231652

BEFORE THE

SURFACE TRANSPORTATION BOARD

EX PARTE NO. 712

IMPROVING REGULATION AND REGULATORY REVIEW

COMMENTS OF
ALLIANCE FOR RAIL COMPETITION
MONTANA WHEAT & BARLEY COMMITTEE
COLORADO WHEAT ADMINISTRATIVE COMMITTEE
IDAHO BARLEY COMMISSION
IDAHO WHEAT COMMISSION
MONTANA FARMERS UNION
NEBRASKA WHEAT BOARD
OKLAHOMA WHEAT COMMISSION
SOUTH DAKOTA WHEAT COMMISSION
TEXAS WHEAT PRODUCER BOARD
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The Alliance for Rail Competition and the agricultural interests identified on the cover (hereafter collectively "ARC") welcome the opportunity to file comments in this proceeding. We recognize that, in similar proceedings before other agencies, the focus is likely to be on instances of excessive or unnecessary regulation, which may be counterproductive or may impose costs that are out of proportion to benefits. ARC believes that there are regulations, particularly in the areas of health, security and the environment, that are excessive.

The STB, in contrast, engages primarily in economic regulation, and is charged by Congress with balancing the need of the railroad industry for adequate revenues with the need of captive shippers for protection against abuses of railroad power, as well as the need of all shippers for reasonable railroad practices, including car supplies, interchanges, and common carrier service. The railroad industry, like trucking, ocean shipping, and air transport, is important not in itself but because its services support the larger U.S. and global economies.

ARC fully expects railroads to claim in this proceeding that they are overregulated, but it is difficult to identify any legitimate interests that major railroads have been prevented from pursuing due to STB prohibitions. Given the immunity from antitrust claims by captive customers that railroads enjoy under the Keogh doctrine, and federal preemption of state regulation under 49 U.S.C. § 10501, railroads are the least regulated industry in the U.S., among industries enjoying significant market power.

That market power is also unparalleled in many states, regions and market segments, such as grain, coal and other bulk commodities for which service by Class I railroads is required. The fact that more than 90% of rail freight is controlled by just four railroads, two in the East and two in the West, is indicative of extreme market power. The major Class Is have largely neutralized potential competition from Class II and Class III railroads through paper and steel barriers and through the commercial leverage they have over whether a short line will survive. Competition among Class Is is limited due to factors such as the Bottleneck decisions and the Mid-Tec case.

The result of all this is that for many captive shippers, there is an absence of effective competition, an absence of effective regulation, and no recourse under the antitrust laws. Large numbers of captive shippers, especially if they are small and/or isolated, as is the case with many ARC members, are essentially powerless in dealing with railroads. Having no legal leverage amounts to having no commercial leverage in negotiations, so private sector solutions are also ineffective.

ARC does not mean to suggest that all rail shippers are captive. Obviously, some shippers have truck or other transportation alternatives. Some shippers benefit from rail-to-rail competition, though conscious parallelism and refusals by major railroads to compete mean that, in many instances, there remains an absence of effective competition, and recourse to STB regulation remains necessary.

Nor does ARC mean to suggest that ICC and STB regulation have never benefited shippers. On occasion, the Board has ordered relief from unreasonable rates or practices. However, STB regulations and precedents reduce the effectiveness of such protections as the Act provides. As a result, the level playing field that captive shippers need is too often more apparent than real. There may be a theoretical remedy shippers could invoke, but the remedies are so costly or so burdensome or so unlikely to produce results that shippers feel remediless.

These problems are compounded by the fact that railroads generally face no penalties for violating the Act. At worst, they must cease the violations, or return the amount of their rates that exceeded a lawful maximum. This may restore the status quo ante, but generally does not make the shipper whole, let alone deter railroad violations at other times and places. The captive shipper does not recover attorneys' fees,[1] or the commercial harm that resulted from excessive rail rates, even if the shipper "wins" a rate case.

To the extent that these limits on relief are required by statute, the resulting benefits to market dominant railroads cannot be remedied by the STB. However, these railroad advantages make it all the more important for the Board to improve the effectiveness of such recourse as Congress directed or permitted it to provide. In particular, ARC calls on the Board to improve regulatory effectiveness and reduce undue burdens of regulation in the following areas.

