

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

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STB Ex Parte No. 722

RAILROAD REVENUE ADEQUACY

**SUPPLEMENTAL COMMENTS OF THE
ASSOCIATION OF AMERICAN RAILROADS**

In a decision served July 29, 2015, the Board held open the record in this proceeding until August 6, 2015 to permit parties to file supplemental comments. The Association of American Railroads (“AAR”) submits these Supplemental Comments to respond to testimony presented by participants at the hearing, to respond to questions and observations made by the Commissioners at the hearing and to further explain its position that the Board should not pursue efforts to implement a revenue adequacy constraint on rail rates.

We note at the outset that the primary focus throughout this proceeding has been on issues of regulatory policy, and AAR maintains that focus in its Supplemental Comments. But there is a legal dimension to the revenue adequacy issue that would come into play if the Board were to attempt to implement a revenue adequacy constraint applicable to rail rates. There are serious doubts as to whether the Board could do so based on the shipper proposals presented in this proceeding. In particular, we note that the shippers’ various revenue adequacy rate constraint proposals are founded on the proposition that the combination of market dominance over a challenged rate and the condition of system wide revenue adequacy for the carrier handling the traffic to which the rate applies creates a presumption that rates on individual movement are unreasonably high. That presumption is unfounded and improper. The statute explicitly states that market dominance does not create a presumption of unreasonableness, and

that provision applies to both revenue and revenue inadequate carriers. Moreover, there is nothing about the status of revenue adequacy that tells the Board anything about the reasonableness of a particular rate. Doubts regarding the legality of a revenue adequacy constraint for railroads should reinforce the strong policy imperative of allowing railroads to pursue overall earnings that will enable them to continue to invest in an expanding rail network.

I. Regulating Rates on the Basis of Firm-Wide Revenues Would Produce the Same Harmful Distortions As Direct Profit Regulation.

The Board should not be misled by assertions that proposals to implement a revenue adequacy constraint are limited in scope, that they would affect only a “small sliver” of railroad traffic, and that they would have a negligible impact on railroads’ incentives and ability to invest. The pernicious effect of the shippers’ revenue adequacy rate regulation proposals is not a function of the number of movements or rates that would be immediately eligible for rate relief, but of the network-wide consequences of regulating rates based on a carrier’s overall level of revenues. Imposing regulatory consequences based on a carrier’s overall revenues is a form of profit regulation that has been largely abandoned by regulators around the world and is widely criticized by economists.¹ As the witnesses of AAR and its members explained at the hearing,

¹ Despite their denials, the shipper proposals for new rate regulation methodologies are in fact proposals for profit regulation. The Board has received extensive evidence in this proceeding about the severe economic distortions caused by profit regulation and the consequent abandonment of profit regulation as a regulatory tool. *See, e.g.*, Reply Comments of the Association of American Railroads, Reply Verified Statement of Joseph P. Kalt, *Railroad Revenue Adequacy*, STB Ex Parte No. 722, at 19-20 (filed Nov. 4, 2014); Opening Comments of Norfolk Southern Railway Co., Verified Statement of David Sappington, *Railroad Revenue Adequacy*, STB Ex Parte No. 722, at 2-4, 6-11 (filed Sept. 5, 2014); Opening Comments of Union Pacific Railroad Co., Verified Statement of Kevin M. Murphy, *Railroad Revenue Adequacy*, STB Ex Parte No. 722, at 25-34 (filed Sept. 5, 2014); Oral Testimony of Joseph P. Kalt, Video Transcript of Morning Portion of Hearing, July 22, 2015, *Railroad Revenue Adequacy*, STB Ex Parte No. 722, at 2:54:00 to 2:59:00; Oral Testimony of David Sappington, Video Transcript of Afternoon Portion of Hearing, July 22, 2015, *Railroad Revenue Adequacy*, STB Ex Parte No. 722, at 0:19:13 to 0:33:18.

this central feature of shippers' proposals, including the Western Coal Traffic League's ("WCTL") rate freeze proposal, would distort market signals and investment incentives across the rail network and negatively affect all shippers, including those shippers whose rates are not regulated.

