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**BEFORE THE
SURFACE TRANSPORTATION BOARD**

STB EX PARTE NO. 665 (Sub-No. 1)

RAIL TRANSPORTATION OF GRAIN, RATE REGULATION REVIEW

SUPPLEMENTAL COMMENTS OF NORFOLK SOUTHERN RAILWAY COMPANY

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In response to the Board's invitation at the June 10, 2015, public hearing in the above-captioned proceeding, Norfolk Southern Railway Company ("NS") submits these supplemental comments to make the following six points:

- First, despite repeated inquiry from the Board, grain shipper parties were unable to articulate any legitimate grounds to justify a separate rate test for grain shipments.

- Second, the record clearly establishes that the relative infrequency of grain rate cases is attributable to the limited number of movements that are even subject to the Board's jurisdiction—at least for NS.

- Third, the proposals submitted by grain shipper associations lack any economic foundation and are little more than an attempt to convince the Board to use rate caps to give special treatment to grain shippers.

- Fourth, although the Transportation Research Board ("TRB") study is too new for any party to have digested fully, it appears to offer little help to the Board because its recommendations fall outside the Board's statutory authority.

- Fifth, the Board should devote its attention to the several areas where parties generally agree.

- Sixth, although there was substantial conversation about various forms of arbitration, the Board does not have authority to mandate arbitration without parties' consent.

I. The Record Demonstrates That There Is No Reason to Treat Grain Differently for Purposes of Determining the Reasonableness of Rail Rates.

Board members repeatedly asked grain shipper parties why the transportation market for rail shipments of grain is so different from the market for other commodities that the creation of a special rate reasonableness test for grain shipments would be justified. Grain shipper parties were unable to offer any such reasons. The only coherent answer to the Board's inquiry was made by National Grain and Feed Association's ("NGFA") witnesses, who attempted to differentiate grain from other commodities by noting that (1) grain shipments have changes in origin and destination pairs; (2) grain shipments have changes in volumes; and (3) grain is driven by global market dynamics.

None of these factors are unique to grain. Indeed, the United States Court of Appeals for the D.C. Circuit rejected the first two as differentiating factors for grain shipments in *Burlington N. R.R. Co. v. ICC.*[1] And, of course, the Board recently has resolved stand-alone cost cases involving many lanes of chemicals shipments with changing volumes and shifting origin and destination pairs, which further amplifies the point made by the D.C. Circuit. *See, e.g., E.I. DuPont de Nemours & Co. v. Norfolk S. Ry. Co.,* STB Docket No. NOR 42125 (STB served Mar. 14, 2014) (final decision involved 138 lanes and 26 commodities, after several amendments to the complaint that the complainant alleged were due to shifting traffic lanes). Finally,

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[1] *See* 985 F.2d 589, 598 (D.C. Cir. 1993) ("The Commission claims that when, as here, there are multiple, scattered points of origin, it is very costly (or perhaps even impossible) to develop stand-alone figures for rates under review. Thus it argues that while CMP/SAC pricing may be best for coal pricing, coal carriage is unique because coal 'is typically shipped in frequent, regular, high-volume (unit-train) movements over high-density rail lines between a very few origin and destination points.' This argument is not supported by the ICC's own treatment of apparently analogous cases.") (internal citations omitted).

testimony from chemical customers in prior Board proceedings confirms that grain is far from the only industry driven by global market dynamics. *See, e.g.*, Comments of E.I. du Pont de Nemours & Co., STB Ex Parte No. 705, at 4–5 (filed Apr. 12, 2011).

In addition, the record reflects that "grain" is not a single, homogenous group. NS explained in its Opening Comments filed June 26, 2014, in this docket ("NS Opening") that grain is not a homogenous term because it potentially encompasses many different agricultural commodities and markets.[2] This point was augmented by the testimony of Pat Simonic, NS's Group Vice President of Agriculture, Fertilizer, and Consumer Products, who noted the diversity in commodities potentially encompassed in the term "grain" and the varying forms of competition at work in the transportation marketplace in which NS competes.

