BEFORE THE
SURFACE TRANSPORTATION BOARD

STB Ex Parte No. 715

RATE REGULATION REFORMS

BNSF RAILWAY COMPANY'S REPLY COMMENTS

BNSF Railway Company ("BNSF") hereby submits its reply comments on the issues addressed in the Board's July 25, 2012 Decision in *Rate Regulation Reforms*, Ex Parte No. 715 ("EP 715 Notice").

I. Introduction

In its Notice initiating this proceeding, the Board requested input from interested parties on a number of proposed refinements to the Board's rate reasonableness methodologies, as well as on the interest rate that should be applied to reparations payments. With respect to the Three Benchmark and Simplified SAC methodologies, the Board proposed to increase the relief cap for the Three Benchmark approach and eliminate the relief cap for Simplified- SAC cases while at the same time modifying the road property investment component of Simplified-SAC to improve accuracy. With respect to the use of cross-over traffic in SAC analyses, the Board proposed to impose limits on cross-over traffic and revise its revenue allocation methodology for allocating cross-over revenues. Finally, the Board proposed to increase the interest rate paid with respect to reparations.

In its opening comments, BNSF explained that modest increases in the relief caps for both Three Benchmark and Simplified-SAC cases could be appropriate as part of a package of refinements that included the elimination of cross-over traffic in Full-SAC cases, adoption of the revised average total cost revenue allocation methodology proposed in the EP 715 Notice ("Alternative ATC"), and an improvement in the accuracy of the Simplified-SAC methodology through new evidentiary requirements concerning road property investment. BNSF opposed as unjustified any increase in the interest rate applied to reparations.

For the most part, the shippers and shipper groups who responded to the Board's invitation to submit comments did not make an effort to provide a constructive response to the Board's suggested reforms. Instead, these shippers used their comments primarily to air complaints about the level of rail rates and to urge the Board to reduce rates regardless of the underlying economic rationale for doing so. These shippers complain that the Board's rate reasonableness methodologies have not produced a large number of rate prescriptions or substantial rate reductions. Where specific suggestions for reform were made, the suggestions generally were result-oriented and lack economic justification. The unabashed objective of these commenters is simply to achieve reduced rates through expanded rate regulation by the Board.

BNSF respectfully submits that economically sound regulation of the rail industry cannot be based on the subjective belief of a small group of shippers that the rail rates they pay are unjustifiably high. It is inappropriate to evaluate the validity of the Board's rate reasonableness methodologies based on the extent to which they lead to shipper victories in rate cases or result in prescriptions at rate levels significantly below the challenged rate. Rational rate regulation can only be based on an objective test for whether challenged rates are unreasonably high. The Constrained Market Pricing ("CMP") principles adopted by the ICC in *Coal Rate Guidelines*,[1] and the SAC test developed to implement those principles, provide a sound foundation for

[1] *Coal Rate Guidelines, Nationwide*, 1 I.C.C. 2d 520 (1985), *aff'd sub nom. Consolidated Rail Corp. v. United States*, 812 F.2d 1444 (3d Cir. 1987).

sensible rate regulation. The Board must continue to preserve these principles. There is no reason for the Board to give serious consideration to proposals that disregard the fundamentals of railroad economics and that are driven purely by a desire to lower rail rates. BNSF and its many shippers who have not submitted comments in this proceeding would be poorly served by a reconfigured regulatory regime designed to provide a short-term windfall to a small group of shippers at the expense the long-term health of the industry.

A major goal of many of the shipper commenters is to modify the Three Benchmark methodology, and to some extent the Simplified-SAC methodology, to provide greater incentives for shippers to bring rate reasonableness cases under those methodologies and to create a greater likelihood of rate reductions when a rate reasonableness case is brought, whether or not such rate reductions are justified. BNSF's Reply Comments explain why the shippers' proposals in these areas are unjustified and inappropriate. The shipper commenters also address the use of cross-over traffic in Full-SAC cases, arguing that they should continue to be free to use cross-over traffic to distort SAC results in their favor. BNSF's Reply Comments also address the flaws in the shippers' approach to cross-over traffic. BNSF refers the Board to the reply comments filed by the Association of American Railroads ("AAR") for a detailed analysis of the flaws in the proposals of the Joint Coal Shippers concerning additional modifications to the Board's revenue allocation methodology.[2]

[2] *See* Opening Submission of Western Coal Traffic League, *et al.*, at 69-74 (filed Oct. 23, 2012) ("Joint Coal Shippers") and attached Verified Statement of Thomas D. Crowley and Daniel L. Fapp, at 33-40 ("Crowley/Fapp V.S.").

II. The Board Should Not Eliminate Relief Caps for Three Benchmark and Simplified-SAC Cases

On opening, BNSF indicated that it would support modest increases to the relief caps for both Three Benchmark and Simplified-SAC cases as part of a package of refinements that includes the elimination of cross-over traffic in Full-SAC cases. Commenting shippers generally assert that relief caps should be eliminated for both Three Benchmark[3] and Simplified-SAC[4] cases, not merely increased, and that the removal of relief caps should be done without any regard to whether refinements are made to improve the precision of either methodology.

