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September 5, 2014

Ms. Cynthia Brown
Chief, Section of Administration
Office of Proceedings
Surface Transportation Board
395 E Street, SW
Washington, D.C. 20423-0001

Re: *Railroad Revenue Adequacy*, STB Ex Parte No. 722

Dear Ms. Brown:

Enclosed for filing in the above-referenced proceeding are the Opening Comments of BNSF Railway Company. Thank you for your attention to this matter.

Sincerely,

Adam Weiskittel

BEFORE THE
SURFACE TRANSPORTATION BOARD

STB EX PARTE NO. 722

RAILROAD REVENUE ADEQUACY

OPENING COMMENTS OF
BNSF RAILWAY COMPANY

In response to the Surface Transportation Board's ("Board" or "STB") decisions dated April 2 and June 16, 2014, BNSF Railway Company ("BNSF") respectfully submits its opening comments in this proceeding.

As explained in its April 2 decision, the Board has commenced this proceeding to receive public comment on, among other things, the Board's methodology for determining railroad revenue adequacy and what it should mean for a railroad to be revenue adequate, including how such status might impact a review of the reasonableness of that railroad's rates. The Association of American Railroads ("AAR") is submitting evidence and opening comments which address in detail the topics raised in the Board's April 2 decision. BNSF joins in and supports the AAR's comments. BNSF submits these additional comments in order to highlight several principles that BNSF believes must frame the Board's analysis of the issues raised in this proceeding.

I. The revenue adequacy yardstick is inappropriate for use as a rate regulation tool because it indicates nothing about the complex markets in which BNSF operates.

The Board's current rate reasonableness standards are based on competitive market principles. In the Staggers Act, Congress established a national rail transportation policy "to allow, to the maximum extent possible, competition and the demand for services to establish reasonable rates for transportation by rail[.]" 49 U.S.C. 10101(1). Market forces, rather than arbitrary regulatory decisions, are supposed to determine rail rate levels to the maximum extent possible.

A railroad's status as revenue adequate or inadequate over a long term says nothing about the market dynamics and competitive forces that shape the negotiation and setting of that railroad's rate with any particular shipper. Under the Board's existing methodology, a railroad's revenue adequacy or inadequacy determination is based on calculations about a railroad's firm-wide returns on the book value of assets, and is unrelated to any examination of market forces or competitive conditions in particular markets. Because long term revenue adequacy or inadequacy is so far removed from the market dynamics impacting an individual shipper's situation, the use of a rate limitation based on revenue adequacy in an individual rate reasonableness case would be arbitrary and capricious.

Market forces are strong determinants of rail pricing in the markets in which BNSF operates. A few examples are sufficient to show the wide variety of market forces and competitive conditions that influence the rates charged by BNSF. BNSF is particularly active in three commodity markets that illustrate this point.

- Agricultural Products. BNSF described in detail the market factors that characterize grain and grain transportation markets in comments filed in the Board's Ex Parte 665 (Sub-No.1) proceeding. As BNSF explained, rail pricing is responsive to numerous market forces and is constrained by both modal and geographic competition. Demand for transportation service is highly variable and responsive to numerous factors, including weather. Changes in demand for grain, both domestic demand and foreign demand, are highly unpredictable but have a direct impact on where grain will move and the prices that can be charged for the grain transportation. Export markets, particularly China, have become increasingly important to U.S. grain producers, but foreign demand changes frequently and there is intense competition from other grain producing countries to serve those export markets.

BNSF's grain movements face direct competition from trucks that can move grain to alternative destinations or to alternative transportation suppliers, including other railroads and barges. In addition, several types of strong geographic competition constrain BNSF's grain pricing. Grain shippers have numerous destination markets to choose from. Destination markets served by BNSF are also served by other transportation suppliers. As noted above, export grain markets have become particularly important to U.S. grain producers, but there is strong competition by other grain producing countries for export sales, which constrains the price that can be charged for U.S. grain transportation for export. Moreover, most of BNSF's grain movements are for large, vertically integrated firms that are fully capable of using their leverage in different markets to constrain BNSF's pricing.[1]

[1] The competitive factors impacting BNSF's rates for the transportation of agricultural products are discussed at length in the verified statements of Dr. William W. Wilson and John H. Miller, BNSF's Group Vice President, Agricultural Products, attached to BNSF's June 26, 2014 comments in EP 665 (Sub-No. 1).

