board has succinctly stated,

> a strictly cost-based approach would not reflect the carrier's ability (or inability) to impose the assigned allocations and cover its costs. If a carrier sought to apply the formula price to all its traffic, it would lose that traffic for which the demand could not support the price assigned. Therefore, following the directive from Congress in the Staggers Rail Act of 1980, unattributable costs must be covered through demand-based differential pricing.

Major Issues in Rail Rate Cases, EP 657 (Sub-No. 1) (STB served Oct. 30, 2006) ("*Major Issues*") (citing *Coal Rate Guidelines*, at 526).

CMP, as adopted by the Board, meets this goal by placing constraints on the ability of railroads to price their services while taking into account market demand. The Stand Alone Cost ("SAC") constraint's[2] stated intent is to protect shippers from bearing costs of inefficiencies or from cross-subsidizing other traffic by paying more than the revenue needed to replicate rail service to a select subset of the carrier's traffic base. *Coal Rate Guidelines*, at 542-46. A SAC

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[2] In addition to the SAC constraint, *Coal Rate Guidelines* established constraints based on revenue adequacy, management efficiency, and phasing.

analysis does this by simulating the competitive rate that would exist in a "contestable market," one that is free from barriers to entry. *See Coal Rate Guidelines*, at 528 (citing William J. Baumol, John C. Panzar & Robert D. Willig, *Contestable Markets and the Theory of Industry Structure* (1982)).

Under the SAC constraint as applied by the Board, a challenged rail rate will be found to be unreasonable only if a complainant can show that it is higher than the rate a Stand Alone Railroad ("SARR") would need to charge the complainant to serve it and a subset of the defendant railroad's traffic while fully covering all of its costs, including a reasonable return on investment. *Id.* at 542. *Coal Rate Guidelines* established a basic framework for SAC cases, but did not establish a formula for calculating SAC. Instead, the ICC relied on case-by-case adjudication to develop a body of case law setting forth the governing standards for SAC presentations. In the course of these adjudications, the agency developed a comprehensive body of precedent and rules to govern the presentation of SAC evidence. However, recently, the Board has adopted rules for rate cases through formal rulemakings pursuant to the Administrative Procedure Act in order to lock in rules to prevent parties from re-litigating issues in each case, such as the Board did in *Major Issues*.[3]

[3] Adoption via notice and comment rulemaking makes these rules legally different than the Board's rules created by prior decisions. *See, e.g., Marseilles Land and Water Co. v. FERC,* 345 F.3d 916, 920 (D.C. Cir. 2003) (holding that "an administrative agency may not slip by the notice and comment rule-making requirements needed to amend a rule by merely adopting a *de facto* amendment to its regulation through adjudication").

1. Cross-Over Traffic

Since 1994, the Board has allowed complainants to simplify the SAC analysis by allowing the use of a modeling device referred to as "cross-over traffic." *Bituminous Coal—Hiawatha, Utah, to Moapa, Nev.,* 10 I.C.C. 2d 259, 265-68 (1994). Rather than demonstrating what it would cost for the SARR to build, operate and maintain all of the facilities necessary to serve the traffic group the complainant has selected, complainants have assumed that the "residual incumbent", i.e., the parts of the defendants network necessary to serve the traffic group not replaced by the SARR, remain in place to complete the transportation. The Board has allowed complainants to simply assume that all cross-over traffic could be seamlessly handed off to the residual incumbent and that the residual incumbent would complete the transportation without any regard for profit or efficiency. The Board has justified cross-over traffic as a "simplifying assumption," but has acknowledged that cross-over traffic introduces imprecision into the SAC analysis. *See, e.g., Public Service Company of Colorado D/B/A Xcel Energy v. The Burlington Northern and Santa Fe Railway Company*, NOR 42057, slip op. at 7 (STB served Jan. 19, 2005) ("*Xcel Recon.*").

Though cross-over traffic limits the evidence that a complainant needs to submit regarding the facilities and operations needed to serve the traffic group it has selected, cross-over traffic creates imprecision because of the question that the Board has been struggling with for nearly 20 years: How should the Board allocate revenues from the real-world origin-to-destination rate between the hypothetical "on-SARR" and "off-SARR" segments to calculate the SARR's overall revenues? That is, how should the Board divide up the revenue from real-world defendant's origin to destination service between the part of the network the complainant has elected to "build," i.e., replicate in a SAC analysis, and the part of the route the complainant has not built and assumed would be handled by the residual incumbent.