BNSF explained in its opening comments why it would be inappropriate to eliminate altogether the relief cap in Simplified-SAC cases, even if the Board adopted changes to improve the estimate of road property costs. As BNSF explained, although the Board's proposed changes to road property cost determinations would improve accuracy, the Simplified-SAC approach still relies on several simplifying assumptions and therefore some cap on relief needs to be retained. The shippers urge the Board to eliminate the relief cap and also oppose any changes to the assessment of road property costs. Such a one-sided modification would be inconsistent with the balance the Board sought to achieve in *Simplified Standards for Rail Rate Cases*[5] by offsetting

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[3] Opening Comments of Alliance for Rail Competition, *et al.*, at 7 (filed Oct. 23, 2012) ("ARC"); Joint Opening Comments of The American Chemistry Council, *et al.*, at 27 (filed Oct. 23, 2012) ("Joint Chemical Companies"); Opening Comments of the Chlorine Institute at 5 (filed Oct. 23, 2012); Opening Comments of Consumers United for Rail Equity, at 14 (filed Oct. 22, 2012) ("CURE"); Opening Comments of PPG Industries, Inc., at 9 (filed Oct. 23, 2012) ("PPG"); Joint Coal Shippers at 76-77.

[4] Joint Chemical Companies at 24; CURE at 16-17; Opening Comments of the National Grain and Feed Association, at 6 (filed Oct. 23, 2012) ("NGFA"); PPG at 6-7; Joint Coal Shippers at 75.

[5] STB Ex Parte No. 646 (Sub-No.1)(served Sept. 5, 2007), *aff'd sub nom. CSX Transportation, Inc. v. STB*, 568 F.3d 236 (D.C. Cir.), *vacated in part on reh'g on other grounds*, 584 F.3d 1076 (D.C. Cir. 2009).

the less accurate results of simplified methodologies against limits on the relief available under those simplified methodologies.

Shippers also argue that the relief cap on Simplified-SAC cases should be removed because the existence of a relief cap limits the attractiveness of bringing a Simplified-SAC case. They claim that the cost of litigating a Simplified-SAC case is so high that the existence of a relief cap discourages shippers from bringing a case under the Simplified-SAC methodology. The shipper commenters provide no concrete information, however, on the costs of a Simplified-SAC proceeding. Given that only one Simplified-SAC case has been initiated – and it was settled before opening evidence was filed – there is no basis for estimating the cost of litigating a Simplified-SAC case. It would not be appropriate to make any changes to the relief cap based only on vague assertions about how much it might cost to bring a Simplified-SAC case.

With respect to Three Benchmark cases, shippers' primary argument for eliminating the relief cap is that shippers already have a disincentive to bring cases under the Three Benchmark methodology because the rates likely to be prescribed under that methodology will be higher than rates that would be prescribed if the shipper pursued relief under the Simplified-SAC or Full-SAC methodologies.[6] According to these commenters, rates above the Three Benchmark prescription level are "virtually guaranteed to exceed the stand-alone cost."[7] The shippers argue that since they already have a disincentive to bring Three Benchmark cases, there is no need for a relief cap.

The shippers' argument ignores the purpose of the Three Benchmark relief cap. The relief cap is a trade-off for the inaccuracies that result from the use of the Three Benchmark

[6] ARC at 8; CURE 1-2, 15; Joint Chemical Companies at 28; PPG at 10.

[7] ARC at 9.

methodology. Since the Three Benchmark methodology will necessarily produce less accurate results than a Full-SAC analysis, a relief cap is necessary to limit the damage caused by imposing rate relief that may not be fully justified if a more accurate methodology were used to assess the reasonableness of the challenged rates. As the Board explained in *Simplified Standards*, at 28, imposing limits on the relief available under a simplified approach protects against the impact of potentially inaccurate results under a simplified approach since "carriers can be assured that a large rate dispute will not be subjected to a more simplified process than necessary. . . ." Moreover, the premise of the shippers' argument – that Three Benchmark cases necessarily produce too little rate relief for shippers – is totally unsupported.

The shippers complain that rates prescribed under the Three Benchmark test are too high because "the presumptive maximum reasonable rate equals the monopoly rate."[8] The shippers' argument is that by looking at rates only above the jurisdictional threshold of 180% R/VC, the Three Benchmark test "only evaluates the segment of the market paying monopoly rates."[9] There is no basis for the shippers' claim that a Three Benchmark rate prescription imposes a monopoly price because it bases the reasonableness of the challenged rate on a sample only of "monopoly" rates. There is no basis to conclude that a rate is a "monopoly" rate simply because it is above 180% R/VC. Indeed, the statute itself states that the fact that a rate is above 180% R/VC does not create a presumption either that the carrier has market dominance or that the rate

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[8] Joint Chemical Companies at 28.

