**BEFORE THE
SURFACE TRANSPORTATION BOARD**

Docket No. EP 715

RATE REGULATION REFORMS

REPLY COMMENTS OF UNION PACIFIC RAILROAD COMPANY

GAYLA L. THAL
LOUISE A. RINN
DANIELLE E. BODE
Union Pacific Railroad Company
1400 Douglas Street
Omaha, Nebraska 68179
Phone: (402) 544-3309

MICHAEL L. ROSENTHAL
SPENCER F. WALTERS
Covington & Burling LLP
1201 Pennsylvania Avenue, N.W.
Washington, D.C. 20004
Phone: (202) 662-6000

*Attorneys for Union Pacific
Railroad Company*

December 7, 2012

TABLE OF CONTENTS

BEFORE THE
SURFACE TRANSPORTATION BOARD

Docket No. EP 715

RATE REGULATION REFORMS

REPLY COMMENTS OF UNION PACIFIC RAILROAD COMPANY

Union Pacific Railroad Company ("UP") is filing this reply to address the comments that have been submitted in response to the Board's proposals in *Rate Regulation Reforms*, EP 715 (STB served July 25, 2012). In this reply, as in its opening comments, UP focuses on the Board's proposals for restricting the use of cross-over traffic in Full-SAC cases.[1]

I. The Board can and should restrict the use of cross-over traffic in Full-SAC cases.

UP's opening comments supported the Board's proposals to restrict the use of cross-over traffic in Full-SAC cases and encouraged the Board to undertake a more substantial reevaluation of the use of cross-over traffic in Full-SAC cases. Other railroads also supported the proposed restrictions. The most detailed arguments opposing the restrictions were submitted by two groups, the "Chemical Companies"[2] and the Coal Shippers."[3]

---

[1] UP endorses the Reply Comments filed by the Association of American Railroads.

[2] *See* Joint Opening Comments of The American Chemistry Council, The Fertilizer Institute, The National Industrial Transportation League, Arkema, Inc., The Dow Chemical Company, Olin Corporation, and Westlake Chemical Corporation ("Chemical Companies Op.").

[3] *See* Opening Submission of Western Coal Traffic League, Concerned Captive Coal Shippers, American Public Power Association, Edison Electric Institute, National Rural Electric Cooperative Association, Western Fuels Association, Inc., and Basin Electric Power Cooperative, Inc. ("Coal Shippers Op.").

For the most part, the Chemical Companies' and the Coal Shippers' arguments are based on the erroneous view that the Board may not impose *any* restrictions on the use of cross-over traffic in Full-SAC cases—even if the Board believes that the use of cross-over traffic may be distorting the SAC analysis. Cross-over traffic is a simplifying device, and the Board is well within its authority to limit the use of that device to improve the accuracy and reliability of results in Full-SAC cases. We discuss the Chemical Companies' and the Coal Shippers' arguments in more detail below.

A. Contestable market theory does not prohibit restrictions on the use of cross-over traffic.

The Chemical Companies and the Coal Shippers are incorrect when they assert that the "exclusion of cross-over traffic [would be] contrary to contestable market theory." (Chemical Companies Op. at 5; *see also* Coal Shippers Op. at 32.) The use of cross-over traffic is not part of contestable market theory: "the use of cross-over traffic is nothing more than a simplifying device." *Major Issues in Rail Rate Cases*, EP 657 (Sub-No. 1), slip op. at 32 (STB served Oct. 30, 2006). A SAC analysis requires an examination of all the investment and operating costs involved in serving a selected traffic group from origin to destination. *See id.*, slip op. at 31. "Indeed, the name of the test itself (the 'stand-alone' cost test) reflects an implicit assumption that the SAC analysis would examine a stand-alone network designed to meet the transportation needs of the SAC traffic group." *Id.* Cross-over traffic is merely a simplifying device that the Board has allowed complainants to use to reduce their litigation costs. *See id.* In theory, a SAC analysis should produce the same result whether or not the complainant uses that device. *See id.*, slip op. at 32. Accordingly, the Board would not be violating contestable market theory by prohibiting the use of cross-over traffic in any or all circumstances. To the contrary, restricting the use of cross-over traffic would make SAC analyses more accurate by removing "imprecision" that is "inevitable with any simplifying measures." *Id.*

B. The Board's proposed restrictions on the use of cross-over traffic would not deny shippers effective access to remedies for unreasonable rates.