2. Revenue Allocation

From 1994 to 2006, the agency used some form of mileage-based methodology to apportion revenues to the SARR and to the residual incumbent, though its justification for such a methodology evolved from market based (mileage as a proxy for what the two carriers would charge in the marketplace if the cross-over traffic was interlined) to cost based (costs, at least variable costs as calculated by the Board, vary in proportion to mileage). Beginning in 2003, however, the Board recognized that there might be merit to a revenue-allocation approach that reflected the economies of density experienced by railroads. *Duke Energy Corp. v. Norfolk S. Ry.*, 7 S.T.B. 89, 108 (2003) ("*Duke/NS*"). The Board has concluded that such a focus will establish a revenue allocation method that it believes should maintain, to the extent possible, the relationship between revenues and costs that would exist in a complete SAC analysis. *Otter Tail Power Co. v. BNSF Ry.,* NOR 42071, slip op. at 10-11 (STB served Jan. 27, 2006).

In 2006, the Board modified its rate reasonableness rules by notice and comment rulemaking and addressed cross-over traffic revenue allocation as one of the six recurring major issues in SAC cases. The Board concluded that revenue from cross-over traffic should be allocated based on the proportion of the average total costs ("ATC") of each segment and decided to calculate ATC for each cross-over movement based on system-average variable and fixed costs using the Uniform Railroad Costing System ("URCS") and the density and miles of each segment. The Board then decided to allocate the revenue from the defendant's origin-to-destination rate in proportion to the ATC calculation. *See Major Issues,* at 19-20. The Board concluded that this approach would correctly calculate average costs of each segment and account for the defining characteristic of the railroad industry – economies of scale, scope and density. *Id.* at 34-35. The Board also concluded that ATC would ensure that light density segments of the SARR would be allocated an appropriate amount of revenue. *Id.* at 36. However, the Board recognized that there is no way to determine whether use of ATC actually approximates the outcome of a true, full SAC analysis without performing an analysis using a SARR that actually provides origin-to-destination service for the entire traffic group, which would defeat the purpose of using cross-over traffic. *Id.* at 24.

In the first case to apply ATC, however, the Board modified ATC because application of the rule would result in the on-SARR segments of some movements in the traffic group being allocated insufficient revenues to cover the defendant's URCS variable cost of those segments. *See W. Fuels Ass'n v. BNSF Ry.* ("*Western Fuels*"), NOR 42088 (STB served Sept. 10, 2007). To avoid allocating revenues to the SARR at levels below the defendant's URCS variable costs, the Board changed the rules and created a "modified ATC" approach. First, the Board took the revenue from the origin-to-destination rate and allocated an amount equal to the defendant railroad's URCS variable costs to the on-SARR segment. Second, the remaining revenues, if any, were allocated using the original ATC methodology.

BNSF appealed the decision and the case was remanded to the Board to address whether this "modified ATC" improperly double counted variable costs. *BNSF Ry. v. STB*, 604 F.3d 602, 613 (D.C. Cir. 2010). On remand, the Board, with Commissioner Begeman dissenting, again applied modified ATC. *See W. Fuels Ass'n v. BNSF Ry.*, NOR 42088 (STB served June 15, 2012). The Board acknowledged that modified ATC undermined the weight given to economies of density that characterized the original ATC approach. *Id.* at 10. The Board also expressed concern that the modified ATC approach changed the allocation for all cross-over movements, not just those that had a segment that was allocated revenue less than the defendant's variable costs for that segment. *Id.* at 12. The Board announced that it planned to begin a rulemaking to consider a methodology to restore the focus on economies of density for future cases. *Id.*

B. Simplified Cases

Since the adoption of CMP, the agency has recognized that the expense of a SAC presentation to determine the reasonableness of rail rates may render the analysis infeasible for a subset of small cases, given the value of those cases. The ICC struggled to establish procedures that would balance the need for an economically sound analysis with the desire to limit the expense associated with proceedings at the agency. The ICC nonetheless rejected formulaic rate reasonableness analysis based solely on costs even for simplified cases. *South-West Railroad Car Parts v. Missouri Pacific R.R. Co.*, No. 40073 (ICC served March 16, 1987).

In the ICC Termination Act of 1995, Congress charged the Board with establishing "a simplified and expedited method for determining the reasonableness of challenged rail rates in those cases in which a full stand-alone cost presentation is too costly, given the value of the case." 49 U.S.C. § 10701(d)(3). In response to this directive, the Board adopted the guidelines set forth in *Rate Guidelines – Non-Coal Proceedings*, 1 S.T.B. 1004 (1996) (*Simplified Guidelines*), and made significant changes to those guidelines in *Simplified Standards for Rail Rate Cases*, EP 646 (Sub-No. 1)(STB served Sept. 5, 2007) ("*Simplified Standards*"). In that decision, the Board adopted a two-tiered simplified process with limits on relief for each methodology. *Simplified Standards*: (1) created a simplified stand-alone cost (Simplified-SAC) procedure to use in medium-sized rate disputes for which a full stand-alone cost (Full-SAC) presentation is too costly, given the value of the case; and (2) modified the "Three-Benchmark" rate comparison method of *Simplified Guidelines*, with certain adjustments, for the smallest disputes. Because of the imprecision associated with the simplifying assumptions used in Simplified SAC and the even greater imprecision associated with the use of rate comparisons in the Three-Benchmark method, the Board established limits on relief (both reparations and prescriptive relief) based on the cost of bringing the next more complicated type of case. Relief in a Simplified-SAC case was limited to $5 million over five years based on an estimate of the cost to bring a Full-SAC case. Three-Benchmark cases were limited to $1 million over five years based on an estimate of the cost to bring a Simplified-SAC case. Both limits were indexed for inflation. But the Board stated it would only change those limits after receiving additional evidence regarding the costs to bring the next more complicated type of case. *Simplified Standards,* at 31-32.