Revenue Adequacy Standards and Remedies

ARC believes that the ineffective and burdensome nature of too much STB regulation is largely attributable to the revenue adequacy standards adopted by the ICC and continued (though under changed cost of capital rules) by the STB. For decades, the agency has given the benefit of the doubt to monopoly railroads rather than captive shippers, and these decisions appear to have been influenced by the fear of adverse impacts on railroads' financial health if rate relief is available to more than a few large shippers.

Captive shippers have complained for years that existing revenue adequacy standards are far too generous to railroads, finding their revenues inadequate and leading to minimal or no economic regulation, even as railroad finances have improved. As a result, the last 24 words of 49 U.S.C. § 10701(d)(2) have come to play a disproportionate role in rulemaking proceedings and rate cases.

[1] There is a provision for recovery of attorneys' fees in 49 U.S.C. Section 11704(d), but it applies only to cases in which the shipper goes to court to enforce a Board order for the payment of money. It has rarely, if ever, been used, and is certainly not a deterrent to railroad violations of the Act.

The Board needs to recognize, as Warren Buffett, Wall Street, and the Class Is themselves do, that revenue inadequacy is no longer a problem for major railroads, which have learned to price their services for captive and competitive customers in such a way as to have no difficulty attracting investment and capital.

While acknowledging the revenue adequacy of major railroads is necessary, it is not sufficient, because the ICC and Board have never explained exactly how recognition of revenue adequacy would help captive shippers.

For 26 years, the ICC and STB have begun rate case decisions by describing Constrained Market Pricing, with its SAC and revenue adequacy constraints (of which the management inefficiency constraint is a subset), and then stating that the shipper has elected to proceed under SAC, as if the shipper had any choice.

For 26 years, the ICC and STB have described the revenue adequacy constraint more or less as follows: "The revenue adequacy constraint ensures that a captive shipper will not be required to continue to pay differentially higher rates than other shippers when some or all of that differential is no longer necessary to ensure a financially sound carrier capable of meeting its current and future service needs.'"[2]

The revenue adequacy constraint, such as it is , is described in cursory terms in the ICC's decision in Coal Rate Guidelines, Nationwide, 1 I.C.C. 2d 520, 534-37 (1985), aff'd. Consol. Rail Corp. v. United States, 812 F.2d 1444 (3d Cir. 1987). At that time, a few sentences outlining the conceptual basis for a revenue adequacy constraint may have been acceptable. Even under a revenue adequacy standard shippers would support, it is likely that most Class I railroads would have been found revenue inadequate in the mid-1980s. Today, however, more is needed.

[2] See the Board's decision served November 22, 2011 in Docket No. 42113, Arizona Electric Coop v. BNSF, at p. 4.

For example, the revenue adequacy constraint speaks of achieving revenue adequacy, or achieving "long term" revenue adequacy. What happens at that point is too vague, as is the meaning of "long term," but what happens when railroads exceed revenue adequacy? Should relief under the constraint include restoration of a share of that excess, or does the Board intend to allow more differential pricing, and for longer, than is necessary to insure a sound carrier?

Assuming that, at some point, the Board actually constrains any rates based on the revenue adequacy constraint, will the constraint apply only to rate increases, or will it apply to base rates if, for example, application solely to rate increases will not prevent a continued trend toward higher and higher revenues in excess of adequacy?

The discussion in Coal Rate Guidelines, supra, at p. 535 suggests that the procedural effect of invoking the revenue adequacy constraint will be to shift certain burdens from shippers to the railroad. Assuming a shipper successfully invokes the constraint in a case against a railroad, will that decision have precedential effect in subsequent cases?

Small shippers may find that the costs of bringing even a follow-up case are too high, assuming a railroad that loses a case develops new evidence in subsequent cases. Will the Board accept rate challenges brought by a group of similarly situated smaller shippers?

These and other questions could be answered on a case by case basis in rate cases brought against individual railroads, but that process would take years. In the meantime, rate regulation based on attaining or exceeding revenue adequacy would be ineffective and excessively burdensome. The time has come for the Board to begin working on these and related issues.

