ASSOCIATION OF
AMERICAN RAILROADS

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

Re: STB Docket No. 42123, *M & G Polymers USA, LLC v. CSX Transportation, Inc.*

Dear Ms. Brown:

Pursuant to the Board's Decisions served on September 27, 2012 and October 25, 2012, attached please find the *amicus curiae* Comments of the Association of American Railroads for filing in the above proceeding.

Respectfully submitted,

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BEFORE THE
SURFACE TRANSPORTATION BOARD

STB Docket No. 42123

M& G POLYMERS USA, LLC

v.

CSX TRANSPORTATION, INC.

COMMENTS OF THE
ASSOCIATION OF AMERICAN RAILROADS

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COMMENTS OF THE
ASSOCIATION OF AMERICAN RAILROADS

Pursuant to the decisions of the Surface Transportation Board ("Board") served on September 27, 2012 ("September Decision") and October 25, 2012 ("October Decision"), the Association of American Railroads ("AAR") hereby submits comments as *amicus curiae* on the new test for qualitative market dominance announced in this proceeding.[1]

Introduction

Reflecting the policy adopted by Congress to "allow, to the maximum extent possible, competition and the demand for services to establish reasonable rates for transportation," 49 U.S.C. § 10101(1), the Board's jurisdiction over railroad rates is limited to those rates that apply to traffic over which the rail carrier is found to possess "market dominance." 49 U.S.C.

[1] Consistent with footnote 10 of the October Decision, the AAR's comments focus on the legal and policy implications of the Board's new rule. The AAR takes no position on the application of the rule to this dispute and will not address the specific rates at issue in the underlying complaint.

§ 10701(d)(1), § 10707(b), (c). As defined in the statute, market dominance means "an absence of effective competition" for the traffic. 49 U.S.C. § 10707(a). The Board cannot find market dominance where the rate at issue generates a revenue-to-variable cost ratio ("R/VC") that is less than 180 percent. 49 U.S.C. § 10707(d)(1)(A). Moreover, where the Board calculates an R/VC ratio that is equal to or greater than 180 percent, the Board may not presume that the rail carrier possesses market dominance over such transportation. 49 U.S.C. § 10707(d)(2)(A).

Under this statutory structure, the agency has established a two-step inquiry to determine market dominance. *Market Dominance Determinations*, 365 I.C.C. 118 (1981). The Board first examines quantitative market dominance to see if the challenged rates generate revenues that exceed the traffic's variable cost by 180% or more, using the unadjusted system average variable costs established by the Uniform Railroad Costing System ("URCS"). *See Major Issues in Rail Rates*, EP 657 (Sub-No. 1)(STB served Oct. 30, 2006) ("*Major Issues*"). Second, the Board examines qualitative market dominance. In this analysis, the agency has traditionally determined "whether there are any feasible transportation alternatives that could be used for the issue traffic. . . . Even where an alternative mode or modes of transportation exists, a complainant can establish market dominance by demonstrating that the alternate modes of transportation are not effectively constraining the carrier's ability to increase the rates of the issue traffic." *E.I. du Pont de Nemours & Co. v. CSX Transp.*, Inc., NOR 42100, slip op. at 2-3 (STB served June 30, 2008).

In this proceeding, M&G Polymers USA, LLC, ("M&G") filed a complaint on June 18, 2010, challenging the reasonableness of rates established by CSX Transportation, Inc. ("CSXT") for the transportation of polyethylene terephthalate. By a decision served on May 6, 2011, the Board bifurcated the proceeding to consider the issue of market dominance separately before accepting evidence on stand alone cost. *See M&G Polymers, Inc. v. CSX Transportation, Inc.*, NOR 42123 (STB served May 6, 2011).

On September 27, 2012, the Board issued a decision on market dominance, announcing a new approach to qualitative market dominance. In this new approach, the Board broke the qualitative analysis into two parts. First, the Board considered whether there were "feasible alternatives" to the transportation at issue. Second, where the Board concluded that there were feasible alternatives, the Board weighed whether those alternatives "effectively constrained" the challenged rates.