- Coal. Another important part of the U.S. energy supply chain is coal. As the Board is aware, most of the western coal supply originates in the Powder River Basin ("PRB") of Wyoming and Montana, a region served by both BNSF and Union Pacific Railroad Company. Indeed, the main north-south rail line serving PRB mines is jointly owned by BNSF and UP, resulting in strong head-to-head competition for PRB coal transportation. In addition to the direct competition in PRB coal markets, there are other market forces that impact rail pricing. The most notable of these forces in recent years has been the dramatic drop in natural gas prices produced by the shale gas revolution. The historic low price of natural gas relative to coal has allowed natural gas-fired electricity generation to displace significant amounts of coal-fired generation in many wholesale power markets. Combined with the development of wholesale power markets, which allow power generators to respond quickly to changes in market conditions, the low natural gas prices have had a direct and substantial impact on the coal transportation market.
- Crude-by-Rail. Regularly shifting price spreads and consumer demand impact a railroad's rate setting for the transportation of crude oil to refinery markets. As domestic oil production in the Bakken Shale and elsewhere has increased significantly in the past several years, much of the success of the transportation of crude by rail (in competition with transportation by pipeline, for example), owes to the flexibility rail can give shippers to move the crude oil where current pricing and demand dictates. That flexibility helps shippers pursue the highest value, and receivers pursue the lowest costs, for their crude oil.

The various complex market dynamics impacting BNSF's setting of individual rates for the transportation of agricultural products, coal and crude oil are indifferent to whether BNSF has consistently earned a return higher than the industry's cost of capital over the long term. Indeed, a variety of those factors often serve to effectively constrain BNSF's pricing even in instances when BNSF might be considered market dominant under the Board's current methodology. Given the disconnect between a railroad's long term revenue adequacy or inadequacy and the market forces shaping the rates for any individual shipper, the use of a rate limitation based on revenue adequacy in an individual rate case would be arbitrary and inconsistent with the statutory intent to allow market forces to determine rail rates to the maximum extent possible.

II. Rate regulation based on variable costs and R/VC ratios is inappropriate and counter to the public interest.

Rate regulation based on variable costs and revenue-to-variable cost (R/VC) ratios is bad policy that incentivizes high-costs and inefficiency. Directly incorporating R/VC ratios into regulatory mechanisms discourages both efficient operations and capital investment. Regulatory provisions that impose adverse regulatory consequences on railroads based only on R/VC ratios which may reflect only improved efficiencies clearly could have the perverse consequence of discouraging innovation and improvements in productivity. Generally speaking, if regulated rates were set based on a railroad's costs at a prescribed R/VC ratio, the railroad would not be incented to pursue cost reductions because those cost reductions would result in lower regulated rates. The public interest is not advanced by creating an incentive to maintain high rail costs.

Manifesting the concept of long term revenue adequacy as a revenue cap expressed on an R/VC basis would raise the same problems as R/VC-based tools in other regulatory situations. In the recent filings in EP 665 (Sub-No.1), certain shipper groups argued that the improved financial health of railroads justified the widespread use of simplified rate reasonableness standards based on capping rates by reference to the R/VC ratio of the movement.[2] But the goal of further simplifying the rate review process does not justify doubling down on an inherently flawed R/VC-based approach.

III. A railroad should not be penalized for successfully participating in and expanding competitive markets.

As noted above, the Staggers Act intended to permit market forces to govern the rail industry to the fullest extent possible. BNSF is an example of why that structure has been successful for railroads and shippers alike. Since deregulation, BNSF has grown its franchise largely on its ability to succeed in competitive markets. Most of BNSF's current traffic is competitive traffic that falls outside the Board's jurisdiction, and BNSF has been successful due to its ability to serve this competitive traffic with efficient transportation. BNSF's growth in the intermodal market illustrates the importance of competitive traffic to BNSF's network.

- Intermodal. Over the past thirty years BNSF has become a leader in the domestic and international intermodal sectors through product innovation and the ability to reinvest in its core intermodal network. For example, BNSF has invested more than $3 billion over the last 10 years in BNSF's transcon corridor, double tracking nearly all of this route and making it the fastest intermodal route connecting Southern California to the Midwest, and invested over $1 billion in BNSF's southeastern corridor to increase capacity by 65% and improve consistency.

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[2] Under the National Grain and Feed Association proposal, for example, rates for grain movements would be capped at or near the jurisdictional threshold R/VC of 180%. The Alliance for Rail Competition proposed similar R/VC-based rate regulation with similar results.