[9] Joint Chemical Companies Opening Comments, Verified Statement of Thomas D. Crowley and Robert D. Mulholland, at 58 ("Crowley/Mulholland V.S."). On opening, Mr. Crowley authored or co-authored three verified statements that total approximately 170 pages. Mr. Crowley's verified statement on behalf of the Chlorine Institute is referred to hereafter as the "Crowley V.S." Mr. Crowley's verified statement on behalf of the Joint Coal Shippers is referred to as the "Crowley/Fapp V.S."

is unreasonable. 49 U.S.C. § 10707(d)(2). Thus, the pool from which comparable traffic is identified does not consist only of traffic with "monopoly" rates.

There is also no basis for the shippers' contention that the Three Benchmark test by definition produces rates that are above SAC maximum rates, or that a shipper is leaving relief to which it is "entitled" under the SAC test on the table because of the relief cap. The Three Benchmark and SAC methodologies determine maximum reasonable rates through entirely different processes that use inputs and assumptions that have nothing in common. SAC results in a particular case turn on circumstances relating to the issue traffic that are totally irrelevant to the outcome of a Three Benchmark analysis. A SAC maximum rate for a particular movement may be higher or lower than a maximum reasonable rate for the movement under the Three Benchmark test. Indeed, there could be many cases involving movements that use low density lines where a Three Benchmark analysis would require a rate reduction while a Full-SAC analysis would find that the shipper is not entitled to any relief. It is precisely because the Three Benchmark test is a simplified, less accurate methodology capable of producing false positives that a cap on relief is necessary.

In seeking a vastly expanded use of the Three Benchmark methodology, the proponents of eliminating the relief cap in Three Benchmark cases ignore altogether the long-recognized and fundamental problem that would arise from widespread use of a rate regulation methodology that relies on averages. The shippers' objective in seeking elimination of the relief cap is to make the Three Benchmark methodology more attractive to shippers and thereby expand its usage. But efforts to artificially expand the use of the Three Benchmark methodology would inevitably lead to the ratcheting-down effect on rates condemned by the D.C. Circuit in *McCarty Farms*[10] as a "fundamental conceptual problem" with methodologies that set maximum rates by comparison to average rates. Repeated use of the Three Benchmark methodology to cap rates at an average R/VC level would lead to spiraling declines in average rate levels as each new calculation of the average decreased because of the elimination of higher than average rates from the comparison group sample. The Board acknowledged the validity of the D.C. Circuit's criticism in *Simplified Standards*, at 73-74, but asserted that the ratcheting-down effect could be avoided in practice under the Three Benchmark methodology because the relief cap would limit the extent to which average rates in Three Benchmark comparison groups would be affected. If the Board were now to eliminate the relief cap, it would remove the primary constraint standing in the way of a regulation-induced downward rate spiral.[11]

III. The Board Should Not Expand this Proceeding to Address Modifications to the Three Benchmark Methodology Proposed by Some Shippers

A number of shipper commenters argue that the Three Benchmark methodology must be revised because it has lost its utility as a rate reasonableness methodology in light of recent changes in rail rates. They contend that average R/VC ratios for comparison groups have become "too high," with the result that rate prescriptions based on rates for comparable movements will not result in substantially reduced rates.[12] These commenters further contend that railroads, at least for certain commodities, have introduced more uniformity in rate levels.

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

[11] If elimination of relief caps were coupled with other changes to the Three Benchmark methodology proposed by shipper commenters, such as relaxing comparability requirements, the ratcheting-down effect would be even worse. This issue is discussed further below.

[12] Crowley V.S. at 5; PPG at 10; Opening Comments of US Magnesium, L.L.C. at 5-6 (filed Oct. 23, 2012) ("U.S. Magnesium").

According to these commenters, since the purpose of the Three Benchmark methodology is essentially to determine whether a particular movement is being singled out unreasonably for the payment of high rates, the introduction of more uniformity in the rate structure means that fewer rates are significantly above average, and fewer rates are therefore subject to successful challenge under the Three Benchmark approach.[13]

The claim that a rate reasonableness methodology is not useful unless it results in numerous and large rate reductions is result-oriented and completely lacking in economic substance. The Three Benchmark methodology does exactly what it was designed to do: it identifies instances in which a particular shipper has been singled out to pay rates that are significantly out of line with rates paid by other shippers whose rates exceed 180% of R/VC for similar transportation services. The Three Benchmark methodology determines whether rates are "too high" by reference to the rates charged to comparable traffic. The Simplified-SAC and Full-SAC methodologies determine whether rates are "too high" by reference to the costs of a hypothetical railroad designed to serve the issue traffic and other traffic that shares facilities with the issue traffic. Each test has its own approach to determining whether a challenged rate is "too high." Shippers' subjective view that rates have become "too high" is irrelevant.

