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SURFACE TRANSPORTATION BOARD

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RAILROAD REVENUE ADEQUACY

OPENING COMMENTS OF

ALLIANCE FOR RAIL COMPETITION
MONTANA WHEAT & BARLEY COMMITTEE
USA DRY PEA AND LENTIL COUNCIL
COLORADO WHEAT ADMINISTRATIVE COMMITTEE
IDAHO BARLEY COMMISSION
IDAHO GRAIN PRODUCERS ASSOCIATION
IDAHO WHEAT COMMISSION
MONTANA FARMERS UNION
NORTH DAKOTA GRAIN DEALERS ASSOCIATION
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I. INTRODUCTION

Alliance for Rail Competition ("ARC") and the agricultural shipper and producer interests identified on the cover of these Opening Comments[1] (collectively "ARC, et al.") commend the STB for initiating this proceeding. For decades, the goal of railroad revenue adequacy has guided ICC and STB regulation of railroads. Achievement of that milestone is now upon us, and the time has come to consider how past regulatory policies adopted when railroads were found revenue inadequate should change for railroads that attain or exceed revenue adequacy.

ARC, et al. have recently filed comments addressing, among other issues, revenue adequacy in the context of grain rate regulation in EP 665 (Sub-No. 1), Rail Transportation of Grain, Rate Regulation Review. The Board's attention is respectfully directed to those comments, and to comments filed in that proceeding by The National Grain and Feed Association ("NGFA"), and the U.S. Department of Transportation ("USDA"), for a fuller discussion of grain rate regulation for railroads that have achieved revenue adequacy (and for railroads not yet found revenue adequate).

[1] Colorado Wheat Administrative Committee, Idaho Barley Association, Idaho Grain Producers Association, Idaho Wheat Commission, Montana Farmers Union, Montana Wheat and Barley Committee, Nebraska Wheat Board, North Dakota Grain Dealers Association, Oklahoma Wheat Commission, Oregon Wheat Commission, South Dakota Wheat Commission, Texas Wheat Producer Board, Washington Grain Commission, Wyoming Wheat Marketing Commission, and USA Dry Pea and Lentil Council

In our comments in this proceeding, filed on behalf not just of shippers and producers of agricultural commodities but also for ARC members shipping coal, sand (including sand for fracking), glass, chemicals and other commodities, ARC, et al. will focus on revenue adequate railroads, and some of the points made in EP 665 (Sub-No. 1) will be reiterated here. Unfortunately, the Railroad parties in EP 665 (Sub-No. 1) elected to ignore revenue adequacy in that proceeding, leaving the Board to consider sketchy Railroad comments as to regulation of the grain rates of revenue adequate railroads.

The Railroad parties in EP 665 (Sub-No. 1) also took the position that the status quo as to grain rate regulation should not change. Deficiencies cited by ARC, et al., NGFA and USDA were brushed aside, and the railroads went to great lengths to claim that many grain shippers do not pay excessive rates, and do not need improved regulatory remedies. No one claims that all rail customers are captive, or that all captive customers pay unlawfully high rates. Such arguments by Railroads therefore failed to address the issues presented, which concerned the challenges faced by rail customers who are poorly served by the regulatory status quo, in violation of statutory requirements.

The Railroads demand federal intervention to ensure that they earn adequate revenues, but oppose STB intervention needed to protect captive shippers from excessive rates or other abuses of railroad market power. The Interstate Commerce Act and the STB do not exist for the protection of shippers who enjoy effective competition, low rates and good service. At issue here are shippers for whom regulation offers little or no protection, and who are now paying high rates and charges (or may do so anytime a market dominant railroad decides to charge more) and enduring poor service. The SAC, Simplified SAC and Three-Benchmark tests are not affordable and do not work for the overwhelming majority of captive shippers who may need a defense against abuses of railroad market power. For such shippers, the revenue adequacy constraint has held out the hope of a better future.

The Railroads also insisted in EP 665 (Sub-No. 1), as they have in other proceedings and probably will again here (as if repetition were proof), that their rates are “market” based. See, e.g., the reply comments filed August 25, 2014 by UP, at page 22: “All shippers should contribute to fixed and common costs as determined by competitive market principles. It is neither credible nor consistent with the statute to suggest that grain shippers are entitled to rates below levels that would prevail in a competitive market.” What UP and other railroads resist acknowledging is that, for many captive shippers, there is by definition no competitive market. “Competitive market principles” for such shippers are simply camouflage for unregulated monopoly pricing, and most captive shippers would gladly pay rates at levels that would prevail in a market with effective competition. What consistency with the statute requires is that, where market dominance in found, rail rates “must be reasonable,” 49 USC Section 10701(d)(1), but current rate regulation does little to ensure that result.

With respect to revenue adequacy, the Railroads’ comments in EP 665 (Sub-No. 1) provided a few hints as to positions they can be expected to take in this proceeding. First, it appears that the Railroads will argue that they are not revenue adequate, and cannot be found revenue adequate, until their revenues exceed the cost of capital under new STB policies incorporating replacement cost accounting. See the reply comments filed August 25 by Norfolk Southern in EP 665 (Sub-No. 1), at page 6. Second, the Railroads will apparently argue that there should be no change in their current differential pricing practices even after they have been found revenue adequate.

The first of these arguments is undermined by the fact that the ICC and STB have considered and rejected replacement cost accounting for the railroads. It is also undermined by the Railroads' regular presentations to Wall Street and investors to the effect that their revenues and profits are extremely high, and likely to increase in coming years, if trends shown in STB revenue adequacy determinations continue. See, in this regard, the Board's decision served September 2, 2014, in EP 552 (Sub-No. 18), Railroad Revenue Adequacy – 2013 Determination, finding that five Class I Railroads were revenue adequate in 2013.

In making the second of these arguments, the Railroads are effectively rejecting the revenue adequacy constraint and management efficiency constraint of Coal Rate Guidelines, Nationwide, 1 I.C.C. 2d 520 (1985), aff'd sub nom. Consolidated Rail Corp. v. United States, 812 F.2d 1444 (3d Cir. 1987). The Railroads are also apparently rejecting ICC and STB decisions describing Constrained Market Pricing, in dozens of decided rail rate cases, as consisting of three main constraints, two of which are revenue adequacy and management efficiency.[2] And, of course, if the Railroads' rejection of the revenue adequacy constraint were to be accepted by the Board, it would not matter whether or when a railroad becomes revenue adequate, because attaining the Congressional goal of revenue adequacy would change nothing for captive shippers.