The Chemical Companies and the Coal Shippers are also incorrect when they assert that the Board's proposals to restrict the use of cross-over traffic would "place shippers in a 'no-win' position" by forcing them to expand SARRs to "unmanageable" levels or forego the benefits of traffic grouping. (Chemical Companies Op. at 6; *see also* Coal Shippers Op. at 26-32.) Use of cross-over traffic is not essential to SAC cases. "[I]t is clear that the concept of cross-over traffic was not contemplated by the [Interstate Commerce Commission] when it adopted the *[Coal Rate] Guidelines.*" *Major Issues*, slip op. at 31. Indeed, as BNSF observes, complainants have prevailed in Full-SAC cases without using cross-over traffic. (*See* BNSF Op. at 9, citing *W. Tex. Utils. Co. v. Burlington N.R.R.*, 1 S.T.B. 638 (1996), and *Ariz. Pub. Serv. Co. v. Atchison, Topeka & Santa Fe Ry.*, 2 S.T.B. 367 (1997).)

The Chemical Companies and the Coal Shippers do not provide any evidence to support their claims that the Board's proposals would require complainants to expand SARRs to levels that would be "unmanageable." In fact, as complainants have gained experience with the Full-SAC test, they have designed larger and larger SARRs. The Chemical Companies and the Coal Shippers note the Board's concern in *Public Service Co. of Colorado v. Burlington Northern & Santa Fe Ry.*, 7 S.T.B. 589 (2004) ("*Xcel*"), that the complainant's 400-mile SARR would have been a 4,000-mile SARR if cross-over traffic had been prohibited. (*See* Chemical Companies Op. at 7-8; Coal Shippers Op. at 29-31.) However, SARRs have now eclipsed the 4,000-mile mark that the Board found daunting back in 2004: the complainant designed an approximately 8,000-mile SARR in *E.I. du Pont de Nemours & Co. v. Norfolk Southern Ry.*, NOR 42125.

The Chemical Companies and the Coal Shippers also offer no support for their claim that complainants would be harmed by the Board's proposals because the cross-over device "'keeps the SAC analysis properly focused'" on "'the portion of [the defendant's] system that serves the complaining shipper.'" (Chemical Companies Op. at 6 & Coal Shippers Op. at 32, quoting *Xcel*, 7 S.T.B. at 601.) In fact, a SAC test performed without the use of cross-over traffic will produce a more accurate, reliable result than an analysis that includes cross-over traffic because "[s]ome imprecision is inevitable with any simplifying measures." *Major Issues*, slip op. at 32. The "focus" that cross-over traffic supposedly permits is entirely illusory, because the SAC analysis must still account for every part of the defendant's system that serves the cross-over traffic—it just does so though a revenue allocation process, which complainants can and do manipulate in their favor. Indeed, in practice, complainants show little interest in "focusing" the SAC analysis on "the portion of the [defendant's] system that serves the complaining shipper." Complainants almost never construct a SARR that replicates only the portion of the defendant's system that serves the issue traffic. Instead, they routinely expand the SARR's scope to handle cross-over movements on lines that are not needed to handle the issue traffic, and they even reroute issue traffic to capture additional revenue from cross-over traffic, to take advantage of the revenue allocation process. *See, e.g.*, *Ariz. Elec. Power Coop. v. BNSF Ry.*, NOR 42113 (STB served Nov. 22, 2011) (permitting complainant to reroute issue traffic via Vaughn and Amarillo).