In any case, other than generalized expressions of discontent that they are paying more than they want to, commenters in this proceeding have submitted no evidence that R/VC levels have risen to unreasonable levels for any commodity. Mr. Crowley, on behalf of the Chlorine Institute, criticizes the level of BNSF's chlorine prices and the significant change in chlorine

[13] *See, e.g.*, Chlorine Institute, at 7; Crowley V.S. at 4; ARC Opening Comments, Verified Statement of Gerald W. Fauth at 5-6 ("Fauth V.S."); CURE at 15-16; NGFA at 11.

transportation pricing implemented by BNSF in 2011.[14] As BNSF made clear in the Canexus Three Benchmark case,[15] however, BNSF's increases for chlorine rates were a response to changes in the regulatory and market environment. Even after the price increases, the BNSF rates challenged by Canexus were below the R/VC levels prescribed by the Board in other Three Benchmark proceedings involving transportation of chlorine.[16]

The comments of the Alliance for Rail Competition, *et al.*, use BNSF's grain rates in an attempt to illustrate their contention that the Three Benchmark test is not a useful test of rate reasonableness for grain shippers. ARC compares BNSF's Montana grain rates to rates for grain movements from Kansas origins to Houston and shows that the rate levels are comparable. Because the Montana rates are comparable to the Kansas/Houston rates, ARC argues that it would be difficult to get rate relief under the Three Benchmark methodology for Montana rates since the Three Benchmark methodology assesses rate reasonableness by reference to the level of comparable rates.[17] But far from showing that the Three Benchmark methodology is flawed, ARC's example merely shows that the Montana grain rates are not unreasonably high since they are comparable to rates charged on Kansas/Houston movements where there is substantial rail-to-rail competition. ARC does not even attempt to explain why Montana rates should be reduced when those rates are similar to rates charged on competitive traffic.

Some comments complain that the Three Benchmark methodology has become too complex. The Chlorine Institute, for example, points to evidence submitted by BNSF in the

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[14] Crowley V.S. at 3-4.

[15] *Canexus Chemicals Canada, L.P. v. BNSF Railway Co.*, STB Docket No. 42132 ("*Canexus*").

[16] Opening Evidence of BNSF Railway Co., *Canexus*, at 2-3 (filed Feb. 13, 2012).

[17] ARC at 10-12; Fauth V.S. at 5-7.

Canexus case regarding current rate levels and the proper treatment of massive expenditures on Positive Train Control ("PTC") technology that BNSF has incurred as a result of handling of hazardous materials such as chlorine.[18] The shippers' chief witness in this proceeding and in several rate proceedings, Mr. Crowley, contends that, to address shipper concerns about the complexity of Three Benchmark proceedings, railroads should be barred from presenting such evidence.[19] But the Three Benchmark methodology would be an appropriate simplification approach to rate regulation only if it functions as intended: as a test for whether the challenged rates are out of line with rates for truly comparable traffic. When, as in the Canexus case, the complainant attempts to create the impression that *current* rates are unreasonably high by comparing those rates to rate levels as much as six years old that do not reflect substantial changes in the market or railroad costs, the test does not produce economically justifiable results. The same distortions occur when a complainant attempts to create the impression of unreasonable rates by using comparison R/VC levels that reflect market conditions for commodities that are different from the commodity covered by the challenged rate. Shippers' purported concerns about complexity are just a smokescreen for their desire to obtain rate reductions that are not economically justified.

Other changes proposed by shippers to the Three Benchmark methodology are similarly designed to obtain rate reductions without any economic justification.[20] Some shippers contend, for example, that the problem with the Three Benchmark approach is that there are no "outlier"

[18] Chlorine Institute at 7-8; Crowley V.S. at 9-11.

[19] *See*, Crowley V.S. at 11 (arguing that railroads should be barred from raising regulatory lag or PTC issues).

[20] *See, e.g.,* Chlorine Institute at 9 (arguing that changes should be made so that there will be more opportunities to challenge rates under the Three Benchmark approach).

rates to challenge under current railroad pricing strategies.[21] Rate relief is available under the Three Benchmark approach only for a movement that is being charged significantly more than the amount charged to other comparable movements. These shippers propose to resolve the difficulty created by supposedly uniform pricing for transportation of certain commodities by simply expanding the comparable traffic groups so that more "outlier" rates will be subject to challenge. One way to accomplish this, they suggest, is by defining comparability in terms of transportation operating characteristics rather than based on the commodity being transported.[22]

The Three Benchmark methodology will not produce economically rational outcomes unless it is based on sensible comparison groups, and that means that the comparison criteria must be based on economically meaningful factors. Commodity type is a crucial economic factor because different commodities are subject to different supply and demand conditions that influence transportation rates. If commodity type were excluded from the comparison criteria, the Three Benchmark test would end up comparing rates for different commodities that are established in response to entirely different sets of market forces. Such an approach would produce irrational results.

The same commenters suggest an additional means of devising comparison groups that create the appearance of "outlier" rates: allow comparisons that include movements on other railroads.[23] These shippers suggest that the reasonableness of rates should be judged not by comparison of R/VC levels for transportation of the same commodity on the same railroad, but by comparison of the challenged rate to rates for transportation of that commodity (and perhaps

[21] CURE go so far as to suggest that railroads engage in "gaming" when they charge comparable rates to comparable traffic. CURE at 16.

[22] Chlorine Institute at 9; Crowley V.S. at 7; NGFA at 11; U.S. Magnesium at 6.