As an initial matter, the scope of shippers' revenue adequacy proposals – *i.e.*, the number of rates that might be eligible for relief – would not be limited to a small amount of traffic. For example, it was suggested at the hearing that approximately 5% of railroad carloads would be subject immediately to a revenue adequacy constraint and that an additional 14% of railroad carloads covered by contracts could become subject to the constraint upon contract expiration. AAR is not privy to the data and calculations underlying those numbers. Yet, even if these figures reasonably estimated the carloads potentially subject to regulation, that would not mean that only a "small sliver" of railroad traffic would be subject to rate regulation based on a revenue adequacy constraint. Moreover, the percentage of revenue affected by a revenue adequacy constraint could be considerably larger than 20% since the constraint would only apply to higher-rated traffic. It is also important to note that both regulated and contract traffic must be included in any assessment of potential impact. WCTL's rate freeze proposal, for example, would explicitly apply to contract traffic by locking the contract price in place even after the contract expires.² Shippers would likely take advantage of this feature of WCTL's proposal as soon as their current contracts expire. In any event, as Mr. Hamberger pointed out in his

² Joint Opening Comments of the Western Coal Traffic League, *et al.*, *Railroad Revenue Adequacy*, STB Docket Ex Parte No. 722, at 31 (filed Sept. 5, 2014).

testimony, any rate regulation proposal that seeks to reach a fifth of railroad carloads is by definition not narrow in scope.³

Economist Kevin Murphy, testifying on behalf of Union Pacific, explained how rail investment and service would be undermined by rate regulation based on a company-wide measure of overall revenues even if that regulation directly affected only a relatively modest number of rates or movements. If the level of a railroad's overall earnings could trigger rate constraints such as a rate freeze or rate reduction on some traffic, its economic incentives to increase margins by reducing costs and making profitable investments would be undermined. Undermining these profit incentives would adversely affect all traffic, including competitive traffic.⁴

Why would a railroad pursue efficiency measures or commit capital to risky projects intended to increase revenues if it could not expect to benefit from those measures? Railroad incentives would change for both competitive and non-competitive traffic because revenue from competitive traffic would count against railroads in the revenue adequacy calculation, even though shippers of competitive traffic could not obtain rate reductions. Railroads are networks that use the same facilities to serve both competitive and non-competitive traffic. Thus, disincentives to invest would adversely affect all traffic.

Rail pricing decisions would also be distorted for all traffic, not just the movements directly affected by revenue adequacy regulation. Market conditions might permit a railroad to raise a rate for competitive traffic, but the railroad might be reluctant to do so if additional

³ Video Transcript of Morning Portion of Hearing, July 22, 2015, *Railroad Revenue Adequacy*, STB Ex Parte No. 722, at 3:00:04 to 3:01:22.

⁴ Video Transcript of Afternoon Portion of Hearing, July 23, 2015, *Railroad Revenue Adequacy*, STB Ex Parte No. 722, at 2:16:00 to 2:19:07. Professor Kalt offered similar testimony as part of the AAR panel. Video Transcript of Morning Portion of Hearing, July 22, 2015, *Railroad Revenue Adequacy*, STB Ex Parte No. 722, at 3:01:23 to 3:02:08.

revenue would be lost either because it would push the railroad over the revenue adequacy threshold or because the additional revenue would be transferred to a non-competitive shipper as a rate reduction.

