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SURFACE TRANSPORTATION BOARD

DECISION

STB Ex Parte No. 657 (Sub-No. 1)

MAJOR ISSUES IN RAIL RATE CASES

The Board adopts certain procedural and substantive changes regarding the proper application of the stand-alone cost test in rail rate cases and the proper calculation of the floor for any rail rate relief as follows: (1) replace the “percent reduction approach” with a “maximum markup methodology” to calculate maximum lawful rates; (2) adopt an “average total cost” approach to allocate revenue from cross-over traffic; (3) shorten the analysis period to 10 years; (4) use a hybrid-approach for forecasting operating expenses to account for future productivity; (5) use its unadjusted uniform rail costing system in the jurisdictional inquiry; and (6) create new standards to govern when to reopen rate cases.

Decided: October 30, 2006

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BY THE BOARD:

Two decades ago, this agency adopted its existing guidelines for how it would decide major rail rate disputes. See Coal Rate Guidelines, Nationwide, 1 I.C.C.2d 520 (1985) (Guidelines), aff'd sub nom. Consolidated Rail Corp. v. United States, 812 F.2d 1444 (3d Cir. 1987) (Consolidated Rail). Those rate standards have taken shape and been refined through application in individual adjudications. Unfortunately, the complexity of the approach and the cost of seeking relief have seriously escalated, and as we step back and examine how the approach has evolved, we see that the jurisdictional inquiry and application of the methodology have drifted away from what Congress intended in some important respects. Moreover, in the last few years, there have been major issues in large rail rate cases that were being litigated again and again, with the parties in individual cases unable to develop acceptable solutions to problems that they had identified with the existing approach. It was therefore important to correct these problems and resolve these issues before continuing with the rate docket that was pending before the Board.

Meanwhile, the Board's 1996 attempt to address Congressional concerns that many captive shippers were denied meaningful access to regulatory relief proved unsuccessful. The Board had adopted simplified procedures for smaller disputes where the shippers could not use the more robust guidelines because of the high expense. See Rate Guidelines – Non-Coal Proceedings, 1 S.T.B. 1004 (1996) (Simplified Guidelines). However, no captive shipper has wanted to use those simplified procedures, citing concerns over the vagueness of the simplified approach and ambiguity even over who would be eligible to use them. To date, not a single case has been decided under those simplified procedures.

Earlier this year, the Board concluded that the status quo was unacceptable and that the agency must take a more active role and use its rulemaking authority to reform the entire rate process. It therefore launched two separate rulemakings. In this rulemaking, we address the methodology used in large disputes. A separate rulemaking, STB Ex Parte No. 646 (Sub-No. 1), will address the simplified procedures for smaller disputes.

This decision constitutes the first critical step in this broad reform initiative. We close a loophole in the methodology for large rate disputes that permits carriers to unfairly manipulate the outcome of the process. Although the railroads claim they have not taken advantage of the loophole, we are removing the potential so as to protect the integrity of the entire rate dispute resolution process. We also settle two contentious issues with our application of our rate standards, while simplifying our rate analysis and jurisdictional inquiry. In so doing, we place the rate review process back on the path envisioned by Congress by providing a fairer standard and more expeditious resolution of large rate disputes.

In the coming months, we will turn our attention to the task of reforming our procedures and standards for smaller disputes. That effort will take place in Ex Parte No. 646 (Sub-No.1) once all public comments have been received, the last of which are due in late December. When

we do turn to that task, we will benefit from having refined the application of the guidelines that our simplified guidelines seek to emulate, albeit in a less expensive, less complex, but also less precise manner.

INTRODUCTION

On February 27, 2006, the Board issued a decision (Major Issues NPRM) instituting this rulemaking proceeding to obtain comments on Board proposals to address six reoccurring issues in recent stand-alone cost (SAC) cases. First, the Board presented two alternatives to the existing “percent reduction” method that has been used to determine maximum reasonable rates, to address concerns that the percent reduction method can be unfairly manipulated by the railroads. Second, the Board proposed a new, cost-based method for allocating revenue from “cross-over traffic” to reflect economies of density. Third, the Board proposed a method for forecasting the future operating expenses of a stand-alone railroad (SARR) that would reflect anticipated future productivity gains. Fourth, the Board proposed to no longer permit movement-specific adjustments to the Board’s Uniform Railroad Costing System (URCS) when calculating the 180% revenue-to-variable cost (R/VC) jurisdictional floor for rate relief, as such adjustments appear inconsistent with URCS, may distort the variable cost calculation, and contribute inordinately to the complexity and expense of rail rate cases. Fifth, the Board proposed to shorten the time frame for the SAC analyses and corresponding rate prescriptions from 20 years to 10 years in order to simplify the analysis. Sixth, the Board proposed new standards for reopening and vacating a prior Board rate decision (including any resulting rate prescription) that is based on a SAC analysis in order to address a court remand in Burlington Northern & Santa Fe Ry. v. STB, 403 F.3d 771 (D.C. Cir. 2005) (West Texas Remand).

We received public comments on these proposals from over twenty parties, including the United States Department of Transportation, several state public service commissions, trade associations representing shippers as well as several individual shippers, water and rail carriers, and an economic consulting firm. Some of the proposed changes would likely favor shippers, while others would likely favor carriers. For the most part, the positions taken by members of the rail and shipper communities were predictable: where a proposal would likely favor its position in a rate case, it supported that change and opposed any perceived disadvantageous changes. The comments are discussed in more detail below.

The Board’s responsibility is to exercise its own judgment on how best to carry out its charge from Congress. See BNSF Ry. v. STB, 453 F.3d 473, 485 (D.C. Cir. 2006) (“Board ‘is not the prisoner of the parties’ submissions’ but rather has a duty ‘to weigh alternatives and make its choice according to its judgment how best to achieve and advance the goals of the National Transportation Policy’”), citing Baltimore & Ohio R.R. v. United States, 386 U.S. 372, 430 (1967) (Brennan, J., concurring). This entails looking beyond the impact of a change on particular parties and protecting the integrity of the overall approach.

When the SAC test was adopted, our predecessor, the Interstate Commerce Commission (ICC), did not attempt to prescribe a hard-and-fast formula for developing and applying the constraint. It knew that the workability of the guidelines would have to be evaluated in light of experience, as the guidelines are based on rather sophisticated economic theories that require careful interpretation and application. The ICC cautioned that it “may well find, after some experience with applying the guidelines, that modifications are needed to make this approach to maximum rate regulation . . . fully workable.” Guidelines, 1 I.C.C.2d at 525. Moreover, in affirming those guidelines, the reviewing court observed that “the Interstate Commerce Act was not passed as a full employment bill for economists” and that this agency “must be vigilant to minimize costs as specific applications put flesh upon the guidelines.”¹

In the two decades since Guidelines, the SAC test has evolved into an intricate, expensive, and time-consuming process, through an evolution that has been perceived by one side or the other as benefiting its interests in a particular case. This agency is attempting to make its regulatory processes fairer and more workable. Towards that end, we are here placing reasonable limits on the evidence and arguments that will be accepted in an individual proceeding, and more definitively resolving certain recurring issues that are consuming an inordinate amount of resources in individual SAC cases.

After reviewing the comments, we are persuaded that our proposals should be adopted with modest clarifications. The measures adopted here are designed to ensure that both the SAC test and the jurisdictional floor for rail rate relief are applied fairly and in conformity with our statutory responsibilities. Through these changes, we accomplish two important objectives: (1) to improve the soundness of our SAC decisions by replacing the percent reduction method, adopting a cost-based method for allocating revenue from “cross-over traffic” to reflect economies of density, and accounting for productivity gains when forecasting operating expenses; and (2) to reduce the complexity and expense of these rate proceedings by shortening the time frame for the SAC analysis from 20 to 10 years, simplifying the jurisdictional inquiry by using unadjusted UCRS figures, and resolving three major methodological issues.

We set forth below a basic overview of our rate reasonableness standards, our proposals, the material comments we received on those proposals, and the changes we are adopting here to govern future rail SAC cases.

RATE REASONABLENESS STANDARDS

1. Regulatory Framework

Where a railroad has market dominance, its transportation rates must be reasonable. 49 U.S.C. 10701(d)(1), 10702. Market dominance is defined as an absence of effective competition

¹ Consolidated Rail, 812 F.2d at 1463 (Becker, J., concurring in part).

from other rail carriers or modes of transportation for the transportation to which a rate applies. 49 U.S.C. 10707(a). The Board is precluded from finding market dominance if the revenues produced by a challenged rate are less than 180% of the carrier's variable costs of providing the service. 49 U.S.C. 10707(d)(1)(A).