In these opening comments, ARC, et al. will not address issues like replacement cost accounting, which have yet to be explicated in Railroad comments. Instead, we will focus on the revenue adequacy constraint, and the implications of revenue adequacy for STB regulation of maximum rail rates and other regulatory issues.

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[2] See, e.g., the Board's decisions in STB Docket 42056, Texas Municipal Power Agency v. BNSF Railway, served March 24, 2003 at page 12, and in STB Docket 42088, Western Fuels Ass'n., Inc. and Basin Electric Power Coop. v. BNSF Railway, served September 10, 2007, at page 7.

II. BACKGROUND OF THIS PROCEEDING

ARC, et al., have been frequent participants in rulemaking proceedings before the STB. [3] The reason for these efforts is simple. During the almost 35-year period since the Staggers Rail Act of 1980 substituted limited regulation with a focus on captive shippers for pervasive rail regulation, decisions by the ICC and STB have made regulatory recourse more apparent than real, even where railroads have clear market power over their customers.

Many of the decisions in question were issued in the early years after 1980, when many railroads' financial health was considered inadequate. A tendency to favor struggling railroads in those years may be understandable, even aside from the statutory "policy of this part that rail carriers shall earn adequate revenues, as established by the Board". 49 USC 10701(d)(2).

The fact remains that the railroad industry, like the trucking, ocean shipping and air carrier industries, exists to serve its customers and not vice versa. Even revenue inadequate railroads are subject to service obligations, the common carrier obligation of 49 USC 11101, the requirement that rules and practices must be reasonable under 49 USC 10702, and the requirement, cited above, that rates on captive traffic must be reasonable. Monopolies can be good corporate

[3] Examples include EP 658, The 25th Anniversary of the Staggers Rail Act of 1980; EP 575, Review of Access and Competition Issues – Renewed Petition of Western Coal Traffic League; EP 646 (Sub-No.1), Simplified Standards for Rail Rate Cases; EP 671, Rail Capacity and Infrastructure Requirements; EP 705, Competition in the Railroad Industry; EP 712, Improving Regulation and Regulatory Review; EP 715, Rate Regulation Reforms; EP 711, Revised Competitive Switching; EP 431 (Sub-No.4), Review of General Purpose Costing System; and others.

citizens while fulfilling their essential public functions, but they can also abuse their power, as Congress recognized, and as many captive rail shippers know from experience.

The checks and balances mandated by Congress have not always worked well, or at all, necessitating frequent efforts by ARC, et al. and other captive shipper groups and shippers to seek improvements in rail regulation. For example, the ICC adopted Constrained Market Pricing five years after Staggers, in Coal Rate Guidelines, Nationwide, establishing the Stand-Alone Cost ("SAC") test used by captive utility coal shippers to obtain rate relief. However, it would be more than a decade later, and sixteen years after Staggers, before the Board issued a rate reasonableness methodology designed for the more than 90% of captive rail shippers for whom SAC cases are prohibitively expensive or otherwise ineffective. See Ex Parte No. 347 (Sub-No.2), Rate Guidelines – Non-Coal Proceedings, 1 S.T.B. 1004 (1996).

That decision came out at the end of 1996 only because Congress, in the ICC Termination Act of 1995, gave the Board a deadline for establishing a "simplified and expedited method for determining the reasonableness of challenged rail rates in those proceedings in which a full stand-alone cost presentation is too costly, given the value of the case." 49 USC 10701(d)(3). The Three-Benchmark test first adopted in 1996 has not been workable for grain shippers and producers, or for many other smaller captive shippers, despite subsequent modifications to the test.[4]

The statute commands that all rates on captive traffic must be reasonable. It also requires "a simplified and expedited method for determining the reasonableness of rail rates in those cases in

[4] See the decisions in EP 646 (Sub-No.1), Simplified Standards for Rail Rate Cases, served September 5, 2007, in which the Board adopted Simplified SAC ("SSAC") as an alternative to Three-Benchmark, and EP 715, Rate Regulation Reforms, served July 18, 2013, in which it raised the Three-Benchmark relief cap.

which a full stand-alone cost case is too costly, given the value of the case." 49 USC Section 10701(d)(3). See also the Board's decision served March 12, 2012 in EP 646 (Sub-No.3), Waybill Data Released in Three-Benchmark Rail Rate Proceedings, where the Board said "The Three-Benchmark method begins with the assumption that, in setting rail rates for captive traffic, 'the carrier will not exceed substantially the level permitted by the SAC constraint'." Decision at 6, citation omitted. For too many shippers, SSAC and Three-Benchmark fail this test.[5]

The Board still does not have a standard for assessing the reasonableness of many charges imposed on captive shippers, except for demurrage charges and, in broad terms, fuel surcharges. Railroads also have the upper hand when it comes to car supply, having effectively forced many shippers to provide private cars (including many grain and coal cars as well as tank cars), and holding auctions for access to needed railcars. (For background on these car auctions, see National Grain and Feed Ass'n. v. United States, 5 F.3d 306 (8th Cir. 1993).)

On the rail competition front, competition between major railroads has been needlessly curtailed by such decisions as Midtec Paper Corp. v. Chicago & N. W. Transp. Co., 3 I.C.C 2d 171 (1986), aff'd sub nom. Midtec Paper Corp. v. United States, 857 F.2d 1487 (D.C. Cir. 1988), and the Bottleneck Decisions, Central Power & Light Co. v. Southern Pacific R.R., 1 S.T.B. 1059 (1996), aff'd in part, MidAmerican Energy Co. v. S.T.B., 169 F.3d 1099 (8th Cir. 1999).

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[5] The Railroads are always unstinting in their praise for Full SAC, the approach that costs the most and is least accessible to most captive shippers. It should be recognized that, for all its claimed precision, SAC relief depends to a large extent on the ability of a complainant shipper to maximize volumes and minimize mileage through careful design of the stand-alone group, which the railroad defendant invariably attacks. Without grouping, SAC would still cap rates at the cost to the shipper of providing its own rail service, but that cost would be extremely high. As the ICC said in Coal Rate Guidelines, 1 I.C.C 2d at 544, "Without grouping, SAC would not be a very useful test…." In any event, Section 10701(d)(3) does not say that the Board's simplified and expedited alternative can be ineffective, because of a supposed inferiority to SAC.