The "effectively constrained" test, in turn, was comprised of three steps. First, the Board calculated a "limit price," which the Board defined as, "the highest price the railroad theoretically could charge . . . without causing a significant amount of the issue traffic on a particular rail movement to be diverted to any particular competitive alternative." September Decision, at 3-4. The Board concluded, without discussion, that the limit price should be set at the lowest price offered by the identified transportation alternative. *See id.* at 14 & n. 40. Second, the Board calculated the "limit price R/VC ratio" by comparing the revenue that would be generated by the limit price to the defendant railroad's variable costs of providing the service at issue. That is, this R/VC ratio compared the price of the alternative transportation with the defendant's variable cost of providing rail service for that movement. The Board apparently assumes that this R/VC ratio would be the result of the highest rate the rail carrier could charge the issue traffic without losing significant amounts of the business to the identified alternative.

In the third and final step, the Board compared this limit price R/VC ratio to the defendant's most recent Revenue Shortfall Allocation Method ("RSAM") figure—the measure of the average markup that the railroad would need to collect from all of its potentially captive traffic to earn a return on investment equal to the railroad industry's cost of capital, as calculated by the Board. If the limit price R/VC ratio exceeded the most recent RSAM figure, the Board presumed that the alternative cannot exert competitive pressure sufficient to effectively constrain the rate at issue. If the limit price R/VC ratio fell below the RSAM figure, the Board presumed that the competitive alternative effectively constrains the rate at issue. Finally, the Board stated that these presumptions could be overcome by evidence demonstrating that the transportation alternative upon which the limit price is based has certain unquantifiable qualities that bear on the transportation alternative's ability to effectively constrain the rate at issue.

The Board "strongly encouraged" parties to submit comments on the new approach and on potential alternatives. *Id.* at 5 ("If there is a better general approach to this issue, if there is a superior benchmark that can be used to guide this inquiry, or if the application of the refined approach to the facts of this case is somehow flawed, parties are strongly encouraged to use this comment period to bring such concerns to our attention."). In the October Decision, the Board clarified that interested parties other than CSXT and M&G could file comments as *amicus curiae* regarding the new methodology.

The AAR is a trade association whose membership includes freight railroads that operate 82 percent of the line-haul mileage, employ 95 percent of the workers, and account for 97 percent of the freight revenues of all railroads in the United States. The AAR and its freight railroad members have a strong interest in ensuring that the Board adheres to the Interstate Commerce Act's mandate that it exert its rate reasonableness jurisdiction only in cases where the rail carrier truly possesses market dominance.

For the reasons discussed below, the AAR respectfully submits that the Board's replacing the qualitative market dominance approach adopted through notice-and-comment rulemaking in an adjudicatory proceeding has violated the Administrative Procedure Act ("APA"). Moreover, the Board's approach to market dominance establishing a presumption based on R/VC ratios is flawed and, in fact, was properly rejected in 1981. Finally, the use of RSAM as a measure of market dominance has no rational basis.

Discussion

I. The Adoption Of A New Test For Qualitative Market Dominance Without Notice And Comment Violates The Administrative Procedure Act.

The Board's existing and longstanding guidelines on qualitative market dominance were adopted through notice-and-comment rulemaking by the Interstate Commerce Commission ("ICC") in *Market Dominance Determinations*, 365 I.C.C. 118 (1981). That choice to adopt market dominance rules via notice-and-comment rulemaking has consequences. One consequence is that substantive changes to those rules can be completed only through a subsequent notice-and-comment rulemaking consistent with the provisions of the APA. Here, the Board's actions have impermissibly circumvented the APA's procedural requirements by modifying rules adopted by notice-and-comment rulemaking in this adjudicatory proceeding.