The Board has exclusive jurisdiction to determine if a railroad's rate is unreasonable. 49 U.S.C. 10501(b). When a complaint is filed, the Board may investigate the reasonableness of the challenged rate, 49 U.S.C. 10704(b), 11701(a), or dismiss any complaint "it determines does not state reasonable grounds for investigation and action." 49 U.S.C. 11701(b). If, after a full hearing, the Board finds the challenged rate unreasonable, it will order the railroad to pay reparations to the complainant for past movements, 49 U.S.C. 11704(b), and may prescribe the maximum rate the carrier is permitted to charge for future movements, 49 U.S.C. 10704(a)(1). However, the Board may not set the maximum reasonable rate below the level at which the carrier would recover 180% of its variable costs of providing the service.²

In examining the reasonableness of a rate, the Board is guided by the multifaceted rail transportation policy set forth at 49 U.S.C. 10101. It must also give due consideration to the "Long-Cannon" factors contained in 49 U.S.C. 10701(d)(2)(A)-(C). And the Board must recognize that rail carriers should have an opportunity to earn "adequate revenues." 49 U.S.C. 10701(d)(2). Adequate revenues are defined as those that are sufficient – under honest, economical, and efficient management – to cover operating expenses, support prudent capital outlays, repay a reasonable debt level, raise needed equity capital, and otherwise attract and retain capital in amounts adequate to provide a sound rail transportation system. 49 U.S.C. 10704(a)(2).

A Board action may be reconsidered or reopened pursuant to 49 U.S.C. 722(c). The Board has broad discretion to reopen a proceeding or change a Board action at any time upon a showing of "material error, new evidence, or substantially changed circumstances." 49 U.S.C. 722(c). Further, the Board "may change, suspend, or set aside [Board] action on notice." 49 U.S.C. 722(b). The Board also has broad authority to issue appropriate orders to prevent irreparable harm. 49 U.S.C. 721(b)(4).

2. Constrained Market Pricing

The Board's general standards for judging the reasonableness of rail freight rates are set forth in Guidelines. These guidelines adopt a set of pricing principles known as "constrained market pricing" (CMP). The objectives of CMP can be simply stated. A captive shipper should not be required to pay more than is necessary for the carrier involved to earn adequate revenues. Nor should it pay more than is necessary for efficient service. And a captive shipper should not

² Burlington N. R.R. v. STB, 114 F.3d 206, 210 (D.C. Cir. 1997); West Texas Util. v. Burlington N. R.R., 1 S.T.B. 638, 677-78 (1996) (West Texas).

bear the cost of any facilities or services from which it derives no benefit. See Guidelines, 1 I.C.C.2d at 523-24.

CMP contains three main constraints on the extent to which a railroad may charge differentially higher rates on captive traffic.³ The revenue adequacy constraint ensures that a captive shipper will “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.” Id. at 535-36. 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. Id. at 537-42. The SAC constraint protects a captive shipper from bearing costs of inefficiencies or from cross-subsidizing other traffic by paying more than the revenue needed to replicate rail service to a select subset of the carrier’s traffic base. Id. at 542-46. Most captive shippers seek relief under the SAC test.

3. The SAC Test

A SAC analysis seeks to determine whether a complainant is bearing costs resulting from inefficiencies or costs associated with facilities or services from which it derives no benefit; it does this by simulating the competitive rate that would exist in a “contestable market.” A contestable market is defined as one that is free from barriers to entry. The economic theory of contestable markets does not depend on a large number of competing firms in the marketplace to assure a competitive outcome. Guidelines, 1 I.C.C.2d at 528. In a contestable market, even a monopolist must offer competitive rates or lose its customers to a new entrant. Id. In other words, contestable markets have competitive characteristics which preclude monopoly pricing.

To simulate the competitive price that would result if the market for rail service were contestable, the costs and other limitations associated with entry barriers must be omitted from the SAC analysis. Id. at 529. This removes any advantages that the existing railroad would have over a new entrant that create the existing railroad’s monopoly power. A SARR is therefore hypothesized that could serve the traffic at issue if the rail industry were free of entry barriers. Under the SAC constraint, the rate at issue cannot be higher than what the SARR would need to charge to serve the complaining shipper while fully covering all of its costs, including a reasonable return on investment. This analysis produces a simulated competitive rate against which we judge the challenged rate. Id. at 542.

³ A fourth constraint – phasing – can be used to limit the introduction of otherwise-permissible rate increases when necessary for the greater public good. Guidelines, 1 I.C.C.2d at 546-47. See Duke Energy Corp. v. Norfolk S. Ry., STB Docket No. 42069, slip op. at 39-40 (STB served Nov. 6, 2003) (Duke/NS).

To make a SAC presentation, the complainant designs a SARR specifically tailored to serve an identified traffic group, using the optimum physical plant or rail system needed for that traffic. Using information on the types and amounts of traffic moving over the railroad's rail system, the complainant selects a subset of that traffic (including its own traffic to which the challenged rate applies) that the SARR would serve.

Based on the traffic group to be served, the level of services to be provided, and the terrain to be traversed, a detailed operating plan must be developed for the SARR. Once an operating plan is developed that would accommodate the traffic group selected by the complainant, the SARR's investment requirements and operating expense requirements (including such expenses as locomotive and car leasing, personnel, material and supplies, and administrative and overhead costs) must be estimated. The parties must provide appropriate documentation to support their estimates.

It is assumed that investments normally would be made prior to the start of service, that the SARR would continue to operate into the indefinite future, and that recovery of the investment costs would occur over the economic life of the assets. The Board's SAC analyses are limited to a finite period of time and examine the revenue requirements for the SARR based on the operating expenses that would be incurred over that period and the portion of capital costs that would need to be recovered during that period. A computerized discounted cash flow (DCF) model simulates how the SARR would likely recover its capital investments, taking into account inflation, Federal and state tax liabilities, and a reasonable rate of return. The annual revenues required to recover the SARR's capital costs (and taxes) are combined with the annual operating costs to calculate the SARR's total annual revenue requirements.

The revenue requirements of the SARR are then compared to the revenues that the railroad is expected to earn from the traffic group. There is a presumption that the revenue contributions from non-issue traffic should be based on the revenues produced by the current rates. Traffic and rate level trends for that traffic group are forecast into the future to determine the future revenue contributions from that traffic.

The Board then compares the revenue requirements of the SARR against the total revenues to be generated by the traffic group over the full SAC analysis period. Because the analysis period is lengthy, a present value analysis is used that takes into account the time value of money, netting the annual over-recovery and under-recovery as of a common point in time. If the present value of the revenues that would be generated by the traffic group is less than the present value of the SARR's revenue requirements, then the complainant has failed to demonstrate that the challenged rate levels violate the SAC constraint.

On the other hand, if the present value of the revenues from the traffic group exceeds the present value of the revenue requirements of the SARR, then the Board must decide what relief to provide to the complainant by allocating the revenue requirements of the SARR among the traffic group and over time.

REVISIONS TO THE BOARD'S STANDARDS AND PROCEDURES

This proceeding was instituted to address six issues common to virtually all SAC cases. These issues are: (1) how to allocate the total revenue requirements of the SARR among the traffic group; (2) how to allocate the revenues from cross-over traffic between the SARR and residual incumbent; (3) how to index the operating expenses of the SARR; (4) whether to permit movement-specific adjustments to URCS when determining the jurisdictional floor for rate relief; (5) how long a SAC analysis period is appropriate; and (6) when the Board should reopen or vacate a prior SAC decision (including any resulting prescription). Each issue is discussed in turn below.⁴

I. Maximum Rate Determination

1. Background

Once the Board has calculated the total revenue a SARR would require to serve the traffic group and earn a reasonable return on investment (the "SAC costs"), the Board must allocate the total SAC costs among all of the movements in the traffic group to determine if the challenged rate is unreasonably high, and if so by how much. In Guidelines, 1 I.C.C.2d at 546, the ICC left this inquiry to a case-by-case assessment.