ICC and STB approval of paper barriers has largely neutralized short line railroads as competitors for Class I railroads. And while the Board has frequently rejected attempts by major railroads to block build-outs designed to break shipper captivity and bring competition to bear, it has been unable to do much to help when railroads that could compete decline to do so, preferring a comfortable duopoly to the better rates and service the shipper sought.

Those duopolies, one in the East and one in the West, with the four biggest railroads controlling some 95% of rail freight, reflect a series of merger proceedings in which the agency employed the most restrictive possible definition of the competition that needed to be preserved, post-merger.

It is not surprising that the Railroads would attempt to defend the status quo. They currently enjoy conditions that could hardly be improved, from their perspective. They face ineffective competition for much of the grain transportation they provide, particularly in the West. Many shippers and producers cannot reach markets by truck, and barge loading facilities are too far away for many shippers. As for intramodal competition from other railroads, most shippers cannot benefit from competition among major railroads. For many shippers, a second rail carrier is too far away to compete effectively, short lines are prevented by paper and physical barriers from competing effectively, or railroads that could compete elect not to do so.

The Railroads like to cite, in support of minimal regulation, contestable market theory for the proposition that theoretical or potential competition can be as effective as real competition. But in EP 705, <u>Competition in the Railroad Industry</u>, we learned of the problematic obverse of contestable market theory. Shippers had spent hundreds of thousands of dollars to break their own captivity, building out new rail lines to a second major railroad, only to find that the railroads had no interest in competing with each other by offering lower rates or better service.

In EP 711, Petition for Rulemaking to Adopt Revised Competitive Switching Rules, the Railroads have fiercely opposed any changes in ICC and STB precedents and policies undermining the intramodal rail competition called for in 49 USC Section 11102. They are careful to avoid acknowledging that access remedies may help few shippers at best, and will help even fewer if railroads provided access decline to serve new customers, or refuse to compete with incumbent railroads. Rather, the Railroads argue that access remedies will, necessarily and everywhere, adversely affect the efficient operation of their networks.

To the extent that credence is given to these arguments, it seems axiomatic that more effective regulation is needed to counterbalance less effective competition. And yet the Railroads continue to try to minimize both competition and regulation, using revenue inadequacy as a rationale when possible, but downplaying attainment of revenue adequacy when that might undermine a favorable status quo. No similar industry – not electric power, natural gas, or telecommunications – would be allowed to operate without effective competition, effective regulation or both.

For more than 30 years, the Railroads, uniquely in this country, have successfully avoided effective regulation and neutralized effective competition (through mergers and paper barriers) by arguing that they were revenue inadequate. In the early years, such arguments may not have been meritless, particularly given the statutory directive to help railroads achieve revenue adequacy. However, Congress did not intend or provide for complete deregulation of monopoly railroads even when they were far weaker financially than they are today, and the ICC and STB have always recognized that "a rate may be unreasonable even if the carrier is far short of revenue adequacy". Rate Guidelines – Non-Coal Proceedings, 1 S.T.B. 1004, 1017 (1996). Nevertheless, successive decisions in ICC and STB rulemaking proceedings resulted in regulation that offered effective rate relief to too few shippers in too few cases.

From the Railroads' perspective, conditions were ideal for growth and profitability. Neither competition nor regulation significantly affected rail rates on captive traffic, or rail practices or rail service. Railroads could and did act as monopolists, charging whatever the traffic would bear for service on the Railroads' terms.

The Railroads will surely argue that shippers cannot complain about poor service and simultaneously call for more effective regulation of high rail rates. Their implication is that rates must increase, subject only to the current, ineffective regulatory constraints, or else Railroads will not invest in capacity and equipment to improve service.

But adequate service levels cannot lawfully be made contingent on the Railroads' continued ability to price as they see fit, free of any effective regulatory constraints. Operations by Class I railroads are subject to public interest requirements and to the common carrier obligation. And ineffective (or nonexistent) rate regulation is not a right for market dominant railroads. The Act plainly states that when railroad market dominance is found, "the rate established by such carrier for such transportation must be reasonable." 49 USC Section 10701(d)(1), emphasis added.

To the Board's credit, there have been signs recently of a willingness to revisit old policies that were adopted when railroad revenues were far lower than they are now. ARC, et al. commend the Board not just for initiating this proceeding, but also for initiating EP 665 (Sub-No. 1) and EP 711. However, the absence of effective remedies for most captive shippers is a function of decades in which the agency's focus was more on helping to promote railroad revenue adequacy than on preventing abuses of railroad market power. Now that railroad revenue adequacy is here or almost here, the Board's priorities must be revisited.

In the April 2, 2014 decision initiating this proceeding, it was noted that a number of questions as to revenue adequacy have been raised in recent years. See the decision at 4:

> These questions cover a range of issues, such as the viability of the Board's current methodology, and possible alternative methodologies, what it means to be revenue adequate and how such a finding should impact the railroads, and how to apply the revenue adequacy constraint in regulating rates, among many others.

These are important questions, and we are glad they are being asked. Unfortunately, they are being asked in a context in which many captive shippers have come to see STB rail regulation as ineffective at best, and pro-railroad at worst. The last three decades have produced precedents that amount to multi-layered obstacles to relief for captive shippers, and restoring equilibrium in rail regulation will take many more years of effort and expense for captive shippers. This proceeding and others like it are a start, but much more remains to be done before we can address proposals for change, let alone see changes take effect.

III. ARGUMENT

The attainment of revenue adequacy by railroads, particularly under the Board's standards (which captive shipper groups including ARC regard as far too conservative), is a development to be welcomed. It means that decades of effort by the ICC and STB, pursuing with arguably excessive zeal the statutory goal of revenue adequacy, have paid off for railroads. The price for captive shippers has been high. Not only do they generally pay higher rail rates than their non-captive competitors and counterparts, but in proceeding after proceeding, agency concerns about revenue adequacy have led to outcomes that have been favorable to railroads, and that have restricted or eliminated regulatory protections for captive shippers.