C. The Current Proceeding

In the NPR, the Board has now proposed six changes to its rate reasonableness process: (1) to remove the limitation on relief for cases brought under the Simplified-SAC alternative; (2) to improve the accuracy of the road property investment component of the Simplified-SAC test; (3) to double the relief available under the Three-Benchmark method; (4) to curtail the use of cross-over traffic in full stand-alone cost ("Full-SAC") cases; (5) to modify the approach used to allocate revenue from cross-over traffic in Full-SAC and Simplified-SAC cases; and (6) to raise the interest rate that the railroads must pay to complainants for, *inter alia*, reparations when the railroad has been found to have collected unreasonable rates.

As discussed more fully below, the AAR respectfully contends that there is no foundation for eliminating the limits on relief for Simplified-SAC cases, even if the Board improves the precision of the road property investment analysis. The Board should follow the process it announced in *Simplified Standards* to determine whether or not the limits on relief should be raised for Three-Benchmark and Simplified-SAC cases. The AAR commends the Board for recognizing that cross-over traffic is a simplifying device that can introduce imprecision into the SAC analysis due to difficulties in revenue allocation. However, the Board should also recognize that shippers can manipulate the results produced by ATC to bias the outcome of a SAC analysis because they control the SARR design and traffic selection process. If the Board continues to allow shippers to rely on cross-over traffic and is unwilling or unable to eliminate shippers' ability to bias SAC results through the use of ATC, the Board would be justified in limiting the use of cross-over traffic in the ways it has proposed. Moreover, the AAR questions the need to depart from the revenue allocation methodology that the Board has adopted by notice and comment rulemaking on the basis of the illusory problem identified in *Western Fuels*. But to the extent the Board does depart from that methodology, the AAR supports the proposed rule as the best methodology offered to date to solve the perceived problem. Finally, the NPR's results-oriented proposal regarding interest charged on reparations should not be adopted.

Discussion

I. The Board Should Not Adopt its Proposal to Eliminate the Limit on Relief for Simplified SAC

The Board's statutory authority to develop simplified methodologies to determine the reasonableness of rail rates contemplates the use of simplified methods only in cases of limited value. The Board developed Simplified SAC expressly pursuant to its charge by Congress to develop simplified and expedited methods for determining the reasonableness of challenged rail rates "in those cases in which a full stand-alone cost presentation is too costly, given the value of the case" under 49 U.S.C. § 10701(d) (3). *Simplified Standards*, at 4. To comply with this mandate, the Board put reasonable limits on relief for the simplified methodologies to "encourage shippers with larger disputes to pursue relief under the more appropriate methodology without the Board itself trying to determine the likely value of a case. Instead, the complainant must evaluate its own claim, decide for itself the expected value of the case, and balance the value against the litigation costs and the potential relief it may receive." *Simplified Standards*, at 28. The Board concluded that placing reasonable limits on the relief available under both simplified approaches "strikes a reasonable balance between providing a simplified method that permits captive shippers to seek protections from unreasonable rates, while encouraging use of the most precise approach feasible for the amount in dispute." *Simplified Standards*, at 35.

The NPR now proposes to walk away from this balance and eliminate the limits on relief for Simplified SAC. In the NPR, the Board stated,

> We continue to believe that the Three-Benchmark approach should be reserved for small disputes where the litigant cannot justify the expense of a SAC analysis (either in Full or Simplified form). But if we improve the precision of the RPI components of the Simplified-SAC test, as discussed below, we cannot see any justification for continuing to curtail the relief where the analysis has detected that a carrier is abusing its market power and is earning more than a reasonable return on the replacement costs of the facilities being used to serve the captive shippers. In other words, regardless of the amount in dispute, the Full-SAC and Simplified-SAC approaches both appear to be an appropriate method to judge the reasonableness of the challenged rates, and there is no apparent reason to force the shipper to use the more expensive Full-SAC approach over the Simplified-SAC approach in cases where the shipper seeks more than $5 million in relief.

NPR at 14.