II. The Record Demonstrates that Market Forces Are the Reason for a Lack of Grain Rate Cases Involving NS.

Participants urge the Board to conclude that there is something amiss with grain rate regulation processes simply because no new grain rate cases have been filed recently. The record cannot support this reasoning.

First, NS provided unchallenged evidence that most of our grain rates fall below the statutory jurisdiction threshold. The average revenue-to-variable cost ("R/VC") ratio for grain shipments on NS was {{ }} between 2010 and 2012, and {{ }} of grain movements on NS moved at an R/VC less than 180%. *See* NS Opening at 13. Thus, there is only a small universe of shipments that could even meet the quantitative market dominance test.

And many of the shipments within this small universe also are subject to effective competition. The testimony of Mr. Simonic at the Board's hearing on June 10th demonstrated that NS faces competition in all its forms—modal, intermodal, transload, water, import, and

2 *See* NS Opening at 8–13.

product and geographic substitution. NGFA and the Alliance for Rail Competition ("ARC") similarly provided repeated descriptions of such competitive forces in their opening comments in this docket.[3] Of the limited traffic that moves at an R/VC above 180%, some faces this competition, and the Board would therefore lack jurisdiction over even more movements after applying the qualitative market dominance test.

Additionally, most of NS's grain movements are shipped pursuant to transportation contracts. In fact, about {{ }} of all NS grain movements—including some of the movements that have R/VC ratios over 180%—are under contract. Therefore, pursuant to 49 U.S.C. § 10709, the Board lacks jurisdiction over those movements as well. It should be no surprise that NS has entered into contracts with its customers. Indeed, the Board itself noted in adopting the *Coal Rate Guidelines, Nationwide* that clear rate regulation rules "will encourage contract solutions." 1 I.C.C. 2d 520, 524 (1985).

Finally, even where there may be movements that meet the market dominance tests and are shipping pursuant to tariff, NS strives to provide reasonable rates. In short, the most persuasive explanation for the absence of grain rate complaints is the pervasive competition in

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[3] *See, e.g.*, NGFA Opening at 8 ("Significantly, as noted previously, Ag Commodity markets are both national and global in scope. For example, *captive wheat and other commodity producers and elevators* compete not only against each other to sell their crops, but also *with shippers and receivers from other states and Canadian provinces*.") (emphasis added); *id.* (describing "the highly competitive marketplace in which this low-margin, high volume business operates in both domestic and international markets"); *id.* at 9 (explaining that "delivery points to which many Ag Commodities are shipped often have multiple sources of supply"); NGFA Opening, Crowley V.S. at 7 ("Grain and allied products, unlike many other products transported by rail, are extremely fungible, and deviation from the average cost of production and transportation can effectively foreclose a grain shipment from market.").

these markets. As a result, the lack of rate cases is not a signal for the Board to change the dynamics of a well-functioning marketplace.[4]

III. Grain Association Proposals Lack Any Economic Foundation and Are Little More Than Rate Caps.

The proposals tendered by grain shipper groups in this proceeding have no economic foundation and—at the end of the day—are nothing more than rate caps.

The Board has repeatedly and properly explained that "the core regulatory principle in the rail industry is that a railroad must be able to engage in some form of demand-based differential pricing to have the opportunity to earn adequate revenues." *Major Issues in Rail Rate Cases*, STB Ex Parte No. 657 (Sub-No. 1), slip op. at 20 (STB served Oct. 30, 2006). In *Mr. Sprout, Inc. v. United States*, 8 F.3d 118, 124 (2d Cir. 1993), the Court of Appeals for the Second Circuit explained that "Congress in the Staggers Act recognized that railroads must engage in 'differential pricing.'" This proposition is plainly true. It is reflected in the Staggers Act's preference for privately negotiated contracts, its limitations on Board jurisdiction over rate cases, and its explicit direction that rates generating R/VC ratios greater than 180% are not presumed unreasonable. In enacting the Staggers Act, Congress "understood the necessity of such differential pricing," since "because of the existence of competition, all rates cannot pay an equal percentage of 'fixed costs.'" H.R. Rep. No. 1035, 96th Cong., 2d Sess. 39, *reprinted in* 1980 U.S.C.C.A.N. 3978, 3984. "Not all traffic can be transported at fully allocated cost level due to competitive considerations . . . ." S. Rep. No. 96-470, 76th Cong., 1st Sess. 7 (1980).