For their part, the major railroads have taken advantage of their new freedom to abandon tracks and services, reduce labor expenses, shift costs and burdens to shippers, and raise rates and charges. They have also invested heavily in infrastructure, at least in some markets, though periodic service meltdowns continue to occur.

Today, however, with revenue adequacy either achieved or imminent for all major railroads, the time has come for the Board to begin to level the playing field, revisiting policies and precedents that too often left captive shippers defenseless against market dominant railroads. Assuming those policies were defensible when the railroad industry was struggling, they can no longer be justified now that railroads are flourishing, and their future is bright. Revenues for major railroads stayed high during the recent economic downturn, and a growing economy is likely to improve railroad revenues.

ARC, et al., presume that SAC and SSAC, rate case options today, will remain so despite a railroad becoming revenue adequate. We do not believe, however, that SAC or SSAC are today, or will ever be, viable options for the majority of captive shippers. Nor will we attempt in these comments to suggest ways those methodologies might better serve most captive customers. For most of the shippers on whose behalf ARC, et al., are participating in this proceeding, SAC and SSAC would be prohibitively expensive, given the value of a rate case. Accordingly, our focus will be on alternatives to SAC-based approaches. The only existing procedure that approaches feasibility for most shippers is the Three-Benchmark approach. That methodology emphatically needs modification.

Another major concern for captive shippers involves the Board's new Limit Price test for market dominance. Though the Board evidently intended its new test to simplify market dominance determinations, ARC, et al. believe the danger of false negatives, with railroads found to lack market dominance even though effective competition is lacking, is high. As previously pointed out by ARC, et al., the question of whether truck service is available lends itself to gaming, given the number of small trucking companies willing to quote rates for business they do not currently enjoy. See ARC's Amicus Comments filed November 28, 2012 in Docket NOR 42123, M&G Polymers USA, LLC v. CSX Transportation, Inc., at pages 7-16.

Under the Limit Price approach, RSAM appears poised to become the effective threshold of STB jurisdiction, replacing the statutory R/VC percentage of 180. While some RSAM numbers, including BNSF's for 2012, are low, many other RSAM numbers are higher, and their use in Limit Price analyses could preclude even the possibility of a rate challenge by captive shippers with R/VCs above 180% and no real effective competition.[6] For such shippers, the Board should consider a more traditional approach to market dominance determinations, or require satisfaction of the Limit Price test only if a shipper elects to proceed under that test.

Progress in this proceeding offers new hope to captive shippers, and can create new and more promising conditions for private sector solutions such as voluntary arbitration. Enabling

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[6] See the decision served April 21, 2014 in EP 689 (Sub-No. 5), Simplified Standards for Rail Rate Cases – 2012 RSAM and R/VC 180 Calculations.

more shippers without transportation alternatives to challenge high rates, whether they actually file complaints or not, will enhance such customers' leverage in negotiations with railroads. ARC, et al. are strong proponents of alternative dispute resolution, but applicable standards and procedures must give shippers as well as carriers a stake in success. The revenue adequacy constraint can achieve that goal where SAC, SSAC and Three Benchmark do not.

A. Current Ways of Determining Revenue Adequacy can be Improved, but Implementation of the Revenue Adequacy Constraint Should Not be Delayed

ARC, et al., like many other shipper groups and shippers, have believed for years that the STB's procedures for determining railroad revenue adequacy are not ideal. Specifically, railroad revenue adequacy is understated by the current procedures. And improved procedures would, consistent with the Railroads' own statements to investors, make it even clearer than it already is that the major railroads are earning revenue levels adequate to attract needed capital, or are exceeding those levels.

That said, ARC et al. do not plan in these comments to suggest changes in the Board's current standards for determining revenue adequacy, though we are supporting, in EP 664 (Sub-No. 2), Use of a Multi-Stage Discounted Cash Flow Model in Determining the Railroad Industry's Cost of Capital, the call by Western Coal Traffic League for the use of CAPM in cost of capital determinations in place of the current hybrid approach based on CAPM and MSDCF data. The hybrid approach consistently produces errors favoring railroads.

Other aspects of the Board's revenue adequacy procedures could also be improved, and other shipper groups and shippers may make recommendations for doing so. ARC, et al., may respond to such suggestions, as well as to comments by the Railroads, in reply comments in this proceeding. However, our principal concern now is that implementation of the revenue adequacy constraint should not be delayed while the STB consider whether, and if so how, to revise its procedures for determining railroad revenue adequacy. The main effect of such new procedures would be to confirm, on a delayed timetable, long-term revenue adequacy for at least some of the major railroads that are already being found revenue adequate regularly in the Board's annual determinations. It comes as no surprise that BNSF, UP and NS were recently found revenue adequate in 2013, along with SOO and GTC.

Neither this proceeding nor EP 665 (Sub-No.1) involves any proposal for action by the Board. While the comments being filed in the two proceedings (and in EP 711) should help clarify the issues presented, these proceedings are more like advance notices of proposed rulemaking than like notices of proposed rulemaking, which may produce changes. The Board may hold hearings, and it will certainly consider the comments filed by the parties, but action by the Board is likely to require multiple additional notice and comment proceedings. Changes benefiting captive grain and other shippers may not be implemented until 2015 or 2016 at the earliest. Even under today's standards, that should be time enough for several railroads to be found long-term revenue adequate.

This process could take even longer if the Board decides that it should first revisit and adopt changes to its revenue adequacy determination procedures. Time that could be spent deciding how the revenue adequacy constraint should be implemented, and how other regulatory policies should change for revenue adequate railroads, could be lost if the Board first turns its attention to adopting more precise standards of revenue adequacy, possibly including collection of new data. The result of this sequence of events could be continuation of the regulatory status quo for two or three years before the Board addresses how captive shippers may invoke components of Constrained Market Pricing that were adopted almost 30 years ago.

If, as ARC, et al. and others believe, current revenue adequacy standards understate revenue adequacy, then taking several years to improve STB revenue adequacy analysis will do more harm than good. Railroads that are now long-term revenue adequate will have additional years in which to capitalize on the regulatory advantages of revenue inadequate status, and captive shippers will be deprived for additional years of protections they should be enjoying sooner rather than later.