The Board should not remove the limits on relief for Simplified-SAC cases for three reasons. First, the proposed rule violates the relevant statute. The NPR ignores the language of the statute, which directed the Board to establish simplifications to CMP only in those cases "in which a full stand alone cost presentation is too costly." 49 U.S.C. § 10701(d)(3). Instead, the

Board suggests that the crude Three-Benchmark rate comparison approach should be used for "disputes where the litigant cannot justify the expense of a SAC analysis (either in Full or Simplified form)". NPR at 14. In so doing, the NPR appears to contend that Simplified SAC, with the road property investment analysis modified as proposed, would be sufficiently precise to be entitled to the same treatment as Full-SAC cases, in spite of the clear language of the statute, which specifically limits the use of alternatives to a "full stand alone cost" presentation.

Second, the assumptions underlying treating Simplified SAC as "good enough" to be accorded the same relief as full SAC are flawed. The Board has repeatedly held that "CMP, with its SAC constraint, is the most accurate procedure available for determining the reasonableness of rail rates where there is an absence of effective competition." *Simplified Standards*, at 13 (citing *Simplified Guidelines*, 1 S.T.B. at 1021).

The imprecision inherent in the simplifications built into Simplified SAC cannot be expected to yield exactly the same results as a Full-SAC analysis, even if road property investment is made more precise. While changing the road property analysis would help increase the precision of Simplified SAC, that change would not be sufficient to justify eliminating limits on relief because there are other factors that introduce imprecision into a Simplified-SAC analysis. For example, Simplified SAC relies heavily on URCS system average costs to establish operating expenses. Moreover, Simplified SAC is based on a one-year analysis, whereas a Full-SAC case considers the revenue necessary to recover the replacement cost of the needed infrastructure, including a contribution to joint and common costs and a return on investment, over a ten-year period. These simplifications were defensible for cases of limited value, in keeping with Congress's directive in ICCTA, but they do not support the use of Simplified SAC as an unlimited substitute for Full-SAC and CMP.

Beyond the imprecision of Simplified SAC, *Simplified Standards* placed a heavy procedural burden on railroads in the form of a "second disclosure" in Simplified-SAC cases. *Simplified Standards,* at 25. In Simplified-SAC cases, railroads are required to provide:

- Identification of all traffic that moved over the routes replicated by the SARR in the Test Year;
- Information about those movements, in electronic format, aggregated by origin-destination pair and shipper, showing the origin, destination, volume, and total revenues from each movement;
- Total operating and equipment cost calculations for each of those movements, computed in accordance with the Board's methodologies, and provided in electronic format, so the complainant can readily estimate the total operating and equipment costs of the SARR;
- Revenue allocation for the on-SARR portion of each cross-over movement in the traffic group, developed in accordance with the methodology used in Full-SAC cases, provided in electronic format;
- Total trackage rights payments paid or received during the Test Year associated with the route replicated by the SARR;
- All workpapers and documentation necessary to support these calculations.

The Board originally justified placing the burden on the railroad to develop evidence for the shipper in keeping with the simplified nature of the case. *Simplified Standards for Rail Rate Cases*, EP 646 (Sub-No.1)(STB served July 10, 2006) slip op. at 10 ("*Simplified Standards NPR*"). But the Board's proposal to eliminate the limit on relief untethers the burdens on railroad defendants to any reasoned justification. If the Board removes (or significantly increases) the cap on relief in Simplified SAC, it must also shift the burden to the complainant to build its own case, based upon discovery produced by the railroad.[4] The railroad should be under no obligation to build the complainant's case or large portions of it, as is currently required by the onerous second disclosure.

Indeed, this current procedural structure, coupled with no limits on relief, could expose railroads to frivolous complaints and expensive discovery fishing expeditions, as recognized by

[4] Case by case consideration of requests to extend procedural schedules, as proposed in the NPR, would not alleviate this concern.

the Board. *See Simplified Standards*, at 68. Under the current rules, the railroad essentially must put together the shipper's case for it, in the form of the second disclosure, with little to no cost to the complainant. Shippers could use this extensive burden on the railroads as inappropriate bargaining leverage during contract negotiations, forcing railroads to undergo the cost of the second disclosure before shippers even decide whether the case is worth pursuing. In contrast to the Board's discussion of the issue in *Simplified Standards*, the discovery burdens in Simplified SAC are not analogous to the burdens in a Full-SAC case. Instead, because of the simplification requirements of Simplified SAC regarding traffic and facilities, the railroads are required to "disclose" all of the information necessary to calculate the revenue side of the SAC analysis, including the cross-over traffic allocation. The only protection that the Board offered in *Simplified Standards*, a higher filing fee to prevent frivolous claims, has already been removed by subsequent Board action. [5] A cap on relief in Simplified-SAC cases is the only real deterrent to preventing this type of abuse.