Finally, the Chemical Companies and the Coal Shippers misstate the Board's proposals when they claim that the proposals would bias SAC results against complainants by reducing the volume of non-issue traffic available to the SARR. (Chemical Companies Op. at 16-21; Coal Shippers Op. at 28.) Neither proposal restricts the volume of traffic that would be available to the SARR. Under the first proposal, a complainant can include any non-issue traffic in the

SARR traffic group as long as it constructs a SARR that will originate or terminate that traffic. Under the second proposal, a complainant can include non-issue trainload traffic as cross-over traffic, and it can include any non-issue, non-trainload traffic in the SARR traffic group as long as it constructs a SARR that will originate and terminate that traffic. The Coal Shippers contend that a requirement to replicate more of the defendant's network would constitute an impermissible "barrier to entry." (Coal Shippers Op., Verified Statement of Thomas D. Crowley & Daniel L. Fapp at 56.) They are incorrect. Barriers to entry are "'any costs that a new entrant must incur that were not incurred by the incumbent.'" *Major Issues*, slip op. at 32 (quoting *W. Tex. Utils. Co*, 1. S.T.B. at 670). The Board's proposals do not require the SARR to incur any costs the incumbent has not already incurred: they address situations in which the incumbent already is incurring the costs of originating and terminating the traffic on its network.[4]

C. The Board may address concerns with the allocation of cross-over revenue for carload and multi-carload traffic by restricting the use of cross-over traffic, rather than by modifying URCS.

The Chemical Companies and the Coal Shippers are also incorrect when they assert that the Board must address any concerns it has by modifying the URCS costs it uses as part of its revenue allocation process. (Chemical Companies Op. at 13; Coal Shippers Op. at 17-22.) As

---

[4] The Coal Shippers are also incorrect when they assert that the Board's proposals "would place a SARR at a clear cost and efficiency disadvantage to the incumbent." (Coal Shippers Op., Verified Statement of Thomas D. Crowley & Daniel L. Fapp at 56.) Under the Board's proposals, a SARR's traffic group could still include all the same non-issue traffic that it could include today, so the SARR would be able to obtain the same cost and efficiency advantages as the incumbent. Indeed, if the SARR is constructed to be more efficient than the incumbent—as has invariably been the case—the SARR would obtain even more contribution to fixed costs from the traffic in its traffic group than the incumbent. SARRs would also retain an important cost advantage over incumbents—the ability not to select traffic that does not make a contribution to fixed costs. The Board's proposals would not impose on SARRs any costs that are not incurred by the incumbent; they would only remove unfair advantages that complainants gain because of flaws in the Board's revenue allocation methodology.

UP explained in its opening comments, the Board should prohibit the use of cross-over traffic entirely because any method of allocating cross-over revenue is necessarily arbitrary, there is no way of knowing how much inaccuracy the arbitrary allocations introduce into a SAC analysis, and most allocation methods will allow shippers to manipulate SAC results. The Coal Shippers help underscore the arbitrary, unverifiable nature of the revenue allocation process by proposing three new allocation methods, which raises to ten the number of methods that have been considered or used by the Board.[5] Because additional refinements to the revenue allocation process would leave the Board no more confident that the results would be any more accurate or reliable, it is entirely reasonable for the Board to address its concerns directly by restricting the use of cross-over traffic.

Even if the Board is more confident than UP in the accuracy of results produced using cross-over traffic, the Board could still reasonably decide to restrict the use of cross-over traffic, rather than to modify URCS, in circumstances in which it believes cross-over revenue allocations are not accurately reflecting the costs associated with handling cross-over traffic.[6] The Board's concerns are caused by the use of cross-over traffic, so it is reasonable for the Board to address the concerns directly by restricting the use of cross-over traffic. Moreover, modifying URCS

---

[5] The seven methods previously considered or used are: mileage prorate, modified mileage block prorate, modified straight-mileage prorate, DARA, "original" ATC, "modified" ATC, and "proposed alternative" ATC. (Coal Shippers Op. at 36-39.) The Coal Shippers add "corrected modified" ATC, "three step" ATC, and "variable cost allocation." (*Id.* at 69-74.)