The broad effect of any rate regulation scheme based on overall revenues can be illustrated by a concrete example. Consider a line segment that serves several coal shippers over which a railroad is market dominant as defined by the Board. The need for increased network fluidity might call for an increase in capacity on that segment that could be achieved only through additional investment. But confronted with either a rate freeze or a rate rollback based on overall revenue, the railroad might lose its incentive to make the investment. Any revenue benefit flowing from improved fluidity would either be reduced or eliminated under revenue adequacy regulation. If the line segment in this example served a mix of market dominant and competitive traffic, the impact on competitive traffic is also obvious: investments that would benefit all of the railroad's traffic will not be made because the railroad would be faced with rate freezes or rate reductions on market dominant traffic.

WCTL in particular tries to characterize its rate freeze proposal as modest, but the adverse effects of that proposal would be serious and severe. Freezing rates on market dominant traffic would undermine the ability of railroads to respond to market conditions through pricing and therefore defeat a primary goal of the Staggers Act reforms. Railroads could not raise rates on market dominant traffic to respond to increased shipper demand, resulting in sub-optimal investment in capacity. Conversely, where market factors pointed towards a short-term reduction in price, *e.g.*, to obtain incremental volume from a facility with an existing base-load of business, the railroad could be discouraged from reducing prices on traffic because any price reduction could become permanent. In addition, WCTL's proposal to freeze rates at the level

specified in expiring contracts could substantially alter the current structure of rail markets by discouraging the use of contracts. Railroads and shippers alike would become reluctant to use contracts. Railroads would fear that outdated contract rates would become frozen in place. Shippers would decline to enter into long term contracts with rate escalation provisions because they would thereby forgo the option to have their rates frozen for the duration of the contract.

II. Benchmarking Rates Cannot Be a Substitute for SAC.

There was substantial discussion at the hearing about the possibility of assessing rates for market dominant traffic on revenue adequate railroads based on some form of comparison to rates charged to non-market dominant traffic. Some shippers seem to assume they should pay similar rates regardless of the relative values that they place on rail service. That assumption violates a key principle of railroad economics. As the ICC explained in *Coal Rate Guidelines, Nationwide*, 1 I.C.C. 2d 520, 526 (1985) (“*Guidelines*”), railroads have significant “unattributable costs” that “cannot be assigned directly to specific movements by any conventional accounting methodology.” If the railroad had to charge all shippers the same average rate in order to recover those costs instead of differentially pricing based on demand, “it would lose that traffic for which the demand could not support the price assigned. In that event, the remaining shippers might be required to pay a larger portion of the carrier’s unattributable costs because they would lose the benefit of sharing these costs with the lost traffic.”⁵ All shippers benefit from demand-based pricing by expanding the shipper group that pays for the

⁵ *Guidelines*, 1 I.C.C. 2d at 526. Moreover, any rate comparison method would create a disincentive for railroads to attract new traffic by lowering the rate for fear that the reduction could become the basis for lower rates on other supposedly comparable traffic.

large portions of a railroad's costs that are unattributable to particular movements.⁶ Even the Concerned Shipper's economist Kevin Caves acknowledges that railroads must engage in differential pricing.⁷

As AAR's witness Joseph Kalt explained, any valid rate comparison approach would likely end up resembling SAC. Professor Kalt noted that while it might be appealing to compare rates charged a sole-served shipper of market dominant traffic to those charged other shippers served by multiple railroads or trucks in other locations, the comparison would not identify the economically appropriate market-based price because it would not account for the relevant economic characteristics of the specific movements at issue. A valid comparison would have to account for commercial considerations like traffic volume and relative demand elasticity.⁸ Any potentially meaningful comparison of rates would require adjustments to account for a range of specific circumstances, including the relevant network configuration and the existence of economies of scope and density. The type of individualized inquiry required to determine whether rates charged for the issue traffic are truly comparable to "benchmark" rates charged to shippers operating in different market and network circumstances could closely resemble a SAC analysis.⁹

⁶ Recognizing this well-established principle of railroad economics, the courts rejected an ICC attempt to substitute an average rate methodology for SAC in the *McCarty Farms* case. *Burlington Northern Railroad Co. v. ICC*, 985 F.2d 589, 595-99 (D.C. Cir. 1993).