B. Recognition of One or More Railroads as Revenue Adequate Should Have Effects Beyond Maximum Reasonable Rate Regulation

ARC, et al. support implementation of the revenue adequacy and management efficiency constraints of Constrained Market Pricing, as detailed below. However, maximum rate regulation is not the only area in which a finding that a railroad is revenue adequate should be relevant to STB decision-making.

Abuses of railroad market power are not limited to imposition of excessive rates. In fact, a monopolist acting in its own self-interest will rarely charge so much that its customers go out of business.[7] Railroads can also abuse market power by using unreasonable rates or charges or practices to discourage services and routings they would rather not provide, thereby encouraging

[7] An obvious exception could occur when railroad pricing jeopardizes the survival of smaller companies whose freight will shift to larger companies, permitting railroads to keep volumes high while operating over a smaller, higher density network.

businesses to buy, ship and sell in ways that suit the railroad, whether or not those patterns suit railroad customers. Products that should gain market share in competitive markets might lose ground because a monopoly railroad's interests would be better served by the success of inferior products from preferred markets, or by reducing the number of participants in a market, with winners determined by location and railcar flow patterns.

Service complaints, unreasonable practices, paper barriers, merger and acquisition cases, challenges to the reasonableness of railroad charges, railroad decisions to shift costs and burdens to shippers with no reduction of line-haul rates, and other issues are potentially subjects as to which railroad revenue adequacy could warrant consideration. Certainly, railroads in such cases have not hesitated to point to their status as revenue inadequate carriers in arguing against any regulatory interference in their operations and pricing.

Currently, grain shippers and farm producers in the Upper Great Plains states, along with shippers of coal and other commodities, are experiencing such poor service that many businesses are experiencing severe adverse impacts. Other service meltdowns have occurred in the past, e.g., after the UP-SP merger, and after the acquisition of Conrail by NS and CSX.

ARC, et al. understand the caution with which the ICC and STB have exercised their authority to impose emergency service orders. Attempting to improve service by large network industries through regulatory directives from Washington can be necessary, but care must be taken to avoid making a bad situation worse. It may nevertheless be appropriate to hold a railroad that is revenue adequate, or has exceeded revenue adequacy, to higher standards when it comes to calls for remedial or corrective action as to service problems.

In Coal Rate Guidelines, the ICC indicated that further differential pricing of captive traffic should be curtailed after a railroad becomes revenue adequate. By this reasoning, it may be advisable for revenue adequate railroads to treat captive shippers more like non-captive shippers when service improvements are implemented, or when the costs of such improvements are recovered in rail rates and charges.

ARC, et al., are not prepared at this time to offer an exhaustive list of regulatory changes that should be considered for revenue adequate railroads. These non-rate issues may need to be addressed in future rulemaking proceedings with a more specific focus, or in adjudicatory proceedings. In these opening comments we would argue, however, that the implications of railroad revenue adequacy include, but are not limited to, impacts on STB maximum rail rate regulation.

C. The Board Should Use this Proceeding to Expand its Guidance as to the Revenue Adequacy and Management Efficiency Constraints of Constrained Market Pricing

As explained above, a finding that one or more railroads has reached or exceeded revenue adequacy should have implications for several areas of STB rail regulation, not just for application of the revenue adequacy and management efficiency constraints. However, application of those constraints is clearly an important issue in this proceeding, and may be the issue on which the Board should focus first.

Service issues are far from unimportant, and there are doubtless shippers, including those whose rates are not unreasonable, for whom such service concerns may be paramount. However, rate regulation remains a top priority for captive shippers, for several reasons. First, for many captive shippers, high rail rates are the most important challenge they face. Second, market dominant railroads may use pricing to distort the markets in which their customers must operate. Third, it may be easier for the Board to remedy unreasonable rates than to remedy railroad service inadequacies. And fourth, captive shippers who lack leverage when negotiating with market dominant railroads may be better able to get a market dominant railroad's attention as to rate issues than as to service issues, particularly if STB rate regulation can be made less costly, burdensome and time-consuming than is the case today. In the remainder of these comments, ARC, et al. will address some important implications of revenue adequacy for STB rail rate regulation.

D. At a Minimum, The Board Should Apply the Revenue Adequacy Constraint to Limit Future Increases of Rates on Captive Traffic by Revenue Adequate Railroads

Key elements of the changes needed were discussed in Coal Rate Guidelines, cited above. A key change is recognition that, once revenue adequacy is achieved (let alone exceeded), there is little or no justification for additional differential pricing of captive traffic in the future. See 1 I.C.C. 2d at 535-36:

> In other words, captive shippers should not be required to pay differentially higher rates than other shippers when some or all of that differential is no longer necessary to ensure a financially sound carrier capable of meeting its current and future service needs.

Many of the most troubling problems captive shippers face, year in and year out, stem from the fact that railroads can and do price their services differentially, and that effective regulatory recourse has been available to few of those who believe the differentials they must pay are excessive.

The decision in Coal Rate Guidelines goes on to provide specific guidance as to practical implications of revenue adequacy. The first involves rate increases. As the decision explains (at page 536):

> A railroad seeking to earn revenues that would provide it, over the long term, a return on investment above the cost of capital would have to demonstrate, with particularity: (1) a need for the higher revenues; (2) the harm it would suffer if it could not collect them; and (3) why captive shippers should provide them.

The foregoing discussion applies to the revenue adequacy constraint, considered in isolation. However, Constrained Market Pricing also includes another constraint of potential significance. The management efficiency constraint "protects captive shippers from paying for avoidable inefficiencies (whether short-run or long-run) that are shown to increase a railroad's revenue need to a point where the shipper's rate is affected." See the Board's decision served September 5, 2007 in EP No. 646 (Sub-No.1), Simplified Standards for Rail Rate Cases, at page 8. Like the revenue adequacy constraint, the management efficiency constraint has received little attention in the past because so few railroads were close enough to revenue adequacy for management inefficiencies to be analyzed and quantified.

Now, however, this constraint could lead to a finding of revenue adequacy for a railroad that is almost there, or that would be there but for instances of less than honest, economical and efficient management. The management efficiency constraint could also increase the relief available to shippers successfully invoking the revenue adequacy constraint, including relief from further differentially priced rate increases.