In prior SAC cases, the Board has used an allocation process known as the "percent reduction" method. Under that approach, the Board has required the railroad to reduce the challenged rate for each year of the SAC analysis period by the same percentage by which the railroad's total revenues in that year from the SAC traffic group exceed the total SAC costs. For example, if the revenues the railroad is expected to earn in 2006 from the SAC traffic group would be 20% higher than the SAC cost in that year, then the challenged rate would be ordered

⁴ Concerned Captive Coal Shippers, American Public Power Association, Edison Elect. Institute, Western Coal Traffic League, Western Fuels Association, Inc., and National Rural Electric Cooperative Association (collectively Coal Shippers) ask the Board to reconsider its internal cross-subsidy test set forth in PPL Montana, LLC v. Burlington N. & Santa Fe Ry., 6 S.T.B. 286 (2002) (PPL). Such an action cannot be considered in this rulemaking because it would not be a logical outgrowth of the issues noticed by the agency. Nor will we institute a separate rulemaking to reconsider the internal cross-subsidy test at this time. Parties have offered no persuasive reason to reconsider the PPL test, which has been affirmed in a comprehensive and unequivocal decision. See PPL Montana, LLC v. STB, 437 F.3d 1240 (D.C. Cir. 2006). Alternatively, parties ask the Board to reconsider the statement in Otter Tail Power Co. v. BNSF Ry., STB Docket No. 42071, slip op. at 10-11 (STB served Jan. 27, 2006) (Otter Tail), pet. for review docketed, No. 06-1962 (8th Cir. Apr. 10, 2006), that this internal cross-subsidy test represents both a threshold inquiry and a limit on potential rate relief. Coal Shippers have offered no persuasive reason, however, to question the inherent logic of that observation.

reduced in 2006 by 20%. The underlying rationale for the percent reduction approach has been that allocating the SAC costs among the traffic group in proportion to the existing rate structure would implicitly reflect the varying demand elasticities within the SAC traffic group.⁵

A critical problem with the percent reduction approach – which has been brought to light in recent SAC cases – is that a railroad could manipulate the outcome of the Board’s regulatory process. Under the percent reduction approach, a complainant’s share of the SAC costs is a function of the starting point – the challenged rate. Accordingly, the higher the railroad has set the challenged rate, the higher the complainant’s share of the SAC costs is deemed to be and the higher the resulting prescribed rate. Therefore, a carrier could ensure itself of a favorable rate prescription even if the challenged rate were found unreasonable – just by setting the challenged rate at a high enough level. The following table illustrates the problem.

Table 1

	Example 1	Example 2	Example 3
Challenged Rate (per ton)	\$10.00	\$12.00	\$1.00
Issue Traffic (million tons)	2	2	2
Revenue – Issue Traffic (million)	\$20	\$24	\$2
Revenue – Non-Issue Traffic (million)	\$300	\$300	\$300
Total Revenues (million)	\$320	\$324	\$302
SAC Costs (million)	\$270	\$270	\$270
Over-Recovery (million)	\$50	\$54	\$32
Percent Reduction Factor	15.63%	16.67%	10.60%
Prescribed Rate (per ton)	\$8.44	\$10.00	\$0.89

Each of these examples involves an identical amount of issue traffic (2 million tons), non-issue-traffic revenue (\$300 million), and SAC costs (\$270 million). The only difference between them is the initial rate charged by the railroad. As shown in Example 1, if the challenged rate were set at \$10, the SAC rate for the issue traffic would be \$8.44 per ton. But if the railroad were to set the rate at \$12 per ton, as in Example 2, the net over-recovery would increase only modestly, because the issue traffic would represent a small fraction of the total revenues from the SAC traffic group. The prescribed rate would be \$10, the level of the challenged rate in Example 1.

⁵ See Arizona Pub. Serv. Co. v. Atchison, Topeka & Santa Fe Ry., 2 S.T.B. 367, 392 (1997) (APS); Coal Trading Corp. v. Baltimore & Ohio R.R., 6 I.C.C.2d 361, 380 (1990) (Coal Trading).

Thus, under the percent reduction method, a railroad acting strategically could set a rate that it expects to be challenged at a much higher level than it expects to sustain, in order to end up with a prescribed rate level that is to its liking. As the complainant in the CP&L case aptly stated, the railroad could “lose the battle” over the reasonableness of the challenged rate but “win the war” with respect to the rate level that it can charge. Indeed, the railroad in that case conceded that the regulatory process could be manipulated in this manner.⁶

The percent reduction approach is also subject to manipulation by a shipper. Given a traffic group with sufficiently highly rated non-issue traffic, the percent reduction approach could brand any rate level established by a railroad as unreasonable. In Example 3 above, if the railroad were to set the challenged rate at just \$1 per ton, the revenues from the entire traffic group would still exceed the SAC costs by 11%, again because the issue traffic represents only a small fraction of the total revenues from the SAC traffic group. Were it not for the statutory threshold for regulatory review, the Board could conclude that a rate of just \$1 dollar per ton is unreasonably high and prescribe a maximum rate of 89¢. The fact that the percent reduction approach could otherwise lead to such an absurd result reflects a serious shortcoming inherent in that approach. This shortcoming could encourage a shipper to challenge a reasonable rate by grouping its traffic with other traffic charged high rates.

In sum, the parties have exposed a grave flaw with the rate prescription method used in the past. Although we cannot necessarily be certain of a railroad’s motives in selecting the level of a challenged rate, it should not be necessary for us to conduct such an inquiry. The percent reduction method has been shown to be susceptible to manipulation by the parties: by a railroad in setting a challenged rate at an artificially high level, and by a complaining shipper in grouping a challenged rate with non-issue traffic that is much higher rated to generate a larger rate reduction. As the Board has stated, this is sufficient to warrant a change; the maximum reasonable rate that can be charged to a complaining captive shipper should be determined by the Board based upon the evidence and applicable precedent, not by parties’ litigation tactics.⁷

2. Board Proposals

To address this problem, the Board proposed replacing the percent reduction approach with either a Maximum Contribution Methodology or Maximum Markup Methodology. Both approaches would calculate a maximum contribution from each movement in the traffic group such that the total contribution from the traffic group would equal the total SAC costs, and with no movement assigned a contribution higher than the rate charged for that movement.

⁶ See Carolina Power & Light Co. v. Norfolk S. Ry., STB Docket No. 42072, slip op. at 31 (STB served Dec. 23, 2003) (CP&L).

⁷ CP&L at 32.

As explained in the NPRM, either approach would provide railroads the opportunity to earn adequate revenues by permitting demand-based differential pricing. A railroad could justify charging a higher rate to the complainant as an appropriate application of differential pricing – but only to the extent needed to cover SAC costs that could not be covered by a uniform allocation of SAC costs among all the traffic in the traffic group.

Either approach has three advantages over the percent reduction method. First, it would remove the ability of either party to engage in the sort of “gaming” discussed above. A railroad could not affect the complainant’s SAC rate by increasing the common carrier rate. The higher it set the challenged rate, the greater the rate relief to which the complainant would be entitled. And for its part, a complainant would have to show not only that the collective revenue of the entire traffic group it has selected exceeds the SAC costs for providing service to that group, but also that the challenged rate is itself too high.

Second, each of the proposed approaches reflects the important principle that a railroad should recover as much of its costs as possible from each shipper served before charging differentially higher rates to its captive shippers.⁸ The percent reduction approach does not reflect this goal. See Major Issues NPRM at 12.

Third, use of either of these approaches should facilitate rate case settlements and private negotiations. The maximum contribution level in a particular case would provide information parties could use to predict the outcome of their own disputes, because the maximum contribution level would be independent of the level of the rate the railroad might set should negotiations break down. Such information should help the parties negotiate a mutually agreeable rate. In contrast, the possible manipulation of the percent reduction approach prevents prior rate cases from providing guidance during negotiations on what specific rate prescription a complainant could expect if it brought a complaint.

In the NPRM, the Board acknowledged that neither proposed approach would reflect pure Ramsey pricing. Ramsey pricing is too complicated to be applied directly in SAC cases, because we cannot measure the marginal cost of every movement in a traffic group or evaluate relative demand elasticities.⁹ Moreover, while Ramsey pricing represents the most efficient way to price above marginal cost, reliance on pure Ramsey pricing clashes with the Long-Cannon factors of the statute. This is because it would not maximize the revenue contribution from traffic with more-elastic demand (competitive traffic) before calling on traffic with less-elastic demand (captive traffic) to make a differentially higher revenue contribution. Indeed, Guidelines did not adopt pure Ramsey pricing theory. Rather, it stated that the allocation of SAC costs

⁸ See 49 U.S.C. 10701(d)(2) (the Long-Cannon factors); Guidelines, 1 I.C.C.2d at 539 (“Under CMP, a carrier must charge its competitive traffic as much of the unattributable costs as demand will permit.”).

⁹ Guidelines, 1 I.C.C.2d at 527.

should be done in accordance with Ramsey pricing principles, by which it meant that the SARR (and therefore the carrier) must be allowed to engage in demand-based differential pricing to recover the total SAC costs. Guidelines, 1 I.C.C.2d at 523. Both of the approaches proposed here would permit demand-based differential pricing.