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4 An apt example of this fact was provided in shipper and railroad testimony praising Montana's private arbitration process at the hearing on June 10th. BNSF clarified for the Board that 90% of its grain shipments in the state are eligible for this alternative arbitration process, yet only a single dispute has been brought under this program. This program is a testament to the fundamental point that the lack of disputes brought to a forum—whether it is at the Board or a private arbitration process—provide no evidence that the procedures are flawed.

Thus, differential pricing involves charging above fully allocated costs for *sole-served* traffic in order to be able to continue carrying *competitive* traffic at levels much closer to variable costs. *See* H.R. Rep. No. 1035, 96th Cong., 2d Sess. 39 (1980), *reprinted in* 1980 U.S.C.C.A.N. 3978, 3984-85; *see also* S. Rep. No. 470, 96th Cong., 1st Sess. 7 (1980).

However, both rate reasonableness tests that the grain shipper groups proposed are fundamentally inconsistent with differential pricing. First, the so-called Two-Benchmark test is a mere rate cap that sets rates at the defendant railroad's RSAM. *See* ARC Opening, Fauth V.S. at 26 ("Such a test would . . . provide an effective cap of railroad grain rates"). The proposal's primary departure from the Board's Three Benchmark test is its elimination of the R/VC_{COMP} component of the test. The R/VC_{COMP}, however, is the only tool for bringing the market and shipment characteristics into the Three-Benchmark test.

> The R/VC_{COMP} test . . . measures the markup taken on demand-inelastic traffic involving similar commodities moving under similar transportation conditions. Even though the test is crude—the comparison traffic is not likely to have precisely the same degree of demand elasticity—it is the only simple means available to obtain even a rough measure of this very important pricing factor.

Rate Guidelines – Non-Coal Proceedings, STB Ex Parte No. 347 (Sub-No. 2) (STB served Dec. 1, 1995). By excluding the R/VC_{COMP} test, the Two Benchmark test simply eliminates demand-based differential pricing altogether.

Second, NGFA's ACMRM test is equally divorced from sound economics. For example, NGFA proposes to include in the comparison group similar traffic that moves on a carrier other than the defendant. The Board has properly rejected such a proposal in the past:

> We will exclude non-defendant traffic from the comparison group because 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.

Simplified Standards for Rail Rate Cases, STB Ex Parte No. 646 (Sub-No. 1) (STB served Sept. 5, 2007). Moreover, permitting movements on carriers other than the defendant would create a rate regime in which the defendant railroad would never know whether its rate was reasonable (unless it set all rates at R/VC=180%, which is the outcome of these proposals as discussed below). No railroad would be able to predict the outcome of the regulatory test, which is essential in order for the regulated entity to comply with the law, because no railroad knows how another carrier prices its traffic or what is in another carrier's private contracts.