These new requirements, as applied to the rates of captive shippers, would go far to alleviate their current vulnerability to rail rate increases imposed whenever, and in whatever amounts, the railroad sees fit. Rate cases do not currently provide the needed protection for most captive shippers. However, if rates on captive traffic could not be raised differentially, and might not be raised at all, or not raised more than inflation (except for non-captive shippers), the benefit to captive rail customers would be significant. See, in this regard, the Board's decision served May 9, 2000 applying the revenue adequacy constraint in Docket No. 41685, CF Industries, Inc. v. Koch Pipeline Co., LP, aff'd sub nom. CF Industries, Inc. v. S.T.B., 255 F.3d 816 (D.C. Cir. 2001): "If we find that Koch's revenues are adequate without the challenged rate increases, then those rate increases are unreasonable." STB decision at 21.

Of particular help would be the shift of evidentiary burdens to the railroads, which would have to justify increasing rates for captive shippers. Captive shippers and producers might still have to establish market dominance, and might have the burden of proof as to management efficiency, if that constraint were invoked. However, giving the benefit of the doubt to captive customers opposing rate increases rather than to railroads imposing them would better recognize two facts. Railroads typically have greater resources than many of their customers, and much of the relevant data is more likely to be in railroad possession than in the hands of rail customers.

E. The Revenue Adequacy Constraint Should Also Provide a Basis for Appropriate Reductions in Rail Rates on Captive Traffic Charged by Revenue Adequate Railroads

Even if achieving revenue adequacy brings about the changes as to rate increases on captive traffic called for in Coal Rate Guidelines, such limited prospective relief should not be the only benefit for shippers once railroads are revenue adequate. If no other changes in regulation were adopted for revenue adequate railroads, future rate increases would presumably be curtailed. But nothing would be done to remedy any excessive differential pricing already reflected in rates, or remedy other unreasonableness built into rates due to past actions by market dominant railroads. Captive shippers' existing disadvantages might not get worse (thanks to limits on rate increases), but there should also be procedures available to reduce those disadvantages.

The point was stated as follows in Coal Rate Guidelines, 1 I.C.C. 2d at 535:

> Our revenue adequacy standard represents a reasonable level of profitability for a healthy carrier, It fairly rewards investors and assures shippers that the carrier will be able to meet their needs for the long term. Carriers do not need higher revenues than this, and we believe that, in a regulated setting, they are not entitled to any higher revenues.

ARC, et al. recognize that the Board will be reluctant to go so far in making rate reductions available to captive shippers that a revenue adequate railroad might become revenue inadequate. At the same time, the Board should guard against railroad attempts to "game" Board standards in order to avoid being found revenue adequate. The Board must also consider, and consider how to prevent, the possibility of a rush by railroads to quickly raise as many captive shipper rates as possible, by as much as possible, if railroads expect their ability to raise rates further in the future will be curtailed by the revenue adequacy constraint and a finding of revenue adequacy.

In addition, the Board must consider regulatory changes appropriate to a situation in which a railroad's revenues are well above revenue adequate levels. We believe that railroads found to be "long-term" revenue adequate are far more likely to be well above revenue adequacy than to be at, but not above, that level.

Guidance comes from the principle, quoted above, that captive shippers should not have to pay differentially higher rates, to the extent that some or all of the differential is no longer needed for a financially sound (i.e., revenue adequate) rail carrier. As stated elsewhere in Coal Rate Guidelines, a railroad "should not use differential pricing to consistently earn, over time, a return on capital above the cost of capital." See also the Board's decision served October 30, 2006 in EP 657, Major Issues in Rail Rate Cases, recognizing "the important principle that a railroad should recover as much of its costs as possible from each shipper before charging differentially higher rates to its captive customers." Decision at 12.

Applying these concepts to rates charged by long term revenue adequate railroads, there is no sound reason to limit relief to future rate increases, and ignore rates set in the past that were set differentially and helped the railroad not just achieve but exceed revenue adequacy. Rate reductions, and not just limits on future rate increases, should be available, to the extent of excess revenues based on differential pricing of a captive shipper's traffic, and to the extent that revenue adequate railroads will remain revenue adequate. (Of course, rate reductions imposed by the Board also cannot lead to rates with R/VCs below 180%.)

For railroads earning revenues above revenue adequacy, the Board should consider the Long-Cannon provisions, and particularly 49 USC 10701(d)(2)(C), "whether one commodity is paying an unreasonable share of the carrier's overall revenues." Under current STB rate reasonableness procedures, this Long-Cannon factor is addressed in the R/VC>180 benchmark of the Three-Benchmark test. As explained in Rate Guidelines – Non-Coal Proceedings, 1 S.T.B at

1038, the purpose of the R/VC>180 benchmark is to "consider the defendant carrier's rate structure, as judged by Long-Cannon-3, to ensure that the complaining shipper's traffic is not bearing a disproportionate share of the carrier's revenue requirements vis-à-vis other relatively demand-inelastic traffic without good cause."

ARC, et al. believe R/VC>180 could be considered in conjunction with the RSAM benchmark in the future, inasmuch as RSAM "accounts for a railroad's need to earn adequate revenues as required by 49 USC 10704(a)(2)". See 1 S.T.B. at 1027. However, the R/VCCOMP benchmark should have no application in assessing the rates of revenue adequate carriers, because it "provides a means of reflecting demand-based differential pricing principles" (1 S.T.B. at 1034). Differential pricing should not affect rates on captive traffic to the extent those rates provide revenues above revenue adequacy levels.

The R/VCCOMP benchmark is especially flawed in the context of rates which tend to produce uniform R/VC percentages for large groups of shippers and producers. It is also costly and complex to such a degree as to constitute a barrier to rate relief for many captive shippers. In its present form, the Three-Benchmark test is therefore not appropriate for most rate challenges against revenue inadequate railroads, let alone revenue adequate railroads. In fact, where the RSAM and R/VC>180 numbers are near or below 200 (as they are for BNSF for 2012), and the R/VCCOMP numbers are significantly higher, as would be the case for many rates on captive traffic, the conclusion is almost inescapable that the Long-Cannon-3 prohibition against one commodity paying an unreasonable share of a carrier's overall revenues is being violated.