3. Public Comments

The proposal to replace the percent reduction method with either alternative is opposed by the railroads. The railroads contend that gaming allegations of shippers have never been proven, and that the Board has the means of detecting and addressing such conduct without replacing the percent reduction approach.¹⁰ The carriers also argue that both of the alternative proposals are inconsistent with Ramsey pricing principles.¹¹ In a related argument, the carriers assert that neither proposed approach would permit a carrier to engage in demand-based differential pricing and therefore would not permit the carrier the opportunity to earn adequate revenues.¹² Finally, they argue that the approaches would be inconsistent with prior agency precedent, court decisions, and the statute.¹³

The shipper community supports the proposal. They agree that the ability of the carrier to control the regulatory process warrants replacing the percent reduction method.¹⁴ They disagree with the carriers' assertion that the proposed approaches would not permit sufficient demand-based differential pricing. Rather, Coal Shippers note that the Maximum Markup Methodology builds the SAC-based rates from the ground up, using the defendant's rate structure as a measuring tool, such that if revenues actually received by the defendant from a member of the traffic group are lower than its allocable share of the SARR's revenue requirements, the higher demand elasticity is reflected in the allocation as the excess revenue requirement is pushed "upstream" and assigned to higher-rated traffic.¹⁵ They argue that the alternative approaches are consistent with the Long-Cannon factors, while the percent reduction is not.¹⁶ They ask, however, that the Board not fix a single method for allocating SAC costs amongst the traffic group, but rather allow shippers to propose alternative methods in individual

¹⁰ See, e.g., BNSF Open. at 40-45; Norfolk S. Ry. and CSX Transp., Inc. (herein NS/CSXT) Joint Reb. at 11-16.

¹¹ See, e.g., BNSF Open. V.S. Kalt at 23-25, V.S. Willig at 21-22, V.S. Klick at 23; NS/CSXT Reb. at 10-11.

¹² See, e.g., Union Pac. R.R. (UP) Reply at 12-15; UP Reb. at 18-22.

¹³ See, e.g., BNSF Open. at 33-40.

¹⁴ Coal Shippers Open. at 15-17.

¹⁵ Coal Shippers Reply at 15-16.

¹⁶ Coal Shippers Open. at 19; Coal Shippers Reply at 17-18.

cases.¹⁷ While supporting both alternatives, the shippers offer three alternatives that they believe are superior.¹⁸

4. Board Action

We will replace the percent reduction approach with the Maximum Markup Methodology. Under this method, the parties should use unadjusted URCS to estimate the variable cost of each movement in the traffic group, and then determine the maximum contribution of each movement towards SAC costs, expressed as a markup over variable cost. To derive the maximum contribution, the parties should first calculate the average R/VC ratio that would cover the total SAC costs in a given year. They should then check to see if the share of the SAC costs assigned to any movement in the traffic group would exceed what could actually be charged that movement. We will assume that the rates charged by the railroad for non-issue traffic reflect the profit-maximizing rates. Thus, a movement's share of the SAC costs could not be higher than what the railroad actually charges. Where the actual charge is less than the share of SAC costs that would otherwise be allocated to a particular movement, the difference should be reapportioned to the remaining traffic in the traffic group, as an appropriate application of demand-based differential pricing. This will increase the contribution level for the remaining traffic, which in turn could result in further reapportionment. This procedure should therefore be repeated, and the contribution level of the remaining traffic ratcheted upwards, until no movement in the traffic group is assigned a higher share of the SAC costs than its actual charge. Under this approach, the maximum contribution will be expressed as an R/VC ratio, so that a movement with a higher variable cost per ton would have a higher maximum contribution toward total SAC costs, and vice-versa.¹⁹

The SAC rate will be expressed as an R/VC ratio because the share of joint and common costs assigned to a movement would be based on its relative share of the services provided, as measured by URCS variable costs. Congress regarded R/VC ratios as an appropriate measure for allocating joint and common costs among rail shippers, as reflected in the 180% R/VC jurisdictional floor for rate relief.²⁰ While one commenter has suggested the Board use a markup

¹⁷ Coal Shippers Open. at 22-23.

¹⁸ Coal Shippers Open. at 23-24; AEP Texas N. Co. (AEP Texas) Open. at 10-16; Western Fuels Ass'n, Inc. and Basin Elec. Power Coop., Inc. (herein WFA/Basin) Open. at 14-17.

¹⁹ To calculate rate prescriptions, the parties should project the initial (base-year) URCS variable costs forward, using the hybrid approach discussed *infra* for projecting the SARR's operating expenses, as proposed. See Major Issues NPRM at 16 n.14.

²⁰ The concerns with this approach mentioned in the NPRM, see Major Issues NPRM at 15-16, were adequately addressed by Coal Shippers. See Coal Shippers Open. V.S. Crowley at 4-7.

per train-mile instead,²¹ such an approach has not been shown to be superior to the Maximum Markup Methodology. Moreover, expressing the SAC rate as a maximum R/VC ratio is a relatively simple task, using unadjusted URCS to cost each movement, whereas an approach based on train-miles would be more complex.

Our responses to the parties' arguments on this particular proposal are set forth below.

a. Gaming

The principal reason for replacing the percent reduction method is our concern that it permits the railroads to unfairly manipulate the outcome. No one disputes the ability of a carrier to do so. Nonetheless, the carriers argue that “[t]here is absolutely no evidence that railroads have, in fact, attempted to manipulate the results of Board rate proceedings by establishing artificially high rates.”²² They characterize the prospect that a carrier might seek to manipulate the outcome of a case as “purely hypothetical” and “theoretical.”²³ The railroads express optimism that the Board could detect any attempt by a railroad to manipulate the outcome of a case and create a suitable remedy in such circumstances.²⁴

Based on the Board's experience in prior rate cases, we do not share the railroad's optimism. After reviewing allegations of gaming raised in the CP&L case, the agency concluded that it is difficult, if not impossible, to divine the motives of the railroad in setting the challenged rate.²⁵ See CP&L at 32; see also Public Serv. Co. of Colo. d/b/a Xcel Energy v. Burlington N. & S.F. Ry., STB Docket No. 42057, slip op. at 38-39 (STB served June 8, 2004) (Xcel). More importantly, it should not be necessary for the agency to catch a railroad purposefully

²¹ Arkansas Electric Cooperative Corp. (AECC) Open. V.S. Nelson at 6-8.

²² BNSF Open. at 43.

²³ NS/CSXT Open. at 4.

²⁴ BNSF Open. at 44-45, V.S. Kalt at 25-34, V.S. Gaskins 4-8; NS/CSXT Reb. at 15.

²⁵ The flawed efforts of BNSF to show how one might detect manipulation provide compelling evidence of the extreme difficulty of that task. See BNSF Open. V.S. Gaskins at 2-9. BNSF suggested that the Board could detect rate manipulation by comparing current rates to so-called Ramsey rates. Ramsey rates, however, are a function of the amount of unattributable costs that need to be recovered and the relative demand elasticity of all of the traffic using those facilities, none of which BNSF quantified. Moreover, the rate levels that BNSF characterize as “Ramsey rates” appear instead to be the point at which the shipper would shut down the plant completely. But as BNSF notes, “[i]t does the railroad no good to price its customers out of the market.” Id. at 5. Thus, its proposal that the Board look to these high shut-down rates for evidence of gaming would ensure that no gaming would ever be found.

manipulating the process, as the maximum reasonable rate that can be charged to a complaining captive shipper should be determined by the Board, not by the carrier.