Relief Caps in "Simplified" Rate Cases are Too Low

In Simplified Standards for Rail Rate Cases, the Board acknowledged that the rate case methodology it had adopted in Rate Guidelines – Non-Coal Proceedings, 1 S.T.B. 1004 (1996), pursuant to Congressional mandate in 49 U.S.C. § 10701(d)(3), had been ineffective. Over the course of a decade, only two shippers, both large companies, had invoked the methodology the Board had adopted in 1996, and both cases were settled without formal proceedings or evidentiary filings.[3]

As a result, non-coal shippers and coal shippers for whom "a full stand-alone cost presentation is too costly, given the value of the case," were essentially without a means of challenging excessive rates by monopoly railroads for the quarter-century stretching from the end of the "Section 229" rate cases brought in 1980 and 1981 after enactment of the Staggers Act, to 2007. Unfortunately, since 2007, the Board's Simplified SAC and Three Benchmark approaches have proved successful for very few shippers (again, mostly large corporations with deep pockets).

One of the problems with these simplified approaches is that they are subject to excessively low relief caps. A successful shipper using the Three Benchmark approach is limited to maximum relief (reparations and rate reductions) of $1 million over 5 years, and a successful shipper using SSAC can receive no more than $5 million over 5 years. These amounts must be reduced further to account for litigation costs, estimated by the Board to be $250,000 for Three Benchmark and $1 million for SSAC (i.e., roughly one-year's worth of relief).

These limits are simply too low to offer adequate relief to many captive shippers, particularly given railroads' ability to make sure that rate gouging remains profitable even if the shipper "wins." If a railroad overcharges a shipper by $10 million over a 5-year period, the best a shipper under SSAC can recover is half of the unlawful amount collected by the railroad; the railroad keeps the other $5 million, notwithstanding a Board finding of unlawful and excessive rates. For

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[3] See STB Ex Parte No. 646 (Sub-No. 1), Simplified Standards for Rail Rate Cases, decision served September 5, 2007, at p. 4, n. 2.

a Three Benchmark shipper, the imbalance would be even greater, since the railroad would be able, with Board approval, to keep nine dollars of every ten dollars in overcharges.

In Simplified Standards, the Board justifies this by analogy to small claims court, but small claims courts are subject to no statutory mandate comparable to 49 U.S.C. § 10701(d)(2), which provides that rates charged where market dominance is present "must be reasonable." The Board should revisit and eliminate its relief caps for simplified rate cases.

The Three Benchmark Process is Too Easily Neutralized

Excessively low relief caps are not the only obstacle to effective rate regulation for captive shippers who find Full-SAC prohibitively expensive. The Three Benchmark test, which is likely to be the only affordable test for the smallest captive shippers, including many shippers of agricultural commodities and shippers that qualify as small businesses, is too susceptible to railroad gaming.

The Three Benchmark test is essentially a comparable rates test, though the Board has adopted objective subsidiary standards designed to avoid undermining railroad revenue adequacy. Under such an approach the comparison group is critical to success, and railroad defendants devote extensive efforts and resources to arguing in favor of a comparison group with rates similar to or higher than the challenged rates.

In fact, railroads will often be in a position to guarantee that no comparison group can be found with lower rates. All the railroad has to do is raise the rates of all similarly situated shippers in a region, and any threat of rate reductions under Three Benchmark is neutralized. Such defensive action is particularly likely in the West, where a single railroad may dominate a State or growing area. Indeed, market dominant railroads often defend their own decisions to spread high rates around equally among captive shippers. Such pricing may be more fair than pricing favoring some shippers over others, but one result may be ineffective rate regulation under the Three Benchmark test.

The Three Benchmark test is a weak limit on rail rates in the best of circumstances, inasmuch as it produces maximum lawful rates that may exceed the threshold of STB jurisdiction by 100 percentage points or more.[4] The Board could and should improve the effectiveness of this form of rate regulation by adopting measures that address railroad gaming that prevents the possibility of a meaningful comparison group.

Excessive Railroad Charges and Cost Shifting

Though there are weaknesses in STB regulation of excessive rail rates for captive traffic, some of which are identified above, the STB has arguably tried to offer regulatory recourse to captive shippers who believe their rates are too high.

With few exceptions, the ICC and STB have provided little or no protection against excessive railroad charges, or against railroad decisions to shift costs and burdens to captive shippers that were formerly covered by line-haul rates. Captive shippers, including members of ARC, have seen a proliferation of ancillary or accessorial charges, and repeated instances of shifts of costs and burdens from railroads to shippers.