[6] The Chemical Companies and the Coal Shippers also appear to mischaracterize the Board's concern as involving the relation between the SARR's operating costs and the allocation of the incumbent's revenue to the SARR. (Chemical Companies Op. at 10-14; Coal Shippers Op. at 22-26.) UP understands the Board's concern to be that its revenue allocation method is, in certain circumstances, allocating more revenue to the facilities that are being replicated by the SARR than is warranted because the allocations are not accurately reflecting the costs of the services the incumbent is providing on the portions of its route being replicated by the SARR and the costs of the services the incumbent is providing on the portions of its route that are not being replicated by the SARR.

would require the Board to engage in an expensive, time-consuming undertaking. It is entirely reasonable for the Board to address its concerns directly and immediately by limiting the use of cross-over traffic. As discussed above and in UP's opening comments, cross-over traffic is just a simplifying device. The Board remains free to prohibit the use of cross-over traffic when it lacks confidence that the benefits from that device outweigh the costs of uncertainty and imprecision. By restricting the use of cross-over traffic, the Board can be confident that it will obtain more accurate, reliable results than if it tried to address its concerns through a less direct, more expensive effort to modify URCS.

D. The Board's proposed restrictions on the use of cross-over traffic would not cause merger-related harm to shippers.

Finally, the Coal Shippers are incorrect when they assert that the Board's proposals to restrict the use of cross-over traffic would impose competitive harm on complainants that might have to build larger SARRs to include certain non-issue traffic in their traffic groups as a result of past railroad mergers. (Coal Shippers Op. at 33-35.) The adoption of rules that improve the accuracy of Full-SAC analyses could not constitute competitive harm. With regard to the Coal Shippers' particularly odd accusation that the Board's proposed rules amount to a "regulatory bait-and-switch" by the Board (*id.* at 35), there is no evidence that the Board ever encouraged any shipper to support any merger, much less that the Board ever tricked any shipper into supporting any merger, by stating it would never modify the rules governing cross-over traffic.

II. The Board should adopt "proposed alternative" ATC or restore "original" ATC.

UP's opening comments supported the Board's proposed modification to its ATC method of allocating revenue from cross-over traffic, assuming the Board continues to allow the use of cross-over traffic and to apply a variation of ATC other than "original" ATC. Other railroads also supported the Board's proposed modification to ATC or the continued use of "original"

ATC. The Coal Shippers and the Chemical Companies objected to "original" ATC and the Board's proposal on the ground that they do not assign enough "profit" to high density lines. (Coal Shippers Op. at 55-58; Chemical Companies Op. at 22-23.) The Coal Shippers also proposed that the Board consider three new revenue allocation methods, including two new variations on ATC. (Coal Shippers Op. at 69-74.) In addition, Arkansas Electric Cooperative Corporation ("AECC") proposed a revenue allocation method that would assign all of the incumbent's contribution from cross-over traffic to the SARR. (AECC Op. at 9-10.)

As we discuss below, the Coal Shippers' and the Chemical Companies' objections to "original" ATC and "proposed alternative" ATC are misguided, and the Coal Shippers' and AECC's alternative proposals are transparent attempts to further bias the revenue allocation process in favor of the complainants in rate cases.

A. The Coal Shippers' and the Chemical Companies' discussion of "profits" for segments of cross-over movements ignores the Board's recognition that the use of cross-over traffic is a shortcut and the Board's reasons for adopting ATC.