At the end of the day, even if no railroad has yet to take advantage of the percent reduction approach, railroads have a strong incentive to do so at some point, and that is a sufficient reason to take action to foreclose that potential. Railroads are profit-maximizing companies under intense pressure to improve earnings. If it remained lawful to do so, carriers would arguably have an obligation to their shareholders to make the most of any regulatory advantage. Under the percent reduction approach, a carrier can manipulate the outcome before the agency with the stroke of a pen and with very little risk of detection. We conclude that it is improper to keep this loophole open when alternatives are available that remove the ability of railroad to manipulate the outcome of a rate case,²⁶ while still permitting the carrier ample ability to engage in demand-based differential pricing and an opportunity to earn adequate revenues under honest, economical, and efficient management. We firmly believe that we must remove the “gaming” temptation or possibility to protect the integrity of the rate dispute resolution process.

b. Ramsey Pricing & the Long-Cannon Factors

Another reason to replace the percent reduction method is that the method conflicts with the Long-Cannon factors in the statute. See 49 U.S.C. 10701(d)(2); Guidelines, 1 I.C.C.2d at 539 (“Under CMP, a carrier must charge its competitive traffic as much of the unattributable costs as the demand will permit.”). That is because the percent reduction method would not maximize the revenue contribution from traffic with more-elastic demand (competitive traffic) before calling on traffic with less-elastic demand (captive traffic) to make a differentially higher revenue contribution.²⁷ In contrast, the Maximum Markup Methodology reflects the important principle that a railroad should recover as much of its costs as possible from each shipper served before charging differentially higher rates to its captive shippers.²⁸

²⁶ Coal Shippers contend that the railroads can manipulate the outcome of the rate analysis under the Maximum Markup Methodology. See Coal Shippers Open. at 18. Using the example in the NPRM, they observe that if the railroad were charging Shipper 1 a contract rate of \$15.00, it could “engineer a post-litigation rate increase of \$1.44 per ton” by setting the challenged rate at \$25.00 per ton. This analysis misses the point. Under that example, the rate of \$15.00 was reasonable, as would be any rate up to \$16.44. But the carrier cannot affect the maximum lawful rate by raising the challenged rate above \$16.44. No matter if the challenged rate were set at \$16.45, \$25.00, or \$1 million, the maximum lawful rate would remain constant.

²⁷ See Major Issues NPRM at 12.

²⁸ See id. 14-15.

The railroads do not dispute this deficiency of the percent reduction method; they embrace it.²⁹ They argue that Ramsey pricing represents the most efficient way to price above marginal cost, and to minimize the efficiency loss from pricing services above marginal cost, one does not charge competitive traffic as much of the unattributable costs as demand will permit. In other words, it is more efficient to lower the transportation rate to shippers with more competitive alternatives (and thus more elastic demand) and shift recovery of unattributable costs to shippers with fewer competitive alternatives, who will not (because they cannot) respond by reducing their demand as much. However, that is contrary to the second Long-Cannon factor, set forth at 49 U.S.C. 10701(d)(2)(B). And where there is a conflict between economic theory and a statutory directive, the former must give way to the latter.

A simple example illustrates the conflict between the percent reduction method (and pure Ramsey pricing) and the Long-Cannon factor. Assume two shippers share common rail facilities, from which the railroad must collectively recover \$10 to provide a reasonable return on the facilities they share. In **Scenario A**, both shippers have some limited competitive alternatives and the profit-maximizing rate the carrier can charge each is \$5. In **Scenario B**, the second shipper has no competitive alternatives, so that the profit-maximizing rate for that shipper increases to \$10. Using the percent reduction approach as a proxy for Ramsey pricing, the table illustrates the maximum lawful rates (the Ramsey rate) that would recover the necessary \$10 with minimal efficiency loss.

Table 2

	Scenario A		Scenario B	
	Profit-Max Rate	Ramsey Rate	Profit-Max Rate	Ramsey Rate
Shipper 1	\$5	\$5	\$5	\$3.33
Shipper 2	\$5	\$5	\$10	\$6.67
Total	\$10	\$10	\$15	\$10

²⁹ See, e.g., BNSF Open. V.S. Kalt at 23 (“By definition, the Ramsey principles yield the rate structure that maximizes the public interest in an efficient rail system and economy. And . . . [the Maximum Markup Methodology] fail[s] to satisfy such basic aspects of Ramsey pricing as the fact that Ramsey pricing by a SARR implies downward movement of all rates.”) (emphasis added); BNSF Open. V.S. Willig at 19 (“A finding that stand-alone revenues exceed SAC indicates that existing rate levels overstate the positive Ramsey-based mark-ups that are appropriate for every member of the stand-alone traffic group.”); NS/CSXT Open. at 6 (noting Ramsey pricing would “translate into lower rates for all movements in the stand-alone traffic group”); UP Reb. at 21 n.27 (“Leaving lower rates unchanged while reducing higher rates for movements included in the traffic group is not consistent with Ramsey pricing principles.”).

In **Scenario A**, the \$5 rate charged by the railroad to both shippers is reasonable because it provides a reasonable return on the facilities, and no more. But then consider how the analysis changes if Shipper 2's circumstances are altered. In **Scenario B**, the railroad can use its increased market power to extract more profits from that shipper. The maximum lawful rates, if set in accordance with Ramsey pricing principles, change as well. Shipper 2 would be asked to cover more of the costs of the joint facilities simply because it has fewer transportation alternatives, while Shipper 1 would pay significantly less (\$3.33) than its demand would permit (\$5).

The second Long-Cannon factor reflects a Congressional directive that shippers with fewer transportation alternatives (such as Shipper 2) not bear a differentially larger share of the joint and common expenses until the carrier has charged its shippers with more competitive alternatives (such as Shipper 1) as much of the unattributable costs as demand will permit. In other words, Congress envisioned that captive shippers would be the residual suppliers of capital, but only where the competitive traffic cannot provide a sufficient share of the contribution needed to support the rail infrastructure that it uses.

The railroad's experts concede that, if we are guided by Ramsey pricing, every single rate charged by a railroad could be viewed as too high if the collective revenues exceed SAC. It would not matter if the challenged rate were set at \$1 per ton or \$100 per ton. The fact that the percent reduction approach could lead to such an absurd result reflects a serious shortcoming inherent in that approach.

BNSF was the only carrier to address the conflict between the Long-Cannon factor and Ramsey pricing.³⁰ It argues that the second Long-Cannon factor pursues the same Ramsey-pricing principle by "requiring that even lower-rated traffic contributes to unattributable costs to the extent its demand permits."³¹ BNSF further argues that Ramsey-based pricing seeks to maximize revenues from all traffic based on the relative demand elasticity of all shippers.

We do not agree. Ramsey pricing does not seek to maximize revenues from all traffic, a point made repeatedly by all carriers. Indeed, BNSF itself claims that, where regulation is warranted, Ramsey-pricing principles "dictate that rates for all shippers . . . should be reduced."³² Thus, BNSF's statutory analysis would not give reasonable effect to the term "maximize the revenues" in section 10701(d)(2)(B). No party has pointed to any statutory or

³⁰ BNSF Reb. at 14-15, V.S. Kalt at 8-11. We note that even though the Board raised this conflict as a reason to replace the percent reduction approach, Major Issues NPRM at 12, BNSF waited until its rebuttal comments to address this concern, thus depriving other parties of an opportunity to comment on its analysis.

³¹ BNSF Reb. at 15.

³² Id. at 14 n.18.

legislative history to suggest that, in setting the maximum lawful rate, the Board should assume that shippers who already have competitive options should be contributing a lower share of SAC costs than they already are. To the contrary, Congress presumed that rates for shippers with effective competition are reasonable and therefore may not be challenged.³³

Several carriers contend that Ramsey pricing is the outcome that would prevail in a contestable marketplace.³⁴ NS/CSXT argue, for example, that if a SARR did not price in accordance with Ramsey pricing, a competitor would enter the market and profitably displace the SARR by pricing consistent with Ramsey pricing.³⁵ Using **Scenario B** above as an illustration reveals that this outcome would by no means be certain. Assume the SARR in that scenario were to offer both shippers a rate of \$5 per ton, which would be just sufficient to provide a reasonable return on its investment. If a competitor were to enter the market and offer prices more consistent with Ramsey pricing, this would provide Shipper 1 with a lower rate, but would require Shipper 2 to agree to a higher rate. There would be no reason for Shipper 2 to leave the incumbent.³⁶

In sum, as the Board anticipated in Xcel at 38, there are good reasons to depart from Ramsey pricing principles in favor of a form of demand-based differential pricing principles that is more compatible with the statute. The comments we received convince us that Ramsey pricing, and the search for the most efficient allocation of unattributable costs, conflict with the statutory directive that a carrier charge its competitive traffic as much of the unattributable costs as demand will permit before charging differentially higher prices to captive traffic.

³³ Indeed, BNSF's own expert made this same point, noting that competitive markets automatically yield the prices that are efficient and that regulatory attention to prices in competitive markets "is totally inappropriate." BNSF Open. V.S. Willig at 11.

³⁴ See, e.g., BNSF Open. V.S. Willig at 21-22.

³⁵ NS/CSXT Open. at 6.