[23] Crowley V.S. at 7; NGFA at 11.

other commodities that share similar operating characteristics) on other railroads. This proposal is again driven by the goal of achieving favorable rate prescriptions rather than sensible economic principles. The Board explained clearly in *Simplified Standards*, at 83, that comparison of R/VC ratios across railroads is not meaningful: "the R/VC ratio of potentially captive traffic of one carrier provides no useful indicia of the lawful contribution to fixed and common costs for another carrier." As the Board explained,

> R/VC ratios of one carrier cannot fairly be compared with the R/VC ratios charged by another railroad. The reasonable level of contribution to joint and common costs (reflected by the R/VC ratio) is first and foremost a function of the amount of joint and common costs that need to be recovered. This will vary between carriers, creating inevitable and proper differences in R/VC ratios. Moreover, the reasonable degree of differential pricing one carrier can exercise is also a function of the mix of traffic; for example, a carrier with little revenue from competitive traffic will need to recover a larger share of joint and common costs from its potentially captive traffic.

Id. at 82. The proponents of expanding the comparison group in Three Benchmark cases to include other railroads do not offer any rationale for the proposition that R/VC ratios should be uniform across railroads, challenge the Board's prior analysis, or offer any other justification based on economic principles. The Board's analysis in *Simplified Standards* remains valid.

The Chlorine Institute proposes to make the Three Benchmark methodology "more usable for chlorine shippers" by placing a cap on the annual change in the R/VC ratios for the comparable traffic group.[24] No economic justification is offered for such an approach. The obvious objective of this proposal is to allow shippers to obtain rate reductions in Three Benchmark cases without any regard for market factors that have produced rate increases over time. NGFA proposes a different, but equally arbitrary way to expand rate relief under the Three

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[24] Crowley V.S. at 8.

Benchmark methodology. NGFA would simply exclude from the comparison group all movements with R/VC ratios above an unspecified level.[25] There is no principled basis for either proposed change.

The Board should not broaden this proceeding to include consideration of proposals that lack any justification other than the desire to achieve more Three Benchmark rate prescriptions at lower R/VC levels. The proposed modifications disregard the purpose of Three Benchmark test and fundamentals of railroad economics. They are simply efforts to change the rules of the game so that it will appear that relief is justified under the Three Benchmark label.

IV. The Board's Proposed Limitations on the Use of Cross-Over Traffic Are Appropriate

BNSF described in its opening comments the distortions and complexities in Full-SAC cases that have resulted from the use of cross-over traffic. BNSF continues to believe that cross-over traffic should be eliminated entirely in Full-SAC cases and preserved as one of a number of simplifying assumptions and devices used in Simplified-SAC cases. Eliminating cross-over traffic in Full-SAC cases is also the simplest and most straight-forward way of dealing with the particular distortions created by the use of carload traffic as cross-over traffic. BNSF explained that if the Board is unwilling to eliminate cross-over traffic entirely, it should prohibit the use of carload traffic as cross-over traffic.[26]

The Joint Chemical Companies and the Joint Coal Shippers contend that the Board cannot impose limits on the use of cross-over traffic because doing so would interfere with core

[25] NGFA at 12.

[26] To deal with the distortions created by the use of carload traffic as cross-over traffic, BNSF prefers an outright prohibition on carload cross-over traffic to the Board's proposal that complainants be required to originate or terminate any carload cross-over traffic that is included in the SARR.

SAC principles by denying complainants the ability to group traffic or by otherwise preventing complainants from including in their SARRs traffic that moves on the real-world incumbent.[27] This argument is wrong.

Limitations on the use of cross-over traffic do not implicate traffic selection issues because cross-over traffic has never been anything other than a simplification mechanism.[28] Nothing in the limitations proposed by the Board on the use of cross-over traffic prohibits a complainant from including any traffic it wants on a SARR. The Board's proposed restrictions do not affect whether traffic may be included but only how traffic that is included may be used. The restrictions would only prohibit the complainant from using specified traffic as *cross-over traffic*. A complainant would remain free to include the traffic on its SARR, but it would need to design the SARR so that the traffic would not be carried as cross-over traffic. Rather than limiting traffic selection, the Board is limiting the use of a simplification mechanism to those situation where it may actually provide simplification instead of exacerbating the complexities and distortions already created by the presence of cross-over traffic in the analysis.

The Joint Coal Shippers argue that restricting the use of cross-over traffic creates a barrier to entry for the SARR.[29] They assert that the Board is preventing complainants from using traffic in its SARR that the incumbent carriers handle in the real world. Again, the argument is incorrect. The complainant is entitled to take any traffic it wishes if it designs the SARR to carry the traffic on a through movement basis in the same way the real world railroad handles the traffic. There is no barrier to entry created when the Board prohibits the SARR from

[27] Joint Chemical Companies at 5; Joint Coal Shippers at 26-27.

[28] *See* BNSF Railway Company's Opening Comments, at 4-5 (filed Oct. 23, 2012) ("BNSF Opening Comments").