NGFA also proposes to include in the comparison group traffic that generates an R/VC ratio less than 180%. This feature, if adopted, would eviscerate the concept of demand-based differential pricing. The reasonableness of a challenged rate for traffic with inelastic demand for transportation services cannot be compared to (and judged by) the rate for traffic with more elastic demand for transportation. The core foundation of the Staggers Act was to permit railroads to engage in that kind of demand-based differential pricing. Moreover, the Court of Appeals has already explained why that proposal is inconsistent with the statute and with sound economics:

> [S]hippers argue that by excluding traffic with revenue below the 180% R/VC ratio but above fully allocated costs, the Commission wrongly 'exclude[d] any competitive traffic.'. . . Its aim in applying the R/VC test, it said, was to 'develop a benchmark of maximum reasonableness based on the differential pricing experienced by similarly situated traffic, not on a ratio which represents an average mark-up.'. . . This appears completely in accord with the undisputed proposition that Staggers contemplated that rates could be reasonable even though they reflected an exercise of market power. See 49 U.S.C. § 10709(c) ("a finding of market dominance does not establish a presumption that the proposed [or existing] rate exceeds a reasonable maximum"). . . . Further, the shippers' proposal incorporates a principle which, if it were continuously applied, would reduce the rates paid by captive shippers to their share of fully allocated cost. . . . Since railroads cannot expect to recover the very elastic shippers' share of fully allocated costs from them, the shippers' principle would condemn the railroads to revenue inadequacy.

Burlington N. R.R. Co. v. ICC, 985 F.2d at 600.

The goal of these two proposed modifications is simple—to ensure that the movements in the comparison group generate an R/VC of 180% or less so that the maximum rate is always set at the jurisdictional threshold. Because NS does not know about another carrier's rates, consider a case in which another carrier is the defendant. According to Mr. Crowley's testimony at the hearing, movements on NS that meet the criteria to be eligible for inclusion in the comparison group not only could, but would have to, be included in the comparison group. {{ }} of NS's grain movements move at rates that generate an R/VC less than 180%, and the average R/VC of NS's grain movements is {{ }}. The effect of including NS movements simply would be to drag the average below 180%. In short, both ARC's and NGFA's proposed tests eliminate the demand-based differential pricing needed to ensure the economic viability of the railroad system.

IV. The TRB's New Report Seems to Offer the Board Little Help.

At the hearing, the TRB revealed the conclusions of its lengthy report, which it released that morning. Like other parties, NS is reviewing the report. However, even at this early stage, several limitations seem readily apparent. The TRB report is merely an academic exercise and does not attempt to provide insight into how to regulate under the existing statutes. Indeed, Dr. Schmalensee stated that the TRB team was not constrained by existing statutes: "I wish we'd been able to come up with, given your statutory authority, here is the obvious way forward, but we didn't impose that constraint on ourselves . . . ." Testimony of Dr. Schmalensee, STB Ex Parte No. 665 (Sub-No. 1) (June 10, 2015).

The lack of any constraints on the thinking that went into the TRB report seems readily apparent upon an early review. In fact, it appears that the TRB report is untethered from sound economic principles that courts have found underpin the Staggers Act, such as differential pricing. *See Mr. Sprout, Inc. v. United States*, 8 F.3d at 124–25. As an example of the TRB report's failure to consider the economic theory underpinning the regulatory regime that has proved so successful over the past 35 years, the TRB report did not cite, review, or critique significant economic literature explaining constrained market pricing and stand-alone cost. Not one article by Robert D. Willig or William J. Baumol, both of who have been publishing in this area of economics since at least 1982, was cited. Finally, the report does not advance or propose any economic theory for rate regulation in place of those it seemingly would set aside. Without an underlying economic theory, concepts to which the report refers—like "fairness"—are meaningless.

V. There Are Four Areas of Agreement Among the Parties Where the Board Should Devote Its Attention.

Most parties to this proceeding generally agree that there are four issues on which the Board should take action. *See* NS Reply Comments at 6–12.

First, several witnesses, and most prominently the Chief Legal Counsel for the Montana Department of Agriculture, proposed that the Board clarify who can bring a rate case. Accordingly, it may be helpful for the Board to reaffirm the statutory ability of third parties who do not directly pay for transportation to bring rate challenges. By statute a "governmental authority" can bring suit, so there does not seem to be a need for clarification of that point. 49 U.S.C. § 11701(b). Direct purchasers of rail freight transportation clearly have the ability to bring a rate case, as many have. Moreover, an indirect purchaser—a party not directly paying the freight rate—already can bring a rate challenge if it demonstrates a sufficient nexus to the rate at issue. 49 U.S.C. § 11701(b) ("However, the Board may not dismiss a complaint . . . because of the absence of direct damage to the complainant.")