BNSF has also invested heavily in its innovative intermodal facilities. Twenty years ago, BNSF introduced the logistics park concept with the opening of its Alliance, Texas facility, the industry's first logistics park in the DFW area. BNSF has expanded this facility multiple times since, including another expansion in 2014. Following the opening of the Alliance, Texas facility, BNSF opened its second logistics park in Chicago, which quickly grew to become the nation's largest inland port. BNSF continued the logistics park concept, and development of its southeast corridor, with the opening of its Memphis facility in 2010; a facility that included the first large scale operation of wide span cranes. In October 2013, BNSF opened its newest logistics park in Kansas City. Built on a greenfield site, operations at Logistics Park Kansas City have ramped up and BNSF is currently expanding the footprint and adding additional lift capacity.

These investments and innovations have allowed BNSF to expand capacity and add new terminals to accommodate market demand. BNSF currently has 350 active carriers that use its intermodal services to provide freight transportation to over 2,000 beneficial cargo owners who choose BNSF over other forms of transportation due to BNSF's ability to meet customer expectations and market needs. When ATSF and BN merged to form BNSF, intermodal volume for the combined company was approximately 2.5 million units, representing 35% of total company volume. Today, intermodal volume is nearly 5 million units and almost 50% of total company volume.

Having the freedom to innovate and take advantage of price and other market opportunities has allowed BNSF to grow intermodal volumes, even while other forms of freight transportation, such as over-the-road trucking, are subsidized through the federal highway system.

BNSF's ability to improve its financial health by successfully competing in the intermodal and other markets outside of the Board's regulatory framework is precisely the type of success that Congress hoped to promote with the Staggers Act. To the extent that a railroad's long term revenue adequacy or inadequacy status stems from its ability to compete successfully in markets marked by strong inter- and/or intra-modal competition, the Board should not punish that railroad by implementing rate limitations that contravene Rail Transportation Policy.

This is one reason why the Board's increasing reliance on the Revenue Shortfall Allocation Method (RSAM) factor in rate regulation and market dominance proceedings is concerning. The RSAM factor is intended to identify the amount of revenue that a railroad must generate from its theoretically non-competitive traffic to be revenue adequate. But if a railroad is successful in expanding its competitive traffic base, as BNSF has been, and increasing the amount of contribution that it earns from competitive traffic, the amount of contribution it would need from its regulated traffic, as expressed in the RSAM calculation, would decline. Since less contribution would be needed from regulated traffic, the railroad's RSAM would also go down. Under any theoretical rate-regulation scheme using the RSAM in assessing or constraining the level of regulated rates, a railroad that has been successful in expanding its base of competitive traffic would be penalized by having its rates on regulated traffic reduced. RSAM-based regulation therefore creates a perverse penalty against expanding competitive traffic through good business practices, and would result in an overall degradation of rail service, contrary to the public interest.

IV. It is now more important than ever that Board regulations promote growth and reinvestment.

In recent years a variety of rail shippers and shipper associations have pursued the goal of reducing rail rates in a number of contexts,[3] and no doubt will continue that pursuit in this proceeding and the Board's Cost of Capital (Ex Parte 664 (Sub-No. 2)) proceeding. As demonstrated in the ongoing Ex Parte 724 proceeding regarding U.S. Rail Service Issues, despite wishing to reduce railroad revenues, shippers expect that railroads will undertake the investment necessary to provide excellent service.[4] But it is illogical for shippers to demand both artificial rate reductions and continued or enhanced reinvestment necessary to maintain or upgrade service. In considering what regulatory framework might flow from a determination that a railroad is long term revenue adequate, the Board must apply common sense to see that artificial rate reductions or caps will necessarily have an impact on a railroad's ability to make the investments required to meet shippers' high service expectations.

The need for continued growth and reinvestment in the railroad industry is now greater than ever. As the Board is fully aware through its ongoing Ex Parte 724 proceeding, BNSF has experienced tremendous volume growth in certain commodities in recent years and anticipates that overall demand for its services will continue to grow over time. In 2013, for example, BNSF