II. The Board Should Follow the Procedure it Announced in *Simplified Standards* to Consider Whether to Raise the Limits on Relief for Simplified-SAC and/or Three-Benchmark Cases

As stated above, the Board in *Simplified Standards* created eligibility standards for using simplified rate reasonableness methodologies based on a small claims, limit-to-relief, model. The agency did so because the statute requires that the use of non-SAC methodologies be limited based on "the value of the case." 49 U.S.C. § 10701(d)(3). The Board based the limits on relief

[5] The Board originally indicated in *Simplified Standards,* at 68, that the $10,000 filing fee would protect the railroads from this type of abuse. The filing fee has since been lowered to $350. However, given the extensive burden on the railroad from the second disclosure, even the $10,000 filing fee would be insufficient to protect against abuse by shippers. If the Board removes the cap on relief, the only appropriate remedy would be to shift the burden to shippers to construct their own case, based upon normal discovery produced by the railroads.

for Simplified-SAC and Three-Benchmark cases on the estimated cost for complainants to bring the next more complicated type of case. The $5 million limit for Simplified SAC was based on an estimated cost to bring a Full-SAC case and the $1 million limit for Three-Benchmark cases was based on the estimated cost to bring a Simplified-SAC case.

The Board expected those costs to decline over time, as other reforms took effect. The Board stated, "[t]hese cost estimates are based on the best evidence of record. As cases are brought under these two approaches, actual litigation costs will become available, and over time we will observe whether the reforms of *Major Issues* have had the desired effect of reducing litigation costs in Full-SAC cases. At that time, parties may petition the Board to adjust the limit on relief as needed, assuming they provide detailed litigation cost estimates." *Simplified Standards,* at 31-32.

Yet now the NPR would raise the limit on Three-Benchmark cases to $2 million without any evidence of record demonstrating the costs of a Simplified-SAC presentation. Instead, the Board reasoned that its proposed changes to road property investment would increase costs to complainants because the Board had once noted that developing road property investment is "expensive." NPR at 15 (citing *Simplified Standards*, at 39). The Board further supposed that Simplified SAC should be less than half the cost to bring a Full-SAC case, estimated in *Simplified Standards* at $5 million. The Board then arbitrarily proposed to raise the limit to $2 million. The AAR cannot meaningfully comment on the proposal without an evidentiary basis for the Board's conclusion regarding the costs to bring a Simplified-SAC case. If the Board is concerned that the levels of relief do not correspond with the cost to bring the next more complicated type of case, it should follow the procedures it announced in *Simplified Standards* and build a record based on verified statements and discovery so that it can set an accurate limit on relief.

III. Crossover Traffic Is a Simplifying Assumption That Can Introduce Imprecision Into the Analysis Due To Difficulties with Revenue Allocation. Such Imprecision Would Justify the Board's Proposed Limitations

For many years, complainants have relied extensively on the use of "cross-over" traffic to make their Full-SAC presentations." *Major Issues,* at 24. In allowing the use of cross-over traffic, the Board has stated that it seeks "to make the analysis more manageable without introducing bias," *id.* at 24, and has sought to establish a revenue allocation method that would approximate the outcome of complete SAC analysis where a complainant modeled the entire system necessary to serve the selected traffic group. However, the Board has recognized that the use of this simplifying assumption introduces imprecision into the SAC analysis." *Xcel Recon.*, at 7.

History shows that the Board can expect the overwhelming majority of the total revenues of SARRs posited in future cases, and therefore the outcome of those cases, to be determined by how the Board allocates revenue from cross-over traffic, so it is important that the Board try to be as precise as possible in mimicking the outcome of a complete SAC analysis. The Board has concluded that the best way to do that is to calculate the average total costs of the on-SARR and off-SARR segments and allocate revenues based on those calculations, though the Board has continued to struggle with aspects of implementing that conclusion. *See, e.g., Major Issues*, at 25 (citing *Duke/NS* at 18-20); *Western Fuels*. The NPR expresses concerns that carload traffic, as opposed to traffic that moves in unit trains, poses a particularly difficult challenge for allocating revenue from cross-over traffic. NPR at 16. Because of the increased costs associated with carload traffic, the Board recognized that "[t]here is a disconnect between the hypothetical cost of providing service to these movements over the segments replicated by the SARR and the revenue allocated to those facilities." *Id.* Under the current rules, complainants are seemingly allowed to assume that their SARRs can handle carload traffic for a short distance as a unit train, pushing the costs of assembling and delivering the carloads onto the residual defendant. The revenue allocation methodology would allocate the revenue from those movements to the SARR as if it bore those costs as single-car or multi-car movements, rather than the more efficient, lower cost trainload movements that they would be for the SARR. As a result, the Board would allocate more revenue to the facilities replicated by the SARR than is warranted.