[29] Joint Coal Shippers at 28.

doing something that the incumbent never could do, namely carrying traffic as cross-over traffic with an artificial revenue division.[30]

The Joint Chemical Companies and the Joint Coal Shippers also devote considerable effort to arguing that the Board should not be concerned about the use of carload traffic as cross-over traffic.[31] BNSF described the distortions that arise from the use carload cross-over traffic in both the allocation of revenue on cross-over traffic and in the setting of a maximum reasonable rate under the Maximum Markup Methodology ("MMM").[32] The most obvious problem is that both ATC and MMM require the use of URCS system-average costs but complainants assume that a SARR will operate in a manner that allows it to avoid incurring some of those system average costs. Complainants typically assume that the SARR will operate as a "hook-and-haul" railroad and therefore will not incur costs associated with gathering carload traffic for placement on trains, switching carload traffic in yards, train assembly and disassembly, and delivery of cars to their final destination, among others costs incurred by the incumbent railroad to provide carload service. While the SARR avoids these costs for carload traffic, ATC allocates revenues as if the SARR did incur these costs and MMM assigns responsibility for stand-alone costs among shippers on the SARR, including carload shippers, as if the SARR incurred these costs.

The Joint Chemical Companies and the Joint Coal Shippers make two primary arguments why the Board should not worry about the distorting effects caused by including carload traffic as cross-over traffic. First, they assert that the Board should ignore the distortions created by the

[30] Because the Board is not proposing to prevent complainants from including traffic in a SARR, shipper contentions about what would happen to SARR costs if traffic were excluded are not relevant. *See* Crowley/Mulholland V.S. at 45-50.

[31] *See, e.g.*, Joint Chemical Companies at 10-14; Joint Coal Shippers at 14-26.

[32] BNSF Opening Comments at 10-13.

use of carload traffic as cross-over traffic because the Board has established a rule that the allocation of revenue and the setting of a maximum reasonable SAC rate are supposed to be based on the incumbent's costs, not the SARR's costs. While it is true that the incumbent's costs are used in these methodologies, the distortion created by the use of carload traffic does not result from the use of the incumbent's costs. Instead, the distortion results from the fact that the incumbent's costs for the portion of the service replicated by the SARR are not accurately determined by using system-average URCS costs for the entire movement. The Board uses system average URCS to assess the incumbent's costs for purposes of the revenue allocation and maximum reasonable rate determinations, but the incumbent's costs for the portion of the through movement replicated by the SARR will necessarily be overstated when average costs associated with the through movement are used. Since the Board does not permit adjustments to URCS costs to reflect the incumbent's costs only for the portion of the movement replicated by the SARR, the distortion created by a complainant's use of carload traffic as "hook and haul" traffic can be eliminated only by excluding carload traffic altogether as cross-over traffic from the SAC analysis.

Second, the Joint Chemical Companies and the Joint Coal Shippers argue that the avoided costs are minimal and therefore do not justify any methodological change. They rely on sample calculations of variable costs for single-car chemical and multiple-car grain shipments in an effort to show that car-handling and train-assembly variable costs avoided by the SARR due to the "hook-and-haul" assumption are insignificant.[33] The example purports to show that excluding I&I switching costs has little impact on the share of total variable costs accounted for

[33] Joint Chemical Companies at 13; Crowley/Mulholland V.S. at 33-35; Crowley/Fapp V.S. at 49-51.

by each segment in the hypothetical examples. But the demonstration is beside the point because the costs associated with carload traffic that are avoided by the SARR are not limited to URCS system-average I&I switching costs. The SARR is handling the traffic as if it were trainload traffic, with all of the efficiencies associated with trainload traffic, but the URCS variable costs used in the revenue allocation are calculated as if the SARR were transporting carload traffic.

V. The Board Should Adopt its Proposed Alternative ATC Methodology

BNSF supports the Board's proposal to adopt Alternative ATC. Modified ATC was adopted by the Board to address the Board's concern that a revenue allocation methodology should ensure that sufficient revenue is allocated to a SARR to cover the variable costs of the portion of the movement replicated by the SARR. Modified ATC addressed this concern by first allocating revenue to cover variable cost on the on-SARR and off-SARR portions of a movement and then allocating any remaining revenue based on average total costs (variable costs plus fixed costs) of the on-SARR and off-SARR portions of the movement. However, BNSF showed in the WFA/Basin case that in attempting to address the problem of ensuring coverage of variable costs, Modified ATC double counted variable costs in the revenue allocation formula for all movements where revenues exceeded variable costs.[34] By giving excessive weight to variable costs, Modified ATC diluted the impact of economies of density, which are reflected only in fixed costs, in the allocation of revenues to the SARR and the residual incumbent. Moreover, the dilution of economies of density was completely unnecessary for traffic that generated revenues in excess of variable cost. The Board did not need to make any departure from ATC for traffic where sufficient revenues would be allocated to the SARR under ATC to cover variable costs.

[34] *See* Comments of BNSF Railway Company on Remand, *Western Fuels Association, Inc. v. BNSF Railway Co.*, STB Docket No. 42088, 11-16 (filed Nov. 22, 2010) (public version).