The R/VC>180 and RSAM numbers are calculated for each railroad annually by the STB, and are therefore readily available for captive shippers' use in negotiations, or, if necessary, in rate cases. Notably, the Board said in Rate Guidelines – Non-Coal Proceedings that the R/VCCOMP benchmark could be dispensed with in appropriate circumstances:

> There may well be some cases in which there is no readily identifiable traffic that is truly comparable. In those instances, we may have to forego what the R/VCCOMP benchmark would add to the analysis if it were available, and be guided only by the other two benchmarks – the RSAM measure and the fairness of how the carrier is pricing that commodity in relation to other commodities that it handles (the R/VC>180 measure, discussed more fully below).

1 S.T.B. at 1035, fn. omitted.

Given the special circumstances and challenges faced by many captive shippers, the Board would be well-advised to treat such complainants' rate challenges against revenue adequate railroads as warranting use of a Two-Benchmark approach in place of a Three-Benchmark test incorporating R/VCCOMP.

Full implementation of these concepts as applied to rates generating revenue from differential pricing in excess of revenue need levels raises legal and policy issues as to which further proceedings will be needed. The Board did not explain exactly how to apply a Two-Benchmark analysis. Some simplifying assumptions may be needed as a practical matter or as a matter of fairness. However, it would be anomalous to say that, for a railroad enjoying revenues 15% above revenue adequacy levels thanks largely to differential pricing of captive traffic, there should be no application to past rate increases on such traffic of the principle that differentially raising captive shippers' rates is unjustified.

At a minimum, a captive shipper whose own rates have been raised differentially during the two years prior to the filing of a complaint should be able to seek reductions of such rate increases. Without such a remedy, railroads would be encouraged to differentially price as much as possible during the run-up to a finding of revenue adequacy. Moreover, base rates with high R/VC ratios, which are subject to challenge today, certainly cannot be immune from challenge by captive shippers once railroads become revenue adequate or long term revenue adequate, and constrained in their ability to raise those rates further. Some means of testing the reasonableness of such rates will continue to be necessary, and the Two-Benchmark approach, though not previously used, is consistent with principles enunciated in past STB decisions.

This Two-Benchmark standard for testing the reasonableness of rates is not the only option for determining the reasonableness of rates charged by revenue adequate, market dominant railroads. ARC, et al., are aware that NGFA has developed its own approach that also addresses deficiencies in the R/VCCOMP component of the Three-Benchmark test. ARC, et al. believe the concept is promising and warrants further consideration.

ARC, et al. believe a simplified Two-Benchmark approach based on STB published data will improve protection for captive shippers while recognizing the need for railroads to earn adequate revenues. It is likely that BNSF and UP, and possibly other railroads, will not just meet but will significantly exceed revenue adequacy, with the excess increasing in years to come. Under these circumstances, R/VCCOMP, which is designed to reflect demand-based differential pricing, should no longer be needed.

The Two-Benchmark approach has its origins in <u>Rate Guidelines – Non-Coal Proceedings</u>, 1 S.T.B. at 1042-43. The Board's explanation there (as somewhat simplified here) was that when the RSAM level (which measures markups on >180 traffic needed for revenue adequacy) is lower than the R/VC>180 level (which measures actual markups on >180 traffic), then the railroad is exacting greater than necessary markups, and the greater the spread, the more rates can be reduced without jeopardizing adequate revenues. Conversely, if a railroad's R/VC>180 level is lower than RSAM, the greater the upward adjustment of the railroad's average rates on >180 traffic that should be allowed.

R/VCCOMP was designed to add to the foregoing analysis a factor recognizing the higher or lower elasticity of demand for >180 traffic, in recognition of revenue inadequate railroads' need for differential pricing of their >180 traffic. ARC, et al., have not called for elimination of R/VCCOMP for revenue inadequate railroads in EP 665 (Sub-No. 1), though we (and NGFA) regard the current limitations on potential comparison groups as too restrictive. Allowing comparison groups to include some comparable grain traffic on other railroads, and some grain shipments with R/VC percentages below 180%, would make Three Benchmark more useful for more grain shippers and producers, as discussed in EP 665 (Sub-No. 1).

However, we do not see a role for R/VCCOMP as to rates of revenue adequate railroads that is not outweighed by the deficiencies of the R/VCCOMP benchmark. Demand-based differential pricing, with captive shippers charged more than shippers with competitive options, has played a role in helping railroads achieve revenue adequacy. However, differential pricing's benefits for revenue inadequate railroads are not achieved without harm to captive customers, who may not be able to make a go of their businesses paying rail rates significantly higher than rates paid by their competitors.

To the extent that a railroad cannot afford on its own to meet operating costs, differential pricing of captive traffic has been permitted, subject to reasonableness constraints that are more apparent than real for virtually all captive shippers. However, "captive shippers should not be required to continue to pay differentially higher rates than other shippers when some or all of that differential is no longer necessary to ensure a financially sound carrier capable of meeting its current and future service needs." Coal Rate Guidelines, 1 I.C.C. 2d at 535-36.

In an apparent preview of arguments that can be expected in this proceeding from the Railroads, the AAR argued in its opening comments filed June 26, 2014 in EP 665 (Sub-No. 1) that "the Staggers Act's mandate to allow railroads to price differentially was not a temporary remedy to address the financial state of the industry. Rather, demand-based differential pricing was a structural reform that reflects fundamental railroad economics and Congressional intent in limiting regulation." AAR opening comments at 17, emphasis in original.

There are numerous problems with this contention. First, even if there were a good reason for continuing today's levels of differential pricing of captive traffic, that would not justify ineffective regulation of rates that does more to protect monopoly railroads than captive producers or shippers.

In addition, the Railroads regularly cite old ICC and court decisions on the value of differential pricing in helping railroads achieve revenue adequacy, and more arguments along those lines will surely be forthcoming. However, it does not follow that this justification for high rail rates on captive traffic should continue to apply, unmodified, once railroad revenue adequacy has been achieved. As noted above, the higher rates that help railroads can hurt the captive producers and shippers who pay them, and rates can be unlawful even if a railroad is far from revenue adequacy. Talk of "market-based" pricing is doublespeak when shippers are captive to a single railroad, and other railroads do not compete anyway.

Under what legal theory is it necessary to preserve differential pricing that is arguably appropriate for financially weak railroads after they are financially strong, and able to recover high revenue levels from non-captive traffic? Prices set by competition are the goal, and allowing supra-competitive profits to be collected by monopolies can be justified, if at all, only in exceptional circumstances, such as obtained in the late 1970s and early 1980s, when the railroad industry was struggling.