Where an agency modifies a rule adopted through its quasi-legislative role of promulgating rules, it may not later change that rule through the quasi-judicial function of adjudication. *See Am. Mining Congress v. Mine Safety & Health Admin.*, 995 F.2d 1106, 1109 (D.C.Cir.1993) (holding "[i]f a second rule repudiates or is irreconcilable with a prior legislative rule, the second rule must be an amendment of the first," subject to notice-and-comment requirements). Instead, changes to a rule that "effectively amend[] a prior legislative rule" require notice-and-comment rulemaking under the APA. *See United States Telecom Ass'n v. FCC*, 400 F.3d 29, 34-35 (D.C. Cir. 2004). As such, the Board's decision to adopt a new approach to qualitative market dominance in this case was an impermissible amendment of prior legislative rules adopted through notice-and-comment rulemaking to implement the market dominance requirements of 49 U.S.C. § 10707. Indeed, when the Board previously modified its approach to qualitative market dominance established in *Market Dominance Determination,* it did so by a notice-and-comment rulemaking. *See Product and Geographic Competition*, 2 I.C.C.2d 1(1985); *Market Dominance Determinations – Product and Geographic Competition,* 3 S.T.B. 937 (1998).

The limited exceptions to the APA's procedural requirements cannot justify the Board's action here. The Board's modification of its guidelines for qualitative market dominance cannot be understood to fit within the APA's narrow exception to the notice-and-comment requirement that applies to "interpretive rules" or rules of "agency organization, procedure, or practice." 5 U.S.C. § 553(b)(3)(A). The September Decision reverses the 1981 decision in *Market Dominance Determinations* and adopts a presumption of market dominance based on an R/VC ratio formula, redefining the substance of qualitative market dominance. Such a change to a substantive, legislative rule can only be pursued via a notice-and-comment rulemaking proceeding. *See Broadgate Inc. v. U.S. Citizenship and Immigration Services*, 730 F.Supp.2d 240, 244 (D.D.C. 2010) ("[An]agency's intent to exercise legislative power may be shown where the second rule effectively amends the previously adopted legislative rule, either by repudiating it or by virtue of the two rules' irreconcilability."). While the Board may have discretion to change its mind and even revert to a previously rejected prior rule if it notices a proposal, receives public comment, and establishes a reasoned basis for doing so, it may not circumvent the APA by characterizing its reversal in an adjudication as a "refinement." *See Marseilles Land and Water Co. v. FERC*, 345 F.3d 916, 920 (D.C. Cir. 2003) (holding that "an administrative agency may not slip by the notice -and -comment rule- making requirements needed to amend a rule by merely adopting a de facto amendment to its regulation through adjudication "); *see Shalala v. Guernsey Mem'l Hosp.*, 514 U.S. 87, 100 (1995) (an agency interpretation that "adopt[s] a new position inconsistent with ... existing regulations" must follow APA notice -and - comment procedures).

Moreover, the limited opportunity for the public to comment on the adoption of the rule in this proceeding, *ex post*, as *amicus curiae* does not cure the violation of the APA and does not transform this adjudicatory proceeding into a notice-and-comment rulemaking. Among other things, the APA requires that an agency publish notice of changes to a rule in the *Federal Register* and provide opportunity for public comment before adopting the rule. *See* 5 U.S.C. § 553. In this proceeding, however, no notice was filed in the *Federal Register.* Furthermore, the comment process the Board has established in this proceeding raises issues of fundamental fairness. The Board specifically stated in the October Decision that interested parties would "not be permitted to intervene" in this proceeding and interested parties have been given only a short window of time to submit a single round of comments on the new rule. Though the Board invited alternative approaches be submitted, a single round of comments does not allow interested parties to respond to anything contained in other parties' filings. In addition, the Board's limit price rule has already been adopted, indicating the Board's preference to move ahead with the rule change. Allowing interested stakeholders to comment on the rule as *amicus curiae* only after a new rule has been adopted does not satisfy the notice-and-comment requirements of the APA. *See General American Transp. Corp. v. ICC*, 872 F.2d 1048, 1060 (D.C. Cir. 1989) (finding "no authority for [the] theory that an adjudication is converted into a rulemaking solely because an agency solicits and entertains the comments of those who have an interest in prospective application of the principle under study").

II. Presumptions Of Market Dominance Based On R/VC Ratios Are Contrary To The Statute, Agency Precedent, And Sound Economics.