The Board designed ATC to allocate cross-over revenue in relation to the total costs of handling non-issue traffic from origin to destination, not based on an attempt to estimate how much of the incumbent's "profit" a SARR could capture by serving selected segments of the incumbent's origin-to-destination route. *See Major Issues*, slip op. at 31.[7] Indeed, in the real world, a railroad does not earn different levels of profit on movements that can be assigned to distinct segments of an origin-to-destination route. Thus, UP disagrees with the Coal Shippers'

---

[7] A railroad earns contribution towards its fixed costs from particular movements, not "profits." Only if the total contribution from all of its movements system-wide is sufficient to cover all fixed costs and generate a return exceeding its cost of capital does a railroad earn economic profits. The same standard applies to a SARR: it is not profitable unless it recovers all of its costs, including a reasonable return on investment.

and the Chemical Companies' assertions that it is "illogical" or "absurd" that, for a particular movement that traverses both a high-density and a lower density segment, the revenue assigned to a high-density segment might be below the incumbent's variable costs of moving the traffic over that segment (under "original" ATC) or that all contribution over the incumbent's variable cost might be assigned to the lower density segment (under "proposed alternative" ATC). (Coal Shippers Op. at 52-55; Chemical Companies Op. at 22.) There is no real-world standard that makes those results "illogical" or "absurd"—it is meaningless to discuss whether a movement actually earns some contribution on every line segment it traverses. "Original" ATC reflected the Board's decision that it is sensible to allocate cross-over revenue based on the incumbent's average total costs of handling traffic (as measured by the incumbent's URCS system-average costs). If a complainant disagrees with the result of an ATC-based revenue allocation for a particular movement, it can construct its SARR to handle that movement from origin to destination, in which case there would be no need to allocate revenue.

The Coal Shippers' and the Chemical Companies' claim that SARRs are entitled to the "profits" associated with the individual line segments that they choose to replicate improperly assumes that a SARR could choose to enter the market to handle only a portion of the cross-over shipper's through movement over the incumbent carrier. The Board rejected that view of cross-over traffic in *Major Issues* when it explained that cross-over traffic is just a shortcut method of accounting for the costs of handling all movements in a traffic group from origin to destination. Indeed, in *Major Issues*, the Board explained all of this in rejecting arguments that are nearly identical to the ones that the Coal Shippers and the Chemical Companies are making here. *See Major Issues*, slip op. at 35 (rejecting shipper arguments that ATC "will allocate more revenue to lighter-density lines"). If a complainant wants its SARR to capture the incumbent's "profits" associated with a particular movement, it can do so by accounting for the full costs of handling that traffic from origin to destination on the incumbent's network.

B. The Board should reject the Coal Shippers' efforts to further bias the revenue allocation process in favor of complainants.

The Coal Shippers' three proposed alternatives for allocating cross-over revenue reflect transparent attempts to create a revenue allocation method that will prove more favorable to most complainants than "proposed alternative" ATC. The Coal Shippers apparently started from the conclusion that SARRs are entitled to more of an incumbent's revenue when they replicate high-density lines and then worked backwards to develop new methods to obtain that pre-determined result. However, the Board designed ATC to reflect its conclusion that, in order for a SAC test conducted with cross-over traffic to reflect the results of a SAC test conducted without the use of cross-over traffic, cross-over revenue should be allocated on the basis of the incumbent's average total costs of handling the traffic. The Board's approach necessarily implies that "more revenue should be allocated to segments that are lighter-density lines, because those segments, holding other factors constant, will have higher average total costs." *Major Issues*, slip op. at 25-26. Stated another way, lower density lines need a higher share of contribution from each movement to ensure that their fixed costs are covered.[8] The Coal Shippers never explain why assigning more revenue to high-density lines would be more likely to reflect the results of a SAC test conducted without using cross-over traffic than the Board's "proposed alternative" ATC.

---

[8] Significantly, all of the revenue allocation examples offered by the Coal Shippers involve the allocation of revenue for a single movement. That is, they fail to show the consequences of the proposed methodologies when applied to all of the cross-over traffic at issue in a particular case. If the Coal Shippers had presented a full picture, it would show a massive over-assignment of revenue to high-density lines, leaving lower density lines, which are necessary to support the cross-over traffic, without sufficient revenue to cover their costs.