If the Board continues to allow shippers to rely on cross-over traffic and the Board is unwilling or unable to eliminate shippers' ability to bias SAC results through the use of ATC, then the Board would be justified in placing reasonable limitations on the use of cross-over traffic to prevent the most obvious cases of distortion to the analysis. The NPR proposes two such limitations to avoid this distortion: (1) restricting the use of cross-over traffic to movements for which the SARR would either originate or terminate the rail portion of the movement; or (2) restricting the use of cross-over traffic to movements where the entire service provided by the defendant railroad in the real world is in trainload service. In addition, the AAR respectfully requests that the Board consider a third limitation.

Restricting the use of cross-over traffic movements for which the SARR would either originate or terminate would allow the SAC analysis to include more of the services being provided by the defendant railroad in the real world and rely less on URCS and the revenue allocation methodology. This would reduce the need for the revenue allocation methodology to be adjusted to account for the costs of originating or terminating a movement, an issue the Board has struggled with going back to its mileage based allocation methodologies. Similarly, restricting the use of cross-over traffic to movements where the entire service provided by the defendant railroad in the real world is in trainload service would avoid the resulting problems with allocating the revenues for this traffic. Both limitations should be adopted as alternatives. In other words, the Board could require complainants to make a choice in selecting cross-over traffic: either (i) use only movements where the entire service provided by the defendant railroad in the real world is in trainload service; or (ii) use only movements for which the SARR would either originate or terminate the rail portion of the movement. In this way, the Board could better ensure that the revenue allocation process is not distorted by a failure to account for the costs associated with serving carload traffic.

Finally, the treatment of carload traffic is not the only problem associated with cross-over traffic. Because the Board has generally upheld the use of cross-over traffic as a simplifying device, complainants have been allowed to push the envelope with only the justification of more favorable results and without regard for principled rate-making. In a pending case, the complainant has sought to do so allowing the SARR to carry traffic for several discrete segments, handing the traffic back to the incumbent multiple times including segments within the geographic footprint of the SARR network. The parties refer to such traffic as "Leapfrog" trains, because the traffic leaps on and off the SARR network. *See* Norfolk Southern Railway Motion to Hold Case in Abeyance Pending Completion of Rulemaking, NOR 42125 (filed Aug. 6, 2012). Such modeling shortcuts are ripe for abuse. For example, a complainant could propose a SARR that did not construct any tunnels. Instead, it would hand the traffic to the incumbent for the length of the tunnel only as a cross-over segment. Because the slippery slope to abuse of Leapfrog trains is steep, and the Board should adopt a common sense based rule that only allows one "cross-over" per movement for those instances in which "cross-over" traffic continues to be permissible.

IV. The Board's Proposal for Allocating Revenue from Cross-Over Traffic Would Solve the Perceived Problem with ATC

In the first instance, the AAR respectfully submits that the Board's efforts to modify the ATC methodology adopted by notice and comment rulemaking and upheld on appeal[6] have been misguided. The Board concluded in *Western Fuels* that it was necessary to modify ATC to address instances where it would not have allocated revenues to the SARR portion of a movement that were sufficient to cover the defendant railroad's URCS variable costs for that portion of the movement because such a result was "illogical." *Western Fuels*, at 14.

The fact that a segment of a movement in a SARR traffic group would not be allocated revenue sufficient to cover the incumbent's variable costs for that segment is immaterial to the proper allocation of revenue from crossover traffic for three reasons. First, such a result for some movements is consistent with the expected outcome of a complete SAC analysis for that traffic and complainants are free not to include that traffic in the SARR's traffic group. Second, whether or not a given segment is allocated revenue to cover variable costs is not a meaningful inquiry, in and of itself. Third, even if it were a relevant inquiry, the fact that a given segment would not be allocated enough revenue to cover the defendant's URCS variable costs, rather than the SARR's variable costs, is not the proper inquiry.

There is nothing illogical about the SARR receiving proportionally less revenue for low-rated traffic where the average total costs of the on-SARR segment are less than the average total costs of the off-SARR segment. If the fundamental assumption underlying ATC (that a revenue

[6] *See BNSF Railway Co. v. Surface Transportation Board*, 526 F.3d 770, 782 (D.C. Cir. 2008).

allocation methodology based on the proportion of average total costs of the segments will approximate the outcome of a complete SAC analysis) is correct, this result would be expected. The Board has never articulated a rationale why the governing assumption of ATC should not be expected to hold true for low-rated traffic.