Even the question of who can bring a case for reparations is well-settled. The general rule under the Interstate Commerce Act has been that the person or persons that were responsible for the freight charges could be awarded reparations for unreasonable rates. *See Baer Brothers Mercantile Co. v. Denver & Rio Grande R.R. Co.*, 233 U.S. 479, 487–88 (1914); *Merriam & Millard Co. v. Chicago & Alton R.R. Co.*, 39 I.C.C. 485, 486 (1915). So a direct purchaser (the person who pays the freight) can sue for both a prescription and reparations, whereas someone who has no direct damages can file suit so long as there is a sufficient nexus to the freight shipment but only receive injunctive relief. This rule makes perfect sense and is analogous to federal antitrust law. Federal antitrust law permits only direct purchasers to bring claims for both injunctive relief (a rate prescription) and damages; indirect purchasers can bring a claim solely for injunctive relief. *Illinois Brick v. Illinois*, 431 U.S. 720 (1977).[5] It also makes sense because, if the rate is found to be unreasonable using sound economics, the defendant railroad can only be ordered to pay damages once.

Second, there is agreement among the parties to this proceeding (and many other parties) that the Board should jettison the "Limit Price Test" for qualitative market dominance.

Third, the Board could reconsider the prohibition on movement-specific adjustments. As NS noted in its testimony at the hearing, allowing movement specific adjustments is not a grain issue. It is an all or nothing proposition. Those adjustments must be allowed in all cases or no

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[5] In *Illinois Brick*, the Supreme Court declared that, absent clear direction from Congress to the contrary, the interest of enforcing the federal antitrust law are "better served by holding direct purchasers to be injured to the full extent of the overcharge paid by them rather than by attempting to apportion the overcharge among all that may have absorbed a part of it." *Id.* at 746. In effect, determining how much of an overcharge is passed through to a customer is so intrinsically difficult that the Court declared as a matter of federal antitrust law that direct purchasers, rather than indirect purchasers, were the parties injured by the antitrust violation.

cases. But, the parties here seem to be in agreement that the Board may want to reexamine its decision generally to exclude those adjustments.

Fourth, the Board could look at expanding the use of non-binding mediation.

VI. The Board Does Not Have Authority to Mandate Arbitration without Parties' Consent.

Finally, there was extensive discussion at the hearing regarding arbitration in various forms. Despite that conversation, there is a critical fact to remember. The Board has no authority to require binding arbitration. The Board itself has previously recognized that current law does not permit it to order binding arbitration of rate reasonableness complaints.[6] Under the Alternative Dispute Resolution Act, 5 U.S.C. § 570 *et seq.*, the Board lacks authority to delegate its rate regulation authority to another party absent voluntary agreement by both the railroad and shipper.[7] Absent such an agreement, the parties are entitled to decisions from the agency, whose members are appointed by the President and confirmed by the Senate.

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6 *See Arbitration – Various Matters Relating to Its Use as an Effective Means of Resolving Disputes That Are Subject to the Board's Jurisdiction*, STB Ex Parte No. 586, slip op. at 1 (STB served Oct. 26, 2001) (explaining "current law permits arbitration of disputes within the Board's jurisdiction only where the parties agree to use that process").

7 NS Opening at 3–7, *Assessment of Mediation and Arbitration Procedures*, EP 699 (filed May 17, 2012); *see also* AAR Comments at 5–12, *Assessment of Mediation and Arbitration Procedures*, STB Ex Parte No. 699 (filed May 17, 2012) (detailing the Board's lack of authority under 49 U.S.C. § 721 and the Alternative Dispute Resolution Act to impose arbitration "without the voluntary consent of the parties").

Respectfully submitted,

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