Moreover, the Coal Shippers' proposals are flawed on their merits. For example:

- The Coal Shippers' first proposal—to allocate total system fixed costs using track miles rather than route miles—is inconsistent with the Board's conclusion in *Major Issues* that, when costs are calculated using URCS, fixed costs are the same for light-density and heavy-density lines. *Major Issues*, slip op. at 34 n.85. URCS is designed to identify those costs that vary with output, and it treats the remaining costs as fixed. In addition, URCS calculations are performed on a system-average basis, not a location-specific basis, so any line-specific difference in the mix of variable and fixed costs are irrelevant. Moreover, railroads have many types of fixed costs that are not associated with track miles, so allocating fixed costs based on track miles would over-allocate costs to high-density lines. Finally, even focusing on track-mile-related costs, the costs of building double track are not twice the costs of building a single-track line, as the Coal Shippers' proposal implicitly assumes, so again, the proposal would over-allocate costs to high-density lines.

- The Coal Shippers' second proposal is flawed because it incorporates the first proposal's flawed use of track miles rather than route miles. Moreover, the use of variable costs rather than total average costs to allocate contribution is contrary to the Board's conclusion in *Major Issues* that cross-over revenue must be allocated based on average total costs to cover the higher average total costs on lighter density lines.

- The Coal Shippers' third proposal appears to assume that all railroad lines carry the same amount of traffic—that is, there are no lines with higher average total costs than other lines— which is plainly incorrect.[9] Even if some measures suggest that some railroads may have exhausted economies of density on a system-wide basis, railroads still have lighter density branch lines that have above-average total costs and thus that should, according to the premise of the Board's approach to cross-over revenue allocation, be assigned more revenue than high-density lines. Shippers certainly understand that there are still economies of density—that is why they reroute issue traffic over higher density lines in rate cases. *See, e.g.*, *Ariz. Elec. Power Coop., Inc. v. BNSF Ry.*, NOR 42113, slip op. at 14 (STB served Nov. 22, 2011) (explaining that the complainant was allowed to re-route issue traffic over a longer route to "'tak[e] advantage of economies of density'" (quoting *Coal Rate Guidelines, Nationwide*, 1 I.C.C.2d 520, 542 (1985)).

In sum, the Coal Shippers' proposals do not improve on the Board's proposal; instead, they challenge the fundamental premises underlying the Board's adoption of ATC. The Coal

[9] Alternatively, the Coal Shippers might be operating under the assumption that lighter density lines would have a different combination of variable and fixed costs than high-density lines, which might be true in the real world, but which is not true when costs are calculated using system-average URCS.

Shippers' ability to propose a series of new methods for allocating cross-over revenue after so many other methods have been proposed over the course of so many years highlights the inherently arbitrary, unverifiable nature of the revenue allocation process.

C. The Board should reject AECC's effort to revive a proposal that the Board already rejected in *Major Issues.*

AECC's proposal that all contribution from cross-over traffic be assigned to the SARR is the same proposal that AECC made in *Major Issues*. *See Major Issues*, slip op. at 27-28. AECC asserts that its proposal assigns the SARR revenue that "reflects the real-world loss [to the incumbent] that would occur at the margin if the [SARR] segment were not operated" (AECC Op. at 9), but it never explains how that complies with the Board's objective, which is to use a revenue allocation method that approximates results that would be obtained using a SARR that provides origin-to-destination service for the entire traffic group. *See Major Issues*, slip op. at 24. In short, AECC's proposal makes no more sense today than when it was suggested in 2006.

III. The Board should not modify the limits for relief under Simplified-SAC.

UP's opening comments opposed the Board's proposal to modify the limits for relief under Simplified-SAC, even if the Board eliminates the simplification of the Road Property Investment ("RPI") component of the Simplified-SAC test. Other railroads also opposed the Board's proposal. By contrast, shippers and shipper groups generally argued that the Board should remove the limits on relief while retaining use of the simplified RPI component.