The fact that a segment is allocated revenue less than variable cost is not, in and of itself, very meaningful. The Board has held that "an R/VC ratio below 100% does not necessarily reflect improper pricing or money-losing service." *Simplified Standards*, at 21; *see also B.P. Amoco Chemical Co. v. Norfolk Southern Ry.*, NOR 42093, slip op. at 9 (STB served June 6, 2005). In part, this is so because of the structure of URCS. The Board has recognized that "URCS costs may include a significant portion of what may actually be unattributable joint and common costs." *Simplified Guidelines*, at 1027. A movement generating revenue below 100% of URCS variable costs may still be contributing to unattributable joint and common costs and would therefore be worthwhile for the SARR to haul. Moreover, the significance of a segment of that movement, in contrast to the origin to destination movement as a whole, generating revenue below URCS variable costs is even more questionable as URCS is designed to calculate the intermediate system average variable costs for a particular movement of rail traffic, not to allocate costs to any identifiable length of track.

Even if revenues being allocated to a segment at an amount less than URCS variable costs were significant, the focus on the defendant's costs reveals little about whether the traffic would contribute to the joint and common costs of the SARR. A SARR posited by a complainant is the hypothetical, most-efficient replacement for the incumbent. As such, there is no reason to suspect that the URCS costs of the incumbent for a particular segment would mirror the costs of the SARR. Indeed, because the complainant need not include the traffic, the fact that low rated traffic is included at all suggests that the costs associated with the SARR's handling of the traffic would be lower than the incumbent's. That would indicate that the traffic should, in fact, contribute to the SARR's joint and common costs. To find out, the proper inquiry should be whether the allocation covers the SARR's variable costs of handling the traffic, rather than focusing on the defendant's URCS costs for a segment.

AAR does not believe any amendment to ATC is necessary. To the extent that the Board is determined to amend ATC despite the illusory nature of its concerns, the Board's proposal to modify its ATC methodology is reasonable. It is the most reasonable solution offered to date to solve the perceived problem. Moreover, the proposed methodology is narrowly tailored to solve the problem identified: that the allocation method does not drive any segment below the defendant's variable costs for that segment, as calculated by the Board.

The proposed methodology would have two steps. First, using the URCS variable and fixed costs for the carrier, and the density and miles of each segment, parties would calculate the railroad's average total cost per segment of a move. The total revenues from each portion of the movement would then be allocated in proportion to the average total cost of the movement on- and off-SARR. This first step would thus follow the original ATC proposal adopted in *Major Issues*. A second step would then be performed to ensure that the revenue allocated to both the facilities replicated by the SARR and those of the residual defendant carriers would not be driven below the defendant's URCS variable costs for the movement over those segments. If the revenue allocation to the on-SARR (or off-SARR) segment would result in revenues falling below URCS variable costs for that segment, the revenue allocation to the on-SARR (or off-SARR) segment would then be raised to equal 100% of the defendant's URCS variable costs of providing service over that segment. If the total revenue from the cross-over movement were below the Board's measure of total variable cost for the entire movement, revenue would be allocated between the two segments to maintain the existing total R/VC ratio on both segments.

The proposed methodology would take into account the economies of density in the railroad industry by focusing on total, as opposed to variable costs. The proposed methodology would also be narrowly focused on those movements that may cause the result of driving the revenue allocation on any segment below variable costs, in contrast to the existing "modified ATC" approached used by the Board in the *Western Fuels* case, which affects even high-rated traffic. The approach adopted in *Western Fuels* systematically biases the high-density segments apportioning them a larger share of revenues. To the extent the Board continues to perceive a problem with ATC's allocation of revenues below variable costs in some instances, the proposed methodology in the NPR is the best solution to that problem offered to date.

V. The Board Should Not Adopt its Results-Oriented Proposal Regarding Interest on Reparations

The Board should not adopt its proposal with regard to the interest rate applicable to reparations. The current practice of calculating interest based on "the coupon equivalent yield (investment rate) of marketable securities of the United States Government having a duration of 91 days (3 months)", 49 C.F.R § 1141.1(a), reflects a rule established pursuant to notice and comment rulemaking and based on sound economic and adjudicative principles. It should not be changed to reach a results oriented goal of simply raising the rate. *See* NPR at 18 ("We are concerned that the T-Bill rate (currently at (0.10%) may be insufficient.").

Prior to 1976, the ICC generally imposed a simple four percent interest rate on reparations awards in railroad rate proceedings. *See Farmers Export Co. v. United States*, 757 F.2d 733, 737 (D.C. Cir. 1985). In the Railroad Revitalization and Regulatory Reform Act of

1976, as amended by the Staggers Rail Act of 1980, Congress adopted specific provisions for the calculation of interest rates applicable for rail rate investigation proceedings. Those provisions required interest to be paid on reparations awards "at a rate equal to the average yield (on the date the statement [of account] is filed) of marketable securities of the United States Government having a duration of 90 days." *See* Former 49 U.S.C. 10707(d)(1) and (2) (1995). In implementing regulations adopted in 1977, the ICC adopted the 90-day Treasury Bill rate as the applicable interest rate to be used in investigation proceedings as required by statute. The ICC also made the 90-day Treasury Bill rate generally applicable to all other rail proceedings which reparations may be awarded as "a neutral, surrogate measure of the time value of money, applicable equally to all complainants in reparations proceedings, is accordingly both necessary and appropriate." *Revised Procedures to Calculate Interest Rates*, 42 Fed. Reg. 20701 (April 21, 1977).