Congress and the ICC have previously concluded that rail carriers should not be presumed to possess market dominance based on R/VC ratios. The Board's September Decision that adopted a presumption of market dominance based on a quantitative analysis of a limit price R/VC ratio violated 49 U.S.C. § 10707(d)(2) and reflects a flawed formulaic approach to market dominance rejected by the Staggers Act and the ICC. Congress has expressly precluded the Board from presuming that a carrier possesses market dominance based on an R/VC ratio in Section 10707(d)(2). That section states that the Board cannot presume that a rail carrier possesses market dominance because the rate it charges generates an R/VC ratio that is greater than or equal to 180% of its variable costs. This reflects the Congressional intent that the agency engage in a qualitative examination of market dominance separate and apart from the quantitative examination of the rate required by 49 U.S.C. § 10707(d)(1). Indeed, the agency has long recognized that the Interstate Commerce Act, as amended, precludes a finding of market dominance if the challenged rate generates an R/VC ratio of less than 180% and it otherwise requires a qualitative analysis of whether or not traffic with a higher R/VC ratio is subject to effective competition. *See, e.g.*, *Market Dominance Determinations*, at 119. The agency has defined this qualitative investigation as "one based on a variety of qualitative and quantitative evidence separate from the price/cost jurisdictional threshold and not dependent on predetermined statistical measures." *Id.* at 119 & n. 5.

Although the ICC originally relied on rebuttable presumptions of market dominance, including one based on R/VC ratios, the agency rejected their use in 1981, after the passage of the Staggers Act. The reasons for rejecting presumptions still resonate today:

> [T]he use of rebuttable presumptions in market dominance determinations often placed too much emphasis on quantitative evidence which did not fully reflect the circumstances of any given movement. This quantitative evidence was frequently offered at the expense of other evidence which, though less subject to quantification, is more reflective of the degree of market power possessed by a rail carrier over certain traffic.

Id. at 120. A single-minded focus on quantitative measures of market dominance would defeat Congress's intent that the agency look at all of the circumstances regarding a movement of rail traffic to determine whether there is effective competition for the traffic. While the Board now cites its need for objective measures of market dominance to be able to process its docket more efficiently, it should not adopt formulaic solutions to questions that require its expert judgment weighing lane-specific qualitative evidence especially where the formulaic solution itself is of limited economic usefulness as explained below.

Any qualitative market dominance approach based on a quantitative analysis of R/VC ratios would suffer from a number of deficiencies. One weakness of the newly adopted approach is its reliance on system average URCS costs without recognition of the unique characteristics of the move to determine the state of competition for a particular movement of rail traffic. Even before URCS was adopted, the agency recognized the weakness of relying on standard costing measures in capturing movement-specific characteristics of traffic subject to a rate challenge. The ICC explained:

> Since the simplicity of the cost test requires that a standard costing methodology be used, there is no way of avoiding the distorting inaccuracies of such a test. Many rates falling above a designated revenue-to-variable cost ratio would, on that basis of more accurate cost estimates, in fact be below it.

Market Dominance Determinations, at 122.

Even if costs could be accurately measured, however, the agency has long recognized that R/VC ratios reveal little about market power. In 1981, the ICC rejected R/VC ratios as indicative of qualitative market dominance, *Id.* at 122, and since then the Board has consistently ruled that a high R/VC ratio is not a reliable indicator of market power. The September Decision acknowledges that "the Board has in the past expressed a reluctance to rely on the actual R/VC ratio, standing alone, to demonstrate a carrier's exercise of market dominance over a particular movement." September Decision, at 16. Footnote 46 provides some examples of that reluctance:

> *See Potomac Elec. Power Co. v. CSX Transp., Inc.*, 2 S.T.B. 290, 294 (1997) ("Apart from the 180% jurisdictional threshold, which has been set by law, we do not use rate-cost relationships as a basis for qualitative market dominance determinations."); *Mkt. Dominance Determinations*, 365 I.C.C. at 122 (questioning whether actual R/VC ratios "reliably indicate the presence or absence of market dominance" because there "are any number of reasons why a high price/cost ratio may not be indicative of true market power on the part of the railroad"). *See generally* Laurits R. Christensen Associates, Inc., *A Study of Competition in the U.S. Freight Railroad Industry and Analysis of Proposals That Might Enhance Competition—Revised Final Report* at ES-12 to ES-20 (Nov. 2009) (in independent study of competition in U.S. freight railroad market commissioned by the Board, noting relative weakness of R/VC ratio as indicator of market power abuse), *available at* http://www.stb.dot.gov/stb/elibrary/CompetitionStudy.html.