UP remains opposed to the Board's proposal. The Simplified-SAC test, especially with the simplified RPI component, but also as a result of its use of URCS costs to estimate operating expenses and equipment expenses, will never be as accurate as a Full-SAC test, and thus may result in regulation of rates that would not have been regulated had the Board applied the Full-SAC test. Moreover, the removal of the limits on relief would allow more shippers to use the substantial discovery and disclosure burdens that the Simplified-SAC procedures impose on railroads as fishing expeditions before bringing Full-SAC cases or as leverage in rate negotiations.

IV. The Board should not modify the limits for relief under the Three-Benchmark test.

UP remains of the view that there is no justification for modifying the limits for relief under the Three-Benchmark test. Several shippers and shipper groups argued that the Board should eliminate all limits for relief, but that would be flatly inconsistent with the Board's recognition that it would be inappropriate to apply this crude test except in the smallest cases, and that the limits are necessary to minimize the risk that repeated application of the test will produce a downward ratcheting effect on rates. *See Simplified Standards for Rail Rate Cases*, EP 646 (Sub-No. 1), slip op. at 73-74 (STB served Sept. 5, 2007); *see also Burlington N.R.R. v. ICC*, 985 F.2d 589, 597 (D.C. Cir. 1993) (rejecting a similar rate comparison test because of the potential for downward ratcheting effect on rates).

Many shippers and shipper groups assert that railroads should not care if the limits for relief are removed because the Three-Benchmark test would always result in higher prescribed rates than the Full-SAC or Simplified-SAC tests. However, no party offers proof that the Three-Benchmark test would always result in higher prescribed rates than the Board's more accurate tests. UP suspects that application of the Three Benchmark test's "very rough and imprecise" standards, *Simplified Standards*, slip op. at 73, could readily suggest that rates are unreasonable, when the same rates would not have been found unreasonable after a Full-SAC or Simplified-SAC analysis. In other words, the application of the Three-Benchmark test might result in the Board's prescribing rates in circumstances in which the application of the Simplified-SAC or Full-SAC tests would have left rates to be determined by market forces.

One shipper, US Magnesium, L.L.C. ("USM"), suggests, based on its experience in one Simplified-SAC case, Docket NOR 42115, that the Board set the limits for relief in Three-Benchmark cases too low because it underestimated the costs of litigating Simplified-SAC cases. (USM Op. at 10-11.)[10] UP does not believe the Board should make judgments about the cost of Simplified-SAC cases based on the proceeding USM describes. UP was the defendant in that proceeding, which involved the first use of Simplified-SAC. UP does not know how USM spent $750,000 on legal and expert consultant costs, but it suspects that a large portion of the costs were related to challenges UP experienced in producing the required Second Disclosure. (USM Op. at 9.) Specifically, UP was implementing a new computerized process that it had designed to identify "all movements that traveled over the [predominant] route [of the issue movements] in the Test Year," *Simplified Standards*, slip op. at 15, and the process did not work perfectly in that first Simplified-SAC case, which involved movements to several destinations in UP's complex Los Angeles-area rail network.[11] UP improved its processes as a result of lessons learned in that first case, and although it cannot control what complainants choose to spend on litigation, it sees no reason why the costs of subsequent cases should not be in line with the Board's estimates in *Simplified Standards*.

---

[10] As USM describes, USM filed two Simplified-SAC cases, but the one it discusses in detail was further along in the process before the parties settled their disputes.

[11] To be more specific, in Full-SAC cases, it does not matter if traffic moving between an origin and destination point could move over different physical routes, because the complainant can presume the SARR will move that traffic over the route replicated by the SARR. By contrast, the specific routing matters in a Simplified-SAC case, and UP had to design a new method of analyzing the actual operating route used by all of its traffic that shared facilities with the issue traffic and compiling that information in a useable form.