In 1992, the ICC considered revising the interest rates applicable to reparations in complaint cases because, the ICC asserted, it "often understates the opportunity cost of capital (market rate of return to which the lender is entitled.)" *Revision of Procedures to Calculate Interest Rates* ANPR at 3 (Feb. 5, 1992) (57 Fed. Reg. 4594). But, based on the record compiled, the ICC concluded that it should not do so. The ICC found that "the 13-week Treasury Bill yield offers several advantages . . . First, and perhaps most important, it is a universally–accepted short-term baseline opportunity cost rate for all companies, regardless of industry." *Procedures to Calculate Interest Rates*, 9 I.C.C.2d 528, 534 (1993).

Though the statutory interest rate was removed by the ICC Termination Act of 1995, the rationale for use of the 90-day Treasury Bill has not changed. The 90-day Treasury Bill is widely accepted as a measure of a risk free rate of return. Indeed, the ICC recognized the three-month Treasury Bill rate as "a standard risk free investment used by our Commission and by numerous other entities." *Railroad Cost Recovery Procedures*, 1 I.C.C.2d 207, 213 (1984). The Board also currently uses the 90-day Treasury Bill rate to calculate a similar opportunity cost related to labor costs recognized in advance of actual settlements for purpose of calculating the quarterly Rail Cost Adjustment Factor. *See Railroad Cost Recovery Procedures*, EP No. 290 (Sub-No. 2) (ICC served June 20, 1988) slip op. at 16 ("We believe that the interest rate paid should be that of three month Treasury Bills because they are virtual risk free investment, available to shippers and railroads alike."). Similarly, when the Board needed to calculate a risk free rate as part of the beta calculation in the Capital Asset Capital Asset Pricing Model (CAPM) used to calculate the railroad industry cost of capital, it utilized the three month Treasury Bill rate. *See Methodology to Be Employed in Determining the Railroad Industry's Cost of Capital,* EP 664, slip op. at 11 (STB served Jan. 17, 2008).

The NPR proposes to replace the 90-day Treasury Bill with the U.S. Prime Rate. The only rationale offered for the change is that the Prime Rate, currently 3.25%, is higher. The NPR notes that the Prime Rate is "the interest rate that banks charge to their most creditworthy customers." NPR at 18. Thus, rather than being a risk-free rate, the Prime Rate is a higher risk rate, albeit still generally low risk, that banks charge low credit risk customers for short term loans. In contrast, reparation payments generally result from a Board determination that a complainant has made an overpayment on a current liability (transportation charges), which involves the use of short-term working capital funds. Reparation payments represent an essentially risk-free "investment" of funds because the funds involved in reparations proceedings are analogous to idle funds that corporations keep in short term government securities, certificates of deposits or a money market account. As such, the T-Bill rate is the appropriate benchmark.

Today's marketplace for short term government securities, certificates of deposits or a money market accounts have established rates that are at historic lows. But that is the reality of the marketplace caused by many macro-economic factors and federal policies. The 90-day Treasury Bill has ranged has high as 14.03 % in 1981. *See* Economic Report of the President, Appendix B, Table B-73 (2012). The Board should not adopt the proposed change to simply substitute its judgment for that of the marketplace for what an appropriate risk free rate should be.

Conclusion

The AAR commends the Board for trying to improve its rate reasonableness process. Any changes to that process should be grounded first to the fundamental principle of rail rate regulation that railroads must be allowed to establish rates based on demand-based differential pricing. With regard to the specific proposals discussed above, the AAR respectfully submits that the Board should not remove the limit to relief for Simplified-SAC cases. Instead, if the Board is concerned about the levels of relief established in *Simplified Standards*, the Board should follow the process it announced in that rulemaking proceeding. The AAR commends the Board for recognizing that cross-over traffic introduces imprecision into the SAC analysis due to difficulties in revenue allocation. If the Board continues to allow shippers to rely on cross-over traffic and the Board is unwilling or unable to eliminate shippers' ability to bias SAC results through the use of ATC, the Board would be justified in limiting the use of cross-over traffic in the ways it has proposed. The Board should consider the merits of its original ATC methodology to allocate revenue from crossover traffic. But to the extent the Board concludes that ATC must be modified due to the alleged problem announced in *Western Fuels*, the AAR supports the proposed rule as the best methodology offered to date to solve the perceived problem. Finally, the NPR's results-oriented proposal regarding interest charged on reparations should not be adopted.

Respectfully submitted,

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