⁷ Video Transcript of Afternoon Portion of Hearing, July 23, 2015, *Railroad Revenue Adequacy*, STB Ex Parte No. 722, at 0:25:28 to 0:25:49.

⁸ The Board's current Three Benchmark approach recognizes that demand elasticity must be considered as a factor in identifying comparable movements. *Simplified Standards for Rail Rate Cases*, STB Docket No. EP 646 (Sub-No. 1), slip op. at 17 (STB served Sept. 5, 2007).

⁹ Video Transcript of Morning Portion of Hearing, July 22, 2015, *Railroad Revenue Adequacy*, STB Ex Parte No. 722, at 3:06:34 to 3:10:01. Notably, as Commissioner Miller recognized at the hearing, the Transportation Research Board in its recent report came well short of recommending that price comparisons could be used as the method for establishing reasonable

III. Replacement Cost Is the Economically Valid Measure of Asset Values for Calculating Return on Investment.

There was much discussion of the relevance of replacement cost at the hearing. AAR's position on this question should be clear: the Board should not implement a revenue adequacy constraint on rates regardless of how the return-on-investment ("ROI") measure is calculated. Moreover, the error of applying a revenue adequacy constraint would be compounded if the calculation of ROI were to continue to be based on the book value of assets, which results in significant overstatement of railroad returns. The use of accounting-based asset values is particularly inappropriate for capital-intensive firms with long-lived assets, such as railroads.¹⁰

There is no serious dispute that replacement cost is the economically valid measure for calculating economic return on investment. In its most recent decision to address the question, the Board acknowledged findings by the Interstate Commerce Commission and the Rail Accounting Principles Board that replacement cost is "theoretically preferable," better reflects "the true economic costs associated with an investment," and "comes closer to the competitive result."¹¹ The economic literature conclusively establishes that accounting returns of the type

rates. Transportation Research Board, *Modernizing Freight Rail Regulation*, at 91-92 (2015) (rate comparisons could serve as a "benchmark for deciding whether the shipper's rate is unusually high and a candidate for a closer rate reasonableness examination").

¹⁰ The use of accounting-based asset values can provide a useful approach for monitoring financial progress over time, but use of those asset values is not appropriate in regulating rates.

¹¹ See *Petition of the Association of American Railroads to Institute a Rulemaking Proceeding to Adopt a Replacement Cost Methodology to Determine Railroad Revenue Adequacy*, STB Ex Parte No. 679, slip op. at 2-3 (served Oct. 24, 2008) (discussing *Standards for Railroad Revenue Adequacy*, 364 I.C.C. 803 (1981); *Standards for Railroad Revenue Adequacy*, 3 I.C.C. 2d 261 (1986); and the final report of the Rail Accounting Principles Board, *Railroad Accounting Principles* (Sept. 1987)).

presently used by the Board to evaluate revenue adequacy are not a valid measure of economic returns.¹²

The available evidence further demonstrates that accounting-based measures of return consistently produce an overstated ROI when compared to ROIs based on replacement cost. As AAR witness Roger Brinner demonstrated in his written testimony in this proceeding, “the use of current cost valuation of assets has a very large impact on the measurement of the rate of return and . . . the impact of using current costs is particularly large in an industry like the railroad industry with long-lived assets.”¹³ Dr. Brinner’s analysis of Bureau of Economic Affairs data showed that railroad ROI calculated on replacement cost was substantially below ROI calculated on historical costs for the period 2003-2012.¹⁴

The Board, and the ICC before it, rejected use of replacement costs as infeasible. AAR does not believe that that conclusion would hold if the Board were to initiate a proceeding devoted to exploring how replacement cost could be determined. Such a proceeding could address both the feasibility of estimating replacement costs and a method for determining what

¹² See F. Fisher & J. McGowan, “On the Misuses of Accounting Rates of Return to Infer Monopoly Profits,” 73 *The American Economic Review* 82, 90 (1983) (“[T]here is no way in which one can look at accounting rates of return and infer anything about relative economic profitability or, *a fortiori*, about the presence or absence of monopoly profits.”).