As the parenthetical descriptions reveal, the agency has not only had a reluctance to rely on R/VC ratios standing alone to determine market dominance, it has rejected that approach outright. Moreover, as cited by the Board, even independent economists recognize the limited usefulness of R/VC ratios for determinations of qualitative market dominance:

> The weak relationships between R/VC ratios and market structure factors illustrated in Table ES-4 imply that correctly assessing the presence of market-

> dominant behavior requires direct assessment of relevant market structure factors. Thus, regulatory reforms that would establish R/VC tests as the sole quantitative indicator of a railroad's market dominance are not appropriate.

Laurits R. Christensen Associates, Inc., *A Study of Competition in the U.S. Freight Railroad Industry and Analysis of Proposals That Might Enhance Competition—Revised Final Report* at ES-14 (Nov. 2009).

A belief, as the Board seems to hold, that a limit price rule comparing the price of the *alternative form* of transportation, rather than the challenged rate, to the variable costs of the defendant carrier somehow "does not implicate § 10707(d)(2)'s statutory directive or the concerns previously expressed by the Board," September Decision, at 17, does not withstand scrutiny from an economic standpoint. The Board's new rule is an R/VC ratio level (RSAM) that establishes a presumption of market dominance. The fact that the limit price R/VC ratio is based on a theoretical railroad price level rather than a real one is of no consequence. All of the previously identified problems with using an R/VC ratio to determine market dominance are still present. In essence, the question the Board is now posing is, "What is the maximum R/VC ratio the carrier could charge without losing significant amount of the traffic to a competitive alternative?" Fundamentally, that remains a determination of a rail carrier's rate generating an R/VC ratio that establishes a presumption of market dominance, a determination prohibited by 49 U.S.C. § 10707(d)(2). It is the same inquiry premised on the assumption that a high R/VC ratio must mean that a carrier is market dominant that has been rejected in the examples cited above and others.[2]

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[2] Indeed, the Board admits twice that it assumes, without explanation, that an R/VC ratio of 190% must mean that there is effective competition and an R/VC ratio of 500% must mean there is not. *See* September Decision, at 4, 17.

III. A Limit Price R/VC Ratio Greater Than RSAM Does Not Demonstrate A Lack of Effective Competition.

Following on the unfounded assumption that a high R/VC ratio would necessarily mean the presence of market dominance, the Board elected to compare the limit price to the carrier's RSAM to judge whether the limit price R/VC ratio was "too high." But there is no rational basis in the record for the Board to conclude that a limit price R/VC ratio above RSAM demonstrates anything about whether there is effective competition for a particular movement of rail traffic.

RSAM is one of the three benchmarks developed in *Rate Guidelines, Non-Coal Proceedings*, 1 S.T.B. 1004 (1996) and modified in *Simplified Standards for Rail Rate Cases*, EP 646 (Sub-No. 1)(STB served 5, 2007). RSAM is defined as the measure of the average markup that a railroad would need to collect from all of its potentially captive traffic (traffic priced above the jurisdictional threshold of 180% of variable cost) to earn a return on investment equal to the railroad industry cost of capital. The September Decision claims that a comparison of the limit price R/VC ratio to RSAM "provides an objective indication of monopoly pricing." September Decision, at 17. The September Decision is silent, though, on why the Board believes this to be true.

RSAM is not shown to be a measure of whether there is actual competition or how robust that competition is for any particular movement. The information contained in RSAM is unrelated to any specific market and does not incorporate any information on demand. It has not been shown to have any bearing as to whether a rail price in a specific market is effectively constrained by competition.