³⁶ BNSF's arguments to the contrary are unpersuasive. See BNSF Open. V.S. Willig at 23. BNSF argues that holding rates on competitive shippers above the Ramsey optimal level would cause volumes of competitive traffic to be suppressed. It then argues that a second entrant might successfully enter the market by undercutting the price to the competitive traffic and thereby stimulate increased volume of traffic. However, by assumption the prior rates were already set where the incumbent maximized total revenue from that shipper. So while a second entrant could stimulate more traffic by lowering rates, it would reduce its overall profits from that shipper. Thus, there is no basis for BNSF's assertion that, in a contestable marketplace, a SARR would be impelled to establish rates to conform with Ramsey pricing or be vulnerable to displacement by a competitor that does.

c. Demand-Based Differential Pricing and Revenue Adequacy

As explained in Guidelines, 1 I.C.C.2d at 526, 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. The need for such demand-based differential pricing is due to the presence of traffic with competitive alternatives. If the carrier were required to charge all its shippers the same markup over cost, the competitive traffic with lower-cost alternatives would be diverted to those other transportation alternatives. This in turn would require the carriers to charge the remaining traffic even higher rates. Therefore, as stated in Guidelines, 1 I.C.C.2d at 523:

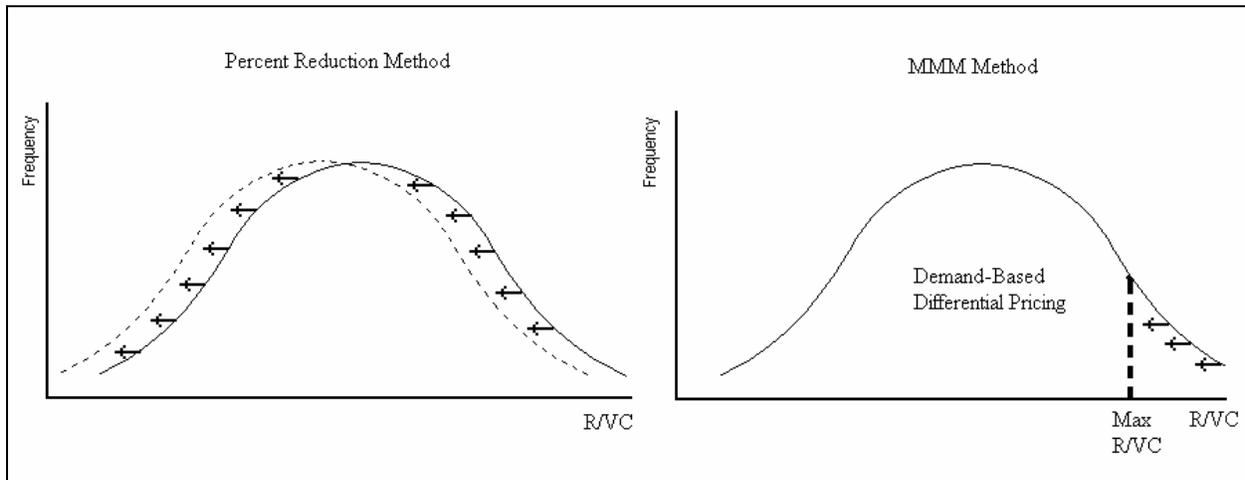
[A] meaningful maximum rate policy could not be founded on a strictly cost-based approach. Because competition compels the railroads to price some of their services below an arbitrarily assigned “cost,” they must be able to price other services above their assigned “cost” in order to compensate. Otherwise, the carriers may never be able to cover all their costs and earn adequate revenues.

In short, a strictly cost-based approach would not reflect the carrier’s ability (or inability) to impose the assigned allocations and cover its costs. If a carrier sought to apply the formula price to all its traffic, it would lose that traffic for which the demand could not support the price assigned. Therefore, following the directive from Congress in the Staggers Rail Act of 1980, unattributable costs must be covered through demand-based differential pricing. Id. at 526.

The Maximum Markup Methodology provides for demand-based differential pricing. The approach recognizes that, because competition would compel the defendant carrier to price some of its services below an average R/VC level, the defendant carrier must be able to price other services above the average to compensate. By design, the Maximum Markup Methodology therefore calculates the precise amount that the defendant carrier would need to price its services above the average R/VC ratio to cover all its costs and earn adequate revenues. This calculation rests on the demand for rail transportation services, as observed in the existing rate structure of the defendant carrier. Accordingly, the railroad is allowed to differentially price among captive shippers. It is only the highest rates that are limited. Thus, the Maximum Markup Methodology is not a strictly cost-based approach.³⁷

³⁷ The Maximum Markup Methodology is a modification of the Maximum Competitive Contribution Methodology (MCCM), which the ICC examined in Guidelines and concluded was consistent with CMP principles, but less practical. See Guidelines, 1 I.C.C.2d at 560; Major Issues NPRM at 9 n.6. MCCM, as proposed, assumed that the carrier was not setting rates for competitive traffic at the profit-maximizing level. As such, that proposal would have entailed an inquiry into the profit-maximizing rate level for all competitive movements. As its name

The railroads object to the Maximum Markup Methodology, claiming it is a departure from demand-based differential pricing.³⁸ But as the graph below illustrates, the Maximum Markup Methodology would indeed permit demand-based differential pricing. The graph reflects a normal distribution of R/VC ratios.³⁹ Some shippers will have low R/VC ratios, which reflect the maximum contribution the railroad can seek from that traffic. Other traffic will have higher R/VC ratios. Where total revenues exceed SAC costs, the Maximum Markup Methodology calculates the maximum R/VC ratio that would permit the railroad to cover all its operating costs and earn a reasonable return on capital investment. Any challenged rate above that rate ceiling would be deemed to be too high. In contrast, under the percent reduction method, every rate in the traffic group – if challenged – would be deemed to be too high.



The maximum R/VC rate ceiling under the Maximum Markup Methodology reflects a limit on the amount of differential pricing permitted. If the collective revenue the railroad earns from the traffic group is insufficient to provide a reasonable return on its investment, then the carrier may engage in full demand-based differential pricing. However, once it has reached the point where it is earning a reasonable return on investment from the selected traffic group, the Maximum Markup Methodology would restrain the degree of differential pricing permitted. The carrier could engage in enough demand-based differential pricing to earn adequate revenues, but no more. This demand-based approach adheres to the important principle that “captive shippers

implies, however, the basic principle behind the MCCM approach was to first maximize contribution from competitive traffic before permitting differential pricing of captive traffic.

³⁸ BNSF Open. at 28-31; NS/CSXT Open. at 6; UP Reb. at 20.

³⁹ These graphs are for illustrative purposes only. The actual distribution of R/VC ratios may not be normal in shape. Furthermore, under the Maximum Markup Method, setting a maximum R/VC level will cause the distribution to spike at that point, creating a discontinuity in the distribution curve.

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.” Guidelines, 1 I.C.C.2d at 535-36.

The carriers object that the Maximum Markup Methodology would cap the rates for all of the traffic at the upper end of the distribution at the same R/VC ratio, as shown in the graph above, regardless of existing differences in demand elasticity between those shippers.⁴⁰ But that does not mean that lower-rated traffic would subsidize higher-rated traffic, as argued by NS/CSXT.⁴¹ It means only that the captive shippers would not be required to pay substantially higher rates until the contribution from lower-rated traffic is maximized. Nor does this approach conflict with statements in Guidelines, relied upon by the carriers, that “[s]etting all captive rates in the same proportion to marginal cost would be contrary to the principle of differential pricing, and could prevent a railroad from covering its total costs.” Guidelines, 1 I.C.C.2d at 533. The Maximum Markup Methodology stands for the intuitive proposition that to the extent there must be limits on a carrier’s pricing, the limits should be on the highest rates. But so long as demand-based differential pricing is needed to cover total costs, the Maximum Markup Methodology will permit sufficient pricing freedom to assure that the carrier can earn a reasonable return from the selected traffic group.

The carriers erroneously equate demand-based differential pricing with Ramsey pricing.⁴² As noted in Guidelines, 1 I.C.C.2d at 526, Ramsey pricing is “a widely recognized method” of differential pricing; it is not, however, the only method. Carriers engage in demand-based differential pricing every day, even though they are not pricing at Ramsey pricing levels. The Maximum Markup Methodology is a more practical way of allocating the SAC costs in accordance with demand, as reflected in the actual rates the defendant railroad has determined it may charge based on perceived market demand. Congress envisioned demand-based differential pricing, but within reasonable limits. The limit set by the Maximum Markup Methodology is a reasonable one.

Because the Maximum Markup Methodology provides for all the demand-based differential pricing needed to cover total costs, it allows the carrier to earn a reasonable return on the portion of its system that is covered by the SAC analysis. The inquiry here is how to allocate the total revenue requirements of the SARR amongst the traffic group. By definition, revenue levels that equal the total revenue requirements of the SARR provides the defendant carrier a reasonable return on the investment needed to serve the complainant. So long as we ensure that whatever approach adopted permits the carrier to earn the total SAC costs from the traffic group,

⁴⁰ See, e.g., BNSF Open. V.S. Willig at 21-22; NS/CSXT Reply at 5; UP Reb. at 20.