ARC acknowledges that the Board offered some relief from excessive fuel surcharges when it held, in Ex Parte No. 661, Rail Fuel Surcharges, decision served January 26, 2007, that it is an unreasonable practice for railroads to impose fuel surcharges with no "real correlation" to fuel cost recovery. ARC also welcomed the Board's denial of UP's motion to dismiss in Dairyland Power Coop v. Union Pacific, decision served July 29, 2008.

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[4] See US Magnesium, LLC v. UP, Docket No. 42114, decision served January 28, 2010, in which prescribed rates, despite significant reductions, remained above 300% of variable costs.

There are, however, many other charges imposed by railroads, and the Board has provided no guidance concerning when those charges are too high.[5] As a result, many shippers have concluded that their only recourse is to file an unreasonable practice complaint challenging the charge as inherently unreasonable, without challenging the level of the charge.

There are situations in which this may be appropriate. For example, many shippers have argued that railroads routinely demand, in industrial sidetrack agreements, that shippers must indemnify the railroad against claims arising out of the railroad's own negligence or willful misconduct. An unreasonable practice complaint would appear appropriate as to such a demand.

However, there are cases in which railroads use high charges to force shippers to assume new burdens. When such charges arguably become excessive, regulatory recourse should be available. However, a shipper challenge to the level of a charge is likely to be met with a railroad argument that recourse is unavailable without a showing of market dominance.

In many instances, this showing could be made, though the added cost makes challenges less cost-effective. However, there is a further obstacle to relief. Assuming market dominance should be shown and is shown, what standard will the Board use to assess a challenge to the level of that charge? Full-SAC, SSAC and Three Benchmark were never intended for use in assessing charges, as opposed to rates. Is it enough to show that there is no "real correlation" between the charge and the cost of the service for which the charge is levied? If not, are ancillary or accessorial charges to be unregulated profit centers for railroads, subject to relief only if a captive shipper challenges the charge in the course of litigating a broader rate case? If so, will the Board order excessive charges reduced to levels approximating costs? Today, STB regulation of rail charges is not effective.

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[5] Demurrage charges are an exception. See Docket FD 35406, Portland & Western Railroad, Inc. – Petition for Declaratory Order, decision served July 27, 2011.

Effective Competition

This issue should not require extended discussion. The statutory definition of market dominance requires a showing and a finding that the defendant railroad is not subject to "effective competition from other rail carriers or modes of transportation for the transportation to which a rate applies." 49 U.S.C. §10707(a).

For captive shippers, competition is "effective" within the meaning of the statute when it prevents an abuse of market power, thus rendering regulation unnecessary. It is for this reason that the abuse of effective competition was adopted by Congress as a threshold test of STB rate reasonableness jurisdiction.

Railroads, in contrast, have every incentive to restrict or eliminate STB regulatory jurisdiction, particularly where they charge extremely high rates. Accordingly, railroads typically ignore the word "effective" in the definition of market dominance, preferring to argue that shippers are not captive, and therefore do not need regulatory recourse, if the railroad can point to competition that is theoretical or potential, even if completely ineffective. It makes no sense to presume that competitors always compete, in the face of extensive evidence to the contrary.

Given the importance of market dominance determinations in rate cases, the Board should clarify that regulatory recourse will be denied based on the presence of competition only when that competition has been shown to be effective. As the court held in Arizona Public Service Co. v. United States, 742 F2d 644 (D.C. Cir. 1984): "At the core of the 'effective competition' standard is the idea that there are competitive, market pressures on the railroads deterring them from charging monopoly prices for transporting goods."

There are doubtless other areas in which STB regulation could be more effective. Rail service quality is an example, and the Board should consider whether provisions in the Code of

Federal Regulations that were intended to help shippers have actually done so. Regulations that have rarely, if ever, been applied, like rate case remedies that go unused for decades, are an indication that regulation is falling short of its goals.

Though this proceeding and Ex Parte No. 705, Competition in the Railroad Industry, represent welcome opportunities for public comment on STB regulation from a comprehensive perspective, more is needed. The Board should initiate proceedings to consider revisions in policies and regulations that will lead to more effective remedies for abuses of railroad market power.

Respectfully submitted,

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Dated: January 10, 2012

CERTIFICATE OF SERVICE

I hereby certify that I have this 10th day of January, 2012, caused copies of the foregoing document to be served on all parties of record by first-class mail.

John M. Cutler, Jr.