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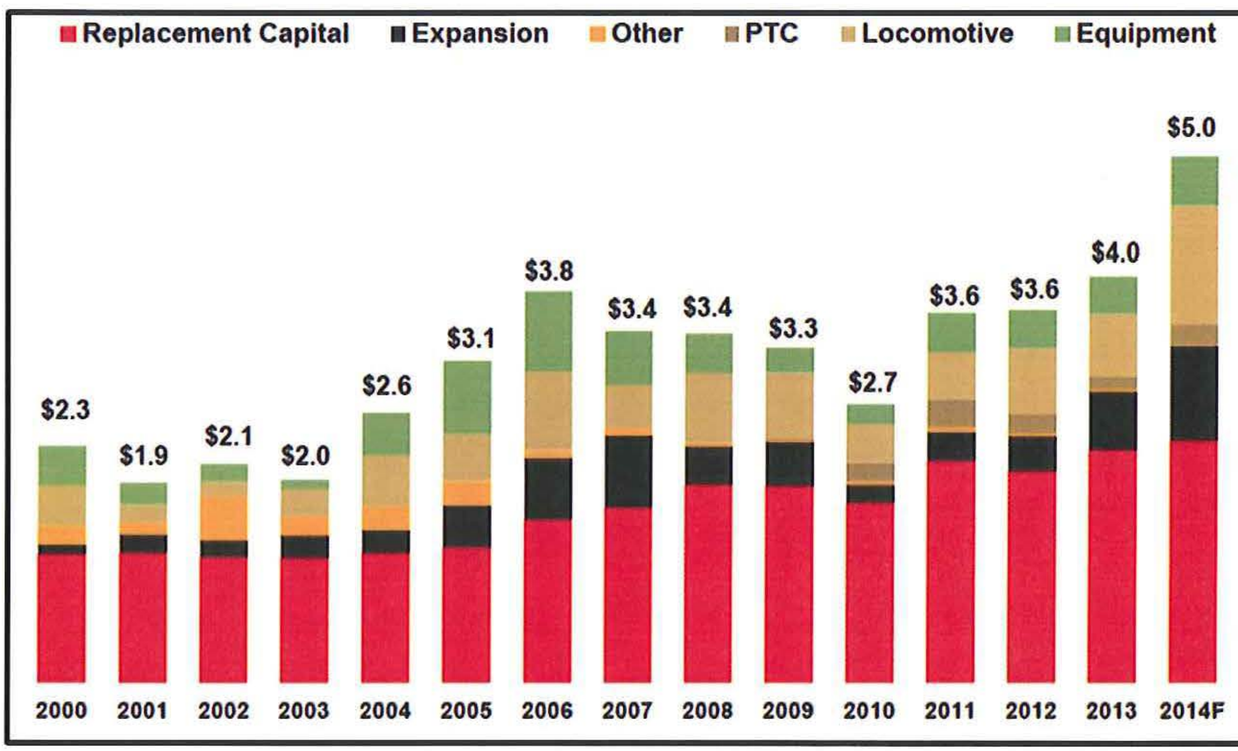
[3] See, e.g., the National Industrial Transportation League's competitive access proposal (now embodied in Ex Parte 711, Petition for Rulemaking to Adopt Revised Competitive Switching Rules); National Grain and Feed Association and Alliance for Rail Competition filings in Ex Parte 665 (Sub No. 2), Rail Transportation of Grain, Rate Regulation Review.

[4] See, e.g., testimony of Lance Peterson, American Soybean Association, United States Rail Service Issues, Docket No. EP 724, hearing transcript at 126 (April 10, 2014) (indicating "support of policies that encourage or provide direct investment in expanding transportation capacity including rail, trucks, and waterways"), and testimony of Hal Clemensen, South Dakota Wheat Growers Cooperative, hearing transcript at 369 ("there needs to be a lot more reinvestment into the rail system").

transported more than 50% of all of the incremental annual traffic growth on the U.S. freight rail network, and transported about 1.7 million more annual units than it transported in 2009. As compared to this point in 2013, BNSF's 2014 volume has increased by more than 5,000 agricultural products units, 22,000 coal units, and 47,000 crude units.

BNSF is making record investments to handle its forecasted growth and must continue making such investments to outpace anticipated capacity constraints. As shown in the chart below (all figures in $ billions), BNSF's capital expenditures have steadily increased in recent years, and in 2014 will reach a record $5 billion dollars.



In 2014 alone, BNSF is planning to invest $2.3 billion on its core network and related assets, $1.6 billion on locomotives, freight cars and other equipment (including, among other things, the addition of 500 locomotives and 5,000 railcars), and $900 million on network expansion and efficiency projects. BNSF also plans to hire 5,000 employees in 2014, many of whom will be dedicated to BNSF's capacity-strained northern corridor.

The ability to earn an adequate return is a crucial factor in enabling BNSF to expend the capital necessary to implement its current service recovery efforts and invest for the expected future growth as described above. As shippers continue to demand more capacity and better service from the U.S. rail network, the Board must be careful that any regulations created based on revenue adequacy status incentivize railroads to become financially stronger, not punish them and shippers by hindering reinvestment.

Respectfully submitted,

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