UP suspects that USM also might have incurred additional costs because UP produced a revised version of its Second Disclosures after the Board released its 2008 URCS costs, and that revised version was itself delayed because of errors that were discovered in the Board's URCS data.

Finally, the National Grain and Feed Association ("NGFA"), The Chlorine Institute ("TCI"), and the U.S. Department of Agriculture ("USDA") propose changes to the Three-Benchmark test that are designed to stack the deck against railroads when it comes to selecting an appropriate comparison group. They propose placing "an upper limit on the R/VC_{Comp} that can be included in the comparison group" (USDA Op. at 4; *see also* NGFA Op. at 12), ignoring the commodity actually at issue when developing comparison groups (USDA Op. at 4; NGFA Op. at 11; TCI Op. at 7), or calculating R/VC_{Comp} using five-year old Waybill Sample data, but only "[i]f the five-year average R/VC ratio is less than the R/VC ratio for the current year" (TCI Op. at 8). All of these suggestions are beyond the scope of the noticed rulemaking, and they also lack any merit. The Board's adoption of any of the proposals would obliterate the concept of a meaningful comparison group and thus destroy the already dubious justification for using the Three-Benchmark test as a test of rate reasonableness: that the "adjusted R/VC ratios" of a "comparison group [that] has been drawn properly from other captive traffic with similar characteristics" as the issue traffic "would fairly reflect the maximum lawful rates the carrier could charge those potentially captive movements." *Simplified Standards*, slip op. at 73.

V. The Board should not modify the interest rate on reparations payments.

UP remains opposed to the Board's proposal to modify the interest rate on reparations payments. No party presented a cogent argument for modifying the current interest rate. The Chemical Companies presented the most detailed argument in support of the Board's proposal. They argue that successful complainants are entitled to an interest rate that more closely reflects a railroad's cost of capital because overpayments are like an "interest free loan" that railroads can invest and "earn their cost of capital." (Chemical Companies Op. at 30.) But that argument is seriously flawed. A complainant is not making a risky investment when it pays freight rates, even if they are later determined to be excessive, so it is not entitled to a level of return that reflects the risks railroads undertake when they make investments.[12] If a complainant prevails in a rate case, it is guaranteed to recover its overpayment. Accordingly, the interest rate should be set at the level of return that a complainant could obtain from a risk-free investment. The T-Bill rate is an appropriate proxy for that level of return, as UP's opening comments explain.

The Chemical Companies appear to suggest that complainants *do* face risk when they bring a rate case—the risk that they will lose and the railroad "keeps all of the tariff premium." (Chemical Companies Op. at 31.) But if the railroad prevails, that means its rates were not unreasonable—there was no "tariff premium." Moreover, complainants are not required to reimburse railroads when railroads defeat meritless claims. In other words, when a railroad prevails in a rate case, it retains only what it was entitled to in the first place, and it is out the costs of its defense. Accordingly, the fact that railroads prevail in some rate cases is no justification for awarding complainants extra higher payments when they prevail.

---

[12] For example, when a railroad invests to double-track a route based on its expectation of moving more volume and earning more revenue, and then a recession dramatically reduces volume instead, the railroad may suffer a loss on that investment.

Respectfully submitted,

GAYLA L. THAL
LOUISE A. RINN
DANIELLE E. BODE
Union Pacific Railroad Company
1400 Douglas Street
Omaha, Nebraska 68179
Phone: (402) 544-3309

MICHAEL L. ROSENTHAL
SPENCER F. WALTERS
Covington & Burling LLP
1201 Pennsylvania Avenue, N.W.
Washington, D.C. 20004
Phone: (202) 662-6000

Attorneys for Union Pacific Railroad Company

December 7, 2012

CERTIFICATE OF SERVICE

I hereby certify that on this 7th day of December, 2012, I caused a copy of the foregoing Reply Comments of Union Pacific Railroad Company to be served by first-class mail, postage prepaid, on all parties of record in this proceeding.

Michael L. Rosenthal