The AAR argument ignores the revenue adequacy constraint discussed in Coal Rate Guidelines. AAR's argument also undermines the Three-Benchmark test which, despite serious shortcomings, the Railroads have defended as adequate to protect captive shippers. Unrestricted differential pricing allows the Railroads to neutralize the R/VC_{COMP} benchmark by making all rates or all R/VCs similar in entire states or regions. It also enables the Railroads to raise the R/VC>180 benchmark by increasing markups far more than necessary to satisfy RSAM revenue need levels.

In addition, captive shippers have spent more than 30 years making disproportionately high contributions to railroad revenue adequacy, and often paying rates that might have been found unlawful if more effective regulatory recourse had been available. Must they spend 30 more years paying high rates so the Railroads can exceed revenue adequacy? By how much and for how long? Railroads whose revenue adequacy was heavily supported by captive shippers should not now be heard to accuse those same shippers of wanting to be "subsidized" by non-jurisdictional shippers with transportation options, who actually do ship in competitive transportation marketplace and whose rates are unregulated.

In any event, ARC, et al. do not seek elimination of all differential pricing, nor could we. Rather, the choice presented to the Board is between reasonable limits on differential pricing of captive traffic, and differential pricing of captive traffic without any effective regulatory limits, as sought by the Railroads.

The STB cannot order reductions of rates to levels with R/VC percentages below 180%, and the threshold of the Board's jurisdiction preserves a significant amount of differential pricing of captive traffic.[8] And while the Railroads like to characterize every move toward more effective regulation as leading inexorably to all rates on captive traffic ending up at 180% of variable cost, any such outcome is so unlikely as to be nothing more than a scare tactic.

Many shippers with no effective competitive alternative will never file a rate case. They cannot afford to establish market dominance, or cannot show market dominance because of the appearance (though not the reality) of effective competition. ARC et al. are particularly concerned about erroneous findings of effective competition under the new Limit Price approach. We would also point out that if a shipper fails to establish market dominance, not only does the challenge to existing high rate levels fail, but the shipper is vulnerable to further rate increases that cannot be challenged. Railroads found market dominant, in contrast, may still win the rate case.

There are also many shippers who might bring a successful rate case but will not do so where the R/VC of the existing rate does not exceed the jurisdictional threshold by enough to justify the risks and costs of litigation. Grain shippers and producers are especially leery of

[8] At the time of enactment of the Staggers Act, it was calculated that if all rail rates were set at 150% of variable cost, railroads would be revenue adequate. The 180% jurisdictional threshold was phased in because they were not revenue adequate in 1980.

litigation, having seen the outcome of McCarty Farms,[9] and having other uses for their scarce resources.

Other shippers with potentially meritorious cases might not file complaints because they can pass on high rail costs to their own customers in product prices, or might not keep all the benefits of success, or might worry about retaliation at other shipping or receiving points. Railroads use "bundling" of services under contracts to deter challenges to rates for particular routings, and rate challenges may also be settled. Under all of these scenarios, the Railroad would retain some, and possibly all, of the differential pricing in its existing rates.

The Board's Three-Benchmark approach obviously preserves significant differential pricing, especially in its present form. Few cases have been filed, and in Docket NOR 42114, U.S, Magnesium, LLC v. Union Pacific RR, decision served January 28, 2010, aff'd sub nom. Union Pacific R.R. v. S.T.B., 628 F.3d 597 (D.C. Cir. 2010), the relief awarded to the successful shipper complainant under Three-Benchmark merely prevented UP rates from exceeding 350% of variable cost. There is significant differential pricing in rates at 180% of variable cost, and far more when R/VCs are almost twice that high.

If, under the revenue adequacy constraint of Coal Rate Guidelines, the Board finds that further differential pricing of captive traffic through future rate increases is unlawful for revenue adequate railroads, or allows increases only upon compelling justification by the railroad, it does not follow that the railroad will lose either the proceeds of past differential pricing, or future collection of differentially higher prices built into base rates (as opposed to rate increases) collected from captive shippers.

[9] See McCarty Farms, Inc. et al. v. Burlington Northern, Inc., 3 S.T.B. 102 (1998).

Even under the Two-Benchmark approach favored by ARC, et al. for revenue adequate railroads, the use of RSAM and R/VC>180 levels based on 4-year averages will preserve some differential pricing, as will any maximum reasonable rate the Board sets, even if that rate is set at the jurisdictional threshold (which includes differential pricing).

Accordingly, even if the Board were to adopt the most straightforward version of a Two-Benchmark approach as discussed above, with rates able to rise to 4-year average RSAM levels when R/VC>180 levels are lower, and challenged rates on captive traffic prevented from exceeding 4-year RSAM levels when average R/VC>180 levels are higher, differential pricing would not be eliminated. Moreover, there are other ways a Two-Benchmark approach could be implemented. A maximum reasonable rate level based on averaging RSAM and R/VC>180 levels (using 4-year averages for both), would increase the permissible level of differential pricing for revenue adequate railroads, as would other variations.

For these reasons, the Railroads' claim that implementation of the revenue adequacy constraint of Constrained Market Pricing would violate a Congressional expectation of unlimited and perpetual differential pricing of captive traffic by market dominant railroads is wrong as a matter of fact and as a matter of law. Equally unavailing, for these same reasons, is another frequent claim by Railroads – that relief for captive shippers will result in an unlawful "ratchet" of rail rates to levels below the threshold of STB jurisdiction. As recognized in <u>Coal Rate Guidelines</u>, 1 I.C.C 2d at 535, of railroad revenues meeting statutory standards of adequacy: "Carriers do not need greater revenues than this standard permits, and we believe that, in a regulated setting, they are not entitled to any higher revenues."

IV. CONCLUSION

For the reasons set forth above, which will be developed in greater detail in reply comments, ARC, et al. urge the Board to initiate further proceedings setting forth how maximum rate reasonableness regulation and other STB regulatory procedures and policies will change after a finding that one or more railroads has achieved or exceeded revenue adequacy.

Respectfully submitted,

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Dated: September 5, 2014

CERTIFICATE OF SERVICE

I hereby certify that I have this 5th day of September, 2014, caused copies of the foregoing Opening Comments of ARC, et al., to be served on all parties of record by first class mail or by electronic means.

Terry Whiteside