⁴¹ NS/CSXT Open. at 6.

⁴² See, e.g., BNSF Open. V.S. Willig at 21; NS/CSXT Reply at 5-6.

the carrier has the opportunity to earn adequate revenues. The Maximum Markup Methodology achieves that goal.

d. Shipper Alternatives

While shippers support both replacing the percent reduction approach and using the Maximum Markup Methodology, they ask that we not prescribe a single methodology, but permit a shipper to advocate its preferred approach in an individual proceeding.⁴³ Alternatively, AEP Texas asks that we adopt what it calls a General Percent Reduction Method (GPRM),⁴⁴ and WFA/Basin advocates a Reasonable Allocation Method (RAM) or Reduced Markup approach.⁴⁵

Permitting shippers to select a different method in particular adjudications would defeat much of the purpose of this rulemaking – to simplify and standardize our procedures in SAC cases – and would in all likelihood deprive carriers of the opportunity to earn adequate revenues. Each alternative approach they suggest would take the total revenue requirements of the SARR and allocate a different share to the movements in the traffic group. If permitted to select the desired approach, a complainant would select whatever approach would end up allocating the smallest amount of the SAC costs to its own movement in its own case. Were all captive shippers in the group to bring their own rate challenges and follow this strategy, the total revenues the carrier could collect from the traffic group could be insufficient to provide for adequate revenues.

Moreover, the alternatives posited by the shippers share the same deficiencies as the percent reduction approach: GPRM and Reduced Markup would permit carriers to manipulate the outcome of the process by setting rates that they expect to be challenged higher than they would otherwise be set, and all three approaches conflict with the second Long-Cannon factor by not maximizing the revenue contribution from competitive traffic.

⁴³ Coal Shippers Open. at 22-23.

⁴⁴ AEP Texas Open. at 10-16. BNSF expresses some confusion over the approach AEP Texas is advocating. See BNSF Reply at 10. The GPRM approach would allocate relief in proportion to the ratio of price markups over variable cost. To the extent AEP Texas is advocating a version of GPRM that uses an iterative approach to reduce all highly rated traffic to a common R/VC ratio, this is the same as the Maximum Markup Methodology approach the Board adopts in this proceeding. If instead it is advocating reducing the markup over variable cost by a common percentage, it is the same as the Reduced Markup approach advocated by WFA/Basin, which does not address the fundamental problems with the percent reduction approach.

⁴⁵ WFA/Basin Open. at 14-17.

II. Revenue Allocation for Cross-Over Traffic

1. Background

In recent SAC cases, complainants have relied extensively on the use of “cross-over” traffic to simplify their SAC presentations. Cross-over traffic refers to movements included in the traffic group that would be routed over the SARR for only a part of its through movement. In such circumstances, the SARR would not replicate all of the defendant railroad’s service, but would instead interchange the traffic with the residual portion of that railroad’s system. This modeling device, which was first accepted by the Board in 1994 in the Nevada Power case, is now a well-established practice in SAC cases.⁴⁶ A continuing issue in SAC cases is how to allocate the total revenues the railroad earns from that cross-over traffic between the facilities replicated by the SARR and the residual network of the railroad needed to serve that traffic.

In allowing the use of cross-over traffic, we seek to make the analysis more manageable without introducing bias.⁴⁷ Thus, the goal in allocating revenue from cross-over traffic should be to ensure that a truncated SAC analysis using cross-over traffic will approximate the outcome of a full SAC analysis, which provides origin-to-destination service for the entire traffic group. A full SAC analysis compares the total SAC costs incurred to serve the selected traffic against the total revenues the carrier is expected to earn from that traffic group. A SAC presentation with cross-over traffic, however, calculates only part of the total SAC costs to serve the cross-over traffic. Thus, to equitably distribute revenues in relation to the cost incurred to generate those revenues, the portion of the revenue allocated to those facilities replicated by the SARR should ideally equal the total revenue from that movement, multiplied by the share of total SAC costs represented by the cross-over segments of the movement (i.e., multiplied by the ratio of the SAC costs with cross-over traffic to the total SAC costs without cross-over traffic).

We face a dilemma, however, if we attempt to allocate revenues based on the relationship between a truncated and full SAC analysis. The full SAC costs for a particular cross-over movement cannot be judged without a full SAC analysis, an undertaking that would defeat the purpose of using cross-over traffic in the first place. Even if the Board knew the total replacement costs of the off-SARR segments used by cross-over movements, it would have no method for allocating a share of those investment costs only to the cross-over movements. The off-SARR segments would have other traffic flowing over those lines that would be expected to contribute to the investment costs, but whose contribution would depend on the profitability of that traffic.

⁴⁶ See, e.g., Otter Tail at 11-13; Duke Energy Corp. v. CSX Transp., Inc., STB Docket No. 42070, slip op. at 20-22 (STB served Feb. 4, 2004) (Duke/CSXT); Texas Mun. Power Agency v. Burlington N. & Santa Fe Ry., 6 S.T.B. 573 (2003) (TMPA); Bituminous Coal – Hiawatha, UT To Moapa, NV, 10 I.C.C.2d 259, 265-68 (1994) (Nevada Power).

⁴⁷ Otter Tail at 14-15.

In Duke/NS, the Board addressed this dilemma by focusing on the average costs that the railroad currently incurs to haul the traffic over the relevant segments. As stated there, the objective was to select a revenue allocation methodology that reflects, to the extent practicable, the carrier's relative average costs of providing service over the two segments (the segment replicated by the SARR, and the residual facilities needed to serve the traffic, at times referred to as the off-SARR segment).⁴⁸ By focusing on the ratio of actual costs incurred by the carrier, the revenue allocation method should maintain, to the extent possible, the relationship between revenues and costs that would exist in a full SAC analysis. In the prolonged debate over how to allocate revenue from cross-over traffic, no party has yet offered a better approach.

Historically, the Board has used a mileage-based allocation procedure to allocate cross-over traffic revenues between the SARR and the residual incumbent. Under the current approach, the "Modified Straight-Mileage Prorate" (MSP), revenue is allocated based on the relative mileage hauled over the facilities replicated by the SARR and the residual facilities needed to serve that traffic, adding a 100-mile block or credit for the additional costs of originating or terminating the traffic.

Parties have pointed out that MSP, while simple and practical to apply, does not meet the stated objective. The MSP approach allocates revenues according to a crude estimate of the relative variable costs of hauling the traffic over the relevant segments, rather than the total costs. The approach therefore fails to take into account the defining characteristic of the railroad industry – economies of scale, scope and density.⁴⁹ There is no reason to believe that economies of density in this industry have been exhausted.⁵⁰ Yet only under such an assumption would a mileage-based approach provide an allocation based on average total costs.

In recent cases, the railroads have advocated an alternative to the MSP approach they call the "Density Adjusted Revenue Allocation" (DARA) method. Under DARA, one would first use URCS to calculate the variable cost to haul the cross-over traffic over the facilities replaced by the SARR and over the residual incumbent's portion of the movement. Then one would compute each movement's total contribution to joint and common costs (the revenue in excess of variable costs) and allocate that contribution to each segment in proportion to that segment's relative distance and in inverse proportion to density. The longer the distance and the lighter the density of lines used, the more revenue DARA would attribute to that segment. The basic premise of the approach is that more revenue should be allocated to segments that are lighter-

⁴⁸ See Duke/NS at 18-20.

⁴⁹ See Guidelines, 1 I.C.C.2d at 531 ("there are at least some production economies in the rail industry, even though their nature and extent are the subject of debate and have not been established precisely").

⁵⁰ See, e.g., Ivaldi & McCullough, Density and Integration Effects of Class I U.S. Freight Railroads, 19 J. Reg. Econ. 161 (2001).

density lines, because those segments, holding other factors constant, will have higher average total costs.