Ignoring what RSAM is and what it is not, the Board states that "effective competition likely exists if the highest price the carrier can theoretically charge to move that potentially captive traffic falls below the average point at which the carrier could achieve revenue adequacy," September Decision at 16 (citing *Simplified Standards*, at 81). That conclusion apparently rests solely on the following statement discussing the calculation of RSAM for use in the adjustment factor in Three-Benchmark cases:

> If for example, the railroad is not yet charging traffic enough to earn a reasonable return on its investment, this means the carrier is not engaging in the full degree of differential pricing that the law permits. The comparison rates must therefore be adjusted upwards, as they do not reflect the maximum lawful rates the carrier can charge, but rather are apparently being constrained by other market forces.

Simplified Standards, at 81. However, the Board's assertion that if a carrier is not revenue adequate, setting maximum lawful rates based on averages of what it currently charges would doom it to be revenue inadequate forever is not the same as proof that any rate below RSAM is necessarily facing effective competition or that all rates above RSAM are not. And that cited statement provides absolutely no support for a conclusion about market dominance based on an R/VC ratio that exceeds RSAM. There is no basis in the record for the Board to conclude anything about an R/VC ratio above RSAM other than it is above the average amount the Board calculates that that particular carrier would need to charge its traffic that currently moves at rates above 180% of its system average variable costs, as calculated by URCS, to be considered revenue adequate in a given year under the Board's annual determination of revenue adequacy.

Moreover, the Board does not in its decision affirmatively conclude that the limit price rule measures what the Board hopes it measures. Instead, it only states that the limit price "is intended" to capture the price point at which the carrier would lose significant amounts[3] of the traffic to an alternative and the limit price comparison to RSAM is "an effort" to determine whether alternatives are sufficient to deter the railroad from charging monopoly prices. September Decision, at 17.

Finally, because RSAM reflects a particular carrier's revenue adequacy findings in the Board's annual determination, the Board's new rule would mean that whether or not a particular movement of rail traffic was found to be facing effective competition would be based on how well that particular carrier recovered all of its costs, including its cost of capital, during four earlier years.[4] That is, two rail carriers in identical situations could have different market dominance results based solely on their revenue adequacy determinations. And an individual carrier could be presumptively constrained in pricing one year and presumptively market dominant the next depending on the carrier's financial performance and the Board's calculations of the rail industry cost of capital for the previous year, even if the cost of competitive alternatives and its variable cost for the move remained unchanged. As these examples illustrate, the results of the limit price test are driven by factors totally unrelated to the presence or absence of "effective competition" in the marketplace, and therefore, the test fundamentally fails to accomplish its designated purpose.[5]

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[3] The September Decision does not quantify what "significant amount" of traffic would divert to an alternative where the limit price R/VC ratio exceeds the carrier's RSAM figure.

[4] Due to the time lag in calculating the RSAM figure, the determination of the market dominance of rates established now would depend on the RSAM figures calculated for the years 2007 through 2010.

[5] The Board's reliance on "intangible features" to overcome the presumption of market dominance does not save the new "limit price" test. *See* September Decision, at 14 ("Finally, when appropriate, we will consider whether the alternative has any intangible features sufficient to overcome the applicable preliminary conclusion."). Likely, the Board will only look to the "intangible features" in close cases, inappropriately eliminating the qualitative market dominance analysis in most cases in exchange for this

Conclusion

As discussed above, the AAR respectfully submits that the limit price test was adopted in contravention of the APA. The Board's adoption of an approach to market dominance establishing a presumption based on R/VC ratios is flawed for the reasons set forth above. The limit price test is further flawed because RSAM has no rational connection to market dominance.

Respectfully Submitted,

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faulty new quantitative test. On the other hand, if the Board does intend to consider "intangible features" in the majority of cases, then the new quantitative filter would serve no purpose, and therefore in addition to being unsound, it also would be pointless.

CERTIFICATE OF SERVICE

I, Rosita M. N'Dikwe, hereby certify that on this date I served by first-class mail, postage prepaid a copy of the Comments of the Association of American Railroad in STB Docket No. 42123, *M & G Polymers USA, LLC v. CSX Transportation, Inc.* on all parties of record.

Rosita M. N'Dikwe

Rosita M. N'Dikwe

Dated: November 28, 2012