¹³ Opening Comments of the Association of American Railroads, Verified Statement of Roger Brinner, *Railroad Revenue Adequacy*, STB Ex Parte No. 722, at 21 (filed Sept. 5, 2014).

¹⁴ *Id.* at 24-25. AAR’s replacement cost petition in Ex Parte No. 679 demonstrated a similar divergence between the higher ROI calculated by the Board based on historical costs and a lower replacement cost based ROI. In that proceeding, AAR witness Michael Baranowski calculated ROI based on replacement cost for 2006 for BNSF (6.04%), CSXT (4.36%), NS (5.5%), and UP (4.83%). Association of American Railroads, *Petition of the Association of American Railroads to Institute a Rulemaking Proceeding to Adopt a Replacement Cost Methodology to Determine Railroad Revenue Adequacy*, STB Ex Parte No. 679, at 36 (filed May 1, 2008). The ROI figures calculated by the Board for 2006 were significantly higher: BNSF (11.43%), CSXT (8.15%), NS (14.36%), and UP (8.21%). *Railroad Revenue Adequacy – 2006 Determination*, STB Ex Parte No. 552 (Sub-No. 11), slip op. at 3 (served May 6, 2008).

rail assets should be included in the replacement cost estimate. The alternative course of persisting in using an asset valuation methodology that produces demonstrably inaccurate results is not sound regulatory practice.

IV. The Board Should Focus on Improving the SAC Process.

The Board has adopted and developed a sophisticated and accurate method for determining the reasonableness of rates for individual movements, the SAC test. The SAC test properly does the job that any valid revenue adequacy test would accomplish by focusing on the level of revenues necessary to cover the full costs of providing the relevant rail service. As the Board and the D.C. Circuit both recognized in the *Xcel* case, “the SAC test is designed to take into account the railroad’s need for revenue adequacy ‘on the portion of its system that is included in the system of the SARR.’”¹⁵

Members of the Board, as well as shippers and railroads themselves, are understandably frustrated with the complexity of SAC cases. In part, impressions of complexity have been heightened by the fact that recent SAC cases involving large volumes of carload traffic have raised issues not addressed in prior SAC cases. No doubt some of the issues in recent cases will be resolved through the evolutionary development of SAC just as many other issues have been resolved in the past. Because regulating rail rates is inherently difficult, some complexity is unavoidable if accurate and economically valid results are to be achieved.¹⁶ But complexity is no reason to bypass well established, court approved rate regulation standards in favor of unsupportable approaches designed to provide easy answers to hard questions.

¹⁵ *BNSF Railway Co. v. STB*, 453 F.3d 473, 480 (D.C. Cir. 2006) (quoting *Public Service Co. of Colorado v. Burlington Northern & Santa Fe Railway Co.*, STB Docket No. NOR 42057, slip op. at 6 (served Jan.19, 2005)).

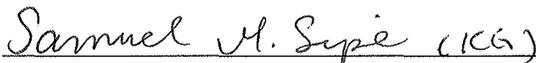
¹⁶ The Board’s decision in *Rate Guidelines – Non-Coal Proceedings*, 1 S.T.B. 1004 (1996), contains a thoughtful discussion of the trade-off between accuracy, which entails complexity, and simplification.

The Board should continue to pursue the goal of accuracy in its rate reasonableness determinations and should focus on improving the SAC process and the administrability of SAC. AAR understands that the Board has recently conducted an internal review of SAC procedures and hopes that the Board will share any insights gained from that process. In addition, the Board heard testimony from several witnesses at the hearing concerning the potential usefulness of technical conferences to help resolve methodological issues with SAC. AAR is committed to working cooperatively with the Board to reduce the burdens for all parties associated with trying a SAC case.

Respectfully submitted,

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