Alternative ATC corrects the defects with Modified ATC. It gives full effect to economies of density for all movements for which the revenue allocation exceeds variable costs and therefore adheres to the Board's governing principle, announced in *Major Issues*, that revenue should be allocated in proportion to the relative share of average total cost to the greatest extent possible.[35] At the same time, Alternative ATC addresses the Board's concern about the need to allocate sufficient revenues to cover the on-SARR variable costs without unnecessarily diluting economies of density. Therefore, in contrast to Modified ATC, Alternative ATC does not routinely bias revenue allocations by overweighting variable costs in the revenue allocation and understating the impact of economies of density. No party has made a persuasive case for retaining Modified ATC, or for adopting a revenue allocation method different from Alternative ATC.[36]

Two commenters, the Joint Chemical Companies and the Joint Coal Shippers, present extensive arguments in favor of Modified ATC, but their arguments are unpersuasive. These commenters make essentially three arguments in support of Modified ATC.

First, on behalf of the Joint Coal Shippers, Messrs. Crowley and Fapp half-heartedly maintain that Modified ATC does not double count variable costs.[37] They contend that each step of Modified ATC, when viewed in isolation, only allocates revenue to variable costs once. In other words, neither step of Modified ATC, by itself, involves a double-count. But the point is

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[35] *Major Issues in Rail Rate Cases*, STB Ex Parte No. 657 (Sub-No. 1), 33-35 (served Oct. 30, 2006) ("*Major Issues*").

[36] BNSF has appealed the Board's decision in the *Western Fuels* case to continue applying Modified ATC in that case. *BNSF Railway Co. v. STB*, Docket No. 12-1327 (D.C. Cir.) (appealing *Western Fuels Association, Inc. v. BNSF Railway Co.*, STB Docket No. 42088 (served June 15, 2012)).

[37] Crowley/Fapp V.S. at 15-16

irrelevant. In allocating revenues, Modified ATC *uses both steps*. Revenue is allocated based on variable costs in the first step, and then again in the second step. This fact cannot be hidden behind semantic games or irrational claims that what happens in the first step can be ignored when turning to the second step. By taking account of variable costs in both steps, Modified ATC undeniably gives undue weight to variable costs and dilutes the impact of economies of density.

The shippers' second argument is that there is an economic principle to the effect that coverage of variable costs is of primary importance, and Modified ATC gives effect to this "principle" by first allocating revenues to cover variable cost.[38] There is no need to address the existence or nature of what Crowley/Frapp describe as "this bedrock economic principle" because Alternative ATC satisfies it. Alternative ATC ensures that the SARR receives at least sufficient revenues to cover the incumbent's variable costs for the portion of the movement replicated by the SARR. Unlike Modified ATC, however, Alternative ATC ensures coverage of variable costs without unnecessarily diluting the impact of economies of density in the allocation of revenues.

Finally, Crowley/Fapp and Crowley/Mulholland argue that Modified ATC is superior to Alternative ATC because Modified ATC allocates relatively more of the through revenues to high-density lines (replicated by the SARR) and therefore better reflects the relative "profitability" of high density line segments. According to Crowley/Fapp, "[h]igh-density lines *are* more profitable on a per unit basis than low density lines."[39] The supposed problem with Alternative ATC is that it does not reflect the higher "profitability" of high-density lines by

[38] Crowley/Fapp at 6-7.

[39] Crowley/Fapp at 24 (emphasis in original).

rewarding a SARR that replicates the incumbent's high density line segments with relatively higher revenue allocation.

Most of the convoluted tables and hypotheticals presented by Crowley/Fapp and Crowley/Mulholland in their discussion of cross-over traffic go towards trying to illustrate their point that high-density line segments are more profitable than low-density line segments and to showing that Alternative ATC and Original ATC fail to reflect this supposedly higher profitability. Tables 1 and 2 of Crowley/Mulholland and Tables 3-6 of Crowley/Fapp all purport to show that when revenues are allocated based on average total costs, the "profitability" of a high-density line segment (revenues in excess of total costs) is lower than the "profitability" of a low-density line segment. Table 3 of Crowley/Mulholland and Table 7 of Crowley/Fapp purport to show that Alternative ATC creates a somewhat larger difference between the "profitability" of high-density and low-density line segments (as reflected in R/VC ratios) than Modified ATC.[40]

There are two fundamental problems with the Crowley/Mulholland and Crowley/Fapp "profitability" argument. First, it makes no sense to think about the relative profitability of two segments of an integrated through movement. BNSF does not set segment-specific prices. It sets a single through rate for service from origin to destination. The relative "profitability" of a

[40] Some of the Tables are pure nonsense. Table 2 of Crowley/Fapp purports to show that Alternative ATC "overweights" fixed costs by comparing the extent to which fixed cost are a percentage of total costs to the extent to which fixed costs are a percentage of revenue. This invented metric is meaningless. The fact that fixed costs become a smaller percentage of revenue as revenues increase above total costs is not an indication of "overweighting." Although the Table does not report it, the same effect occurs with variable costs: as revenues increase above total costs, variable costs also become a smaller percentage of revenue. Messrs. Crowley and Fapp have therefore "demonstrated" that *both* fixed and variable costs are "overweighted." Mr. Crowley presented an identical analysis in the *Western Fuels* case that BNSF addressed in a Motion to Strike. *See* BNSF's Motion to Strike, *Western Fuels Assoication, Inc. v. BNSF Railway Co.*, STB Docket No. 42088, at 11-12 (filed Apr. 7, 2011). The analysis makes no more sense now than it did then.

through rate may be affected by the relative density of different portions of the route over which the transportation is provided. But any benefits that are derived by the incumbent railroad by using high-density lines to provide the service are available only because the incumbent also provides service over any low-density lines that are also required to provide the service. It would be illogical to consider the benefits that a railroad obtains from economies of density without also considering the costs necessary to achieve those benefits.

More important, the "profitability" argument ignores the Board's determination in *Major Issues* that the purpose of allowing cross-over traffic in SAC analysis is to simplify the analysis, not to change the SAC results in a complainant's favor. For several years prior to *Major Issues*, complainants argued that they should be able to use cross-over traffic on high-density line segments to improve SAC results. They repeatedly claimed that complainants should be able to obtain the benefits of an incumbent's economies of density without having any responsibility for the costs necessary to make those economies of density possible. The Board definitively rejected those arguments in *Major Issues*.

As the Board noted in its Notice initiating this proceeding, the objective in allocating revenues on cross-over traffic is to "ensure that a truncated SAC analysis using cross-over traffic approximates the outcome of a Full-SAC analysis, which provides origin-to-destination service for the entire traffic group." EP 715 Notice at 6. The Board concluded in *Major Issues* that cross-over traffic could be used without creating a distortion in SAC results only if revenue were allocated based on average total costs, where the costs reflected any economies of density achieved on high-density line segments. The shippers continue to challenge the Board's conclusion that revenues should be allocated based on costs, but they have identified no valid reason for the Board to abandon its cost-based approach to revenue allocation.

In addition to their efforts to revive Modified ATC, Mr. Crowley and his colleagues propose several potential new methods for allocating revenues.[41] A detailed response to these proposals is contained in the Reply Comments of the AAR and the accompanying verified statement of Michael R. Baranowski. BNSF notes that the proposals reflect the same flawed reasoning as the shippers' defense of Modified ATC. The proposals share a common defect: each seeks to reduce the effect of economies of density by allocating a higher proportion of revenues based on variable costs than fixed costs. Under "Corrected Modified ATC," the overweighting of variable costs from Modified ATC is retained. Under "Three Step ATC," fixed costs are ignored when allocating "profit," which is allocated according to the relative share of variable costs. Under "Simpler Approaches," fixed costs (and economies of density) are ignored entirely and revenue is allocated purely on the basis of variable costs. There is no valid reason to ignore fixed costs or to treat fixed costs as somehow "less worthy" of providing a basis for earning a return than variable costs. None of the proposals is consistent with the objectives the Board has identified for an appropriate revenue allocation methodology and none can be justified on the basis of SAC theory.

VI. The Board Should Not Change the Interest Rate Paid on Reparations

BNSF does not believe that there is a justification for changing the interest rate paid on reparations. Commenters who advocate changing the interest rate do not articulate a principled basis for doing so. Instead, they engage in purely results-oriented reasoning under which the only real criterion is whether an alternative interest rate would result in higher payments than the existing interest rate. Given the *railroad's* uncertainty over the existence or size of any reparations award while a case is pending and the *shipper's* certainty that if an award is made it

[41] Crowley/Fapp V.S. at 33-40.

will be paid, a risk-free interest rate on reparations is appropriate. The Board cannot adopt an alternative interest rate without a reasoned basis for doing so, and no party has identified a valid reason to change the existing approach.

As BNSF pointed out in its opening comments, adopting a higher interest rate would be particularly inappropriate given the length of time it takes to resolve many cases and would exacerbate the adverse impact on railroads caused by extended rate reasonableness proceedings.[42] There are many reasons why rate cases take years to resolve, including unsettled or changing precedent that sometimes leads to extra rounds of evidentiary submissions. Railroads should not be expected to bear higher costs due to delayed proceedings in the form of higher interest rates.

Respectfully submitted,

Samuel M. Sipe, Jr.
Anthony J. LaRocca
Frederick J. Horne
STEPTOE & JOHNSON LLP
1330 Connecticut Avenue, N.W.
Washington, DC 20036
(202) 429-6486

Attorneys for BNSF Railway Company

Richard E. Weicher
Jill K. Mulligan
BNSF RAILWAY COMPANY
2500 Lou Menk Drive
Fort Worth, TX 76131
(817) 352-2353

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[42] BNSF Opening Comments at 18.

CERTIFICATE OF SERVICE

I hereby certify that on this 7th day of December, 2012, I caused a copy of the foregoing to be served by first-class mail, postage prepaid, upon each party who has filed a notice of intent to participate.

Anthony J. LaRocca