As discussed in Xcel, however, DARA is insensitive to the actual economies of density associated with particular movements over specific line segments.⁵¹ Like all capital-intensive industries, the railroad industry is characterized by economies of density, meaning the average total cost for a network of a given size initially decreases with increases in output. But economies of density also diminish with higher output and at some point are exhausted. Therefore, the economies of density achieved by shifting from a 10 million gross ton (MGT) line to a 20 MGT line would be stronger than those achieved by moving from a 50 MGT to a 100 MGT line. Yet DARA would treat these two dissimilar situations as identical. By focusing only on which of the two segments has higher traffic densities, the DARA formula ignores the principle of diminishing economies of density. Because the railroads had failed to justify a departure from agency precedent, the Board continued to use MSP, despite its acknowledged flaws, in prior SAC cases.⁵² In upholding the Board's decision to do so in Xcel, however, the reviewing court explicitly stated that, if the Board were "presented with a model that took account both of the economies of density and of the diminishing returns thereto, a decision to adhere to its MSP model would be on shaky ground indeed."⁵³

2. Board Proposal

As an alternative to MSP, the Board sought comments on using an "Average Total Cost" (ATC) approach for allocating cross-over traffic revenues. Using the URCS variable and fixed costs for the carrier, and the density and miles of each segment, parties can calculate the railroad's average total cost per segment of a move. The revenues from each portion of the movement would then be allocated in proportion to the average total cost of the movement on- and off-SARR.⁵⁴ While this approach is similar to DARA, it does not suffer from the deficiency that led to the Board's rejection of DARA. Thus, the Board believed that this approach should address the railroads' legitimate concerns about the need to take into account economies of density when allocating revenue from cross-over traffic.

3. Public Comments

The shippers and consumer advocates who commented on this subject opposed the proposal to adopt ATC and asked that the Board continue using MSP or revert to an older,

⁵¹ See Public Serv. Co. of Colo. d/b/a Xcel Energy v. Burlington N. & Santa Fe Ry., STB Docket No. 42057, slip op. at 9-11 (STB served Jan. 19, 2005) (Xcel Recon.).

⁵² See, e.g., Otter Tail at 13.

⁵³ BNSF Ry. v. STB, 453 F.3d 473, 484 (D.C. Cir. 2006).

⁵⁴ See Major Issues NPRM at 19-20.

similar version called Modified Mileage Block Prorate (MMP). These groups also opposed alternative proposals made by the railroads.

Specifically, Coal Shippers argue that ATC has not been shown to be superior so as to justify departing from the norm of regularity of MMP or MSP.⁵⁵ Coal Shippers also claim that the ATC method ignores market factors and penalizes high density SARRs, thereby placing new entry barriers on a SARR.⁵⁶

Coal Shippers argue that we should reject ATC for at least four interrelated reasons. First, the ATC method calls for the allocation of fixed costs to specific traffic movements using cost accounting devices, a method which is, by definition, arbitrary.⁵⁷ Second, Coal Shippers claim that ATC suffers from the same defects as the DARA method rejected in Duke/NS. That is, it “contains the initial assumption that light density lines have the same fixed costs per mile as heavy density lines.”⁵⁸ Third, Coal Shippers argue that Guidelines were developed to avoid arbitrary cost-based allocations of carrier fixed costs and that the ATC method does exactly that. Fourth, Coal Shippers argue that the ATC method would arbitrarily allocate disproportionate shares of SARR divisions to lower density off-SARR lines. Coal Shippers contend that, if ATC is adopted, complainant shippers will be forced to model SARRs with less than optimal densities in order to address the revenue penalties inherent in the ATC’s arbitrary allocation of SARR revenues to lower density, off-SARR lines. Coal Shippers also note that some of the railroads have argued against adoption of the ATC methodology.⁵⁹

Arkansas Electric Cooperative Corp. (AECC) argues that the ATC proposal is inconsistent with contestability theory and could also produce incentives for economically inefficient conduct by the SARR and/or by the residual incumbent to capture contribution from cross-over traffic. AECC submits that the treatment of revenue on cross-over traffic should emulate the view of a hypothetical new entrant standing in the shoes of the defendant carrier and consider the defendant carrier’s investment in the facilities used to handle the subject traffic.⁶⁰ AECC offers an alternative proposal that would provide the SARR with the full contribution over total variable costs realized by the incumbent on the entire through movement. AECC

⁵⁵ Coal Shippers Reb. at 16.

⁵⁶ Id. at 27.

⁵⁷ Id. at 17 (citing Rules to Govern the Assembling and Presenting of Cost Evidence, 337 I.C.C. 298, 395 (1970) (“By definition constant or fixed costs are not allocable or assignable upon a cost of service basis . . .”); Guidelines at 526 (fixed costs “cannot be assigned directly to specific movements by any conventional accounting methodology”)).

⁵⁸ Id. at 18 (citing Duke/NS).

⁵⁹ Id. at 19-20.

⁶⁰ AECC Open. at 13-15.

argues that this methodology relies on a sound analytical framework, is computationally straightforward, is consistent with industry practice, and provides a foundation for consistent treatment of ancillary issues.

The South Carolina Office of Regulatory Staff (SCORS) advocates continued use of MSP to allocate cross-over traffic revenues over the proposed ATC method, because SCORS contends that ATC would be biased towards the incumbent railroad.⁶¹

The railroads acknowledge the flaws in the Board's current approach, and offer varying degrees of support to the ATC proposal. NS/CSXT contend that the current method for allocating cross-over traffic revenue between the SARR and the residual incumbent distorts the SAC test in favor of the complainant and does not adequately account for the full costs to the residual incumbent of serving cross-over traffic, particularly on the lower-density feeder lines that the complainant chooses not to include in its SARR.⁶²

In response to the criticisms of ATC raised by Coal Shippers, NS/CSXT stress that the Board's proposal would not require the SARR to provide origin-to-destination service for the entire traffic group; rather, the proposal seeks to approximate a full SAC analysis of origin-to-destination service without requiring the complainant to develop and present a full origin-to-destination SAC analysis.⁶³ It answers the shippers' charge that the ATC would impose an impermissible barrier to entry, pointing out that ATC would not require a SARR to replicate the incumbent's origin-to-destination service for all members of the SARR traffic group. Lastly, NS/CSXT argue that MMP and MSP provide incentives for gaming by a complainant shipper.⁶⁴

Union Pacific Railroad Co. (UP) argues that ATC would not solve what it perceives as the fundamental problem of cross-over revenue allocation: that complainants are relying too heavily on cross-over traffic to feed revenue into their SARR systems. UP submits that the proposal modestly improves on past approaches, but that the cost-based approach to revenue allocation remains fundamentally flawed. UP argues that: (1) there is no basis for allocating contribution from a movement among different segments; (2) the cost-based approach would result in a bias towards the over-assignment of contribution to the on-SARR segments (leading towards a bias of finding the challenged rate unreasonable); (3) the proposal would allow the SARR to rely on financial support from traffic that is not included at all in the SARR's traffic

⁶¹ SCORS Open. at 6.

⁶² NS/CSXT Open. at 8.

⁶³ NS/CSXT Reply at 11-12.

⁶⁴ Id. at 13.

group; and (4) the proposal avoids all of the important questions that a SAC analysis is supposed to answer, relying instead on simple assumptions about costs.⁶⁵

UP offers an alternative methodology. UP proposes that the Board allocate revenue by calculating the incumbent's URCS variable costs for the on-SARR portion of the movement, and allocating that amount of revenue to the SARR – leaving the remaining cross-over revenue to support the residual incumbent's network. According to UP, the SARR's variable costs would be covered and, assuming the SARR were more efficient than the incumbent, the SARR would also earn some margin that would contribute to its fixed costs. UP contends that the SARR would thus have the opportunity to achieve optimally efficient traffic densities by adding cross-over traffic to its network that would contribute some financial support for its network. This method would allow the SARR to obtain the full contribution available from that traffic by building all of the facilities necessary for the movement if the traffic is sufficiently attractive.⁶⁶

UP concedes that its proposal is equivalent to the efficient component pricing (“ECP”) rule that the ICC previously considered and rejected in Nevada Power. UP argues that the ICC focused in that case on the inappropriateness of assuming that the residual incumbent would undermine the viability of the SARR by making a competitive response to the SARR's entry, which the ICC saw as imposing an impermissible barrier to entry. UP asserts that its current proposal – allocating a portion of revenues to the SARR based on avoided costs – would assume no such competitive response and thus would not give rise to a similar objection.⁶⁷

BNSF generally supports the Board's ATC proposal. BNSF contends that the existing MSP method of allocating revenues from cross-over traffic is seriously flawed and biased towards complainants that include a large amount of such traffic in their analysis. BNSF states that the proposed ATC approach would properly reflect the impact of traffic densities on cost, but contends that it could still introduce bias. BNSF offers two alternatives: a modified MSP that would reduce the origin and destination mileage blocks to 25 miles⁶⁸ and a second so-called “avoidable cost” method that would set the SARR's divisions at BNSF's unadjusted URCS costs for replicating on-SARR cross-over traffic service, similar to UP's proposal.⁶⁹

BNSF argues that the shippers' support for MSP and MMP is based upon several faulty premises: (1) that Guidelines, as construed by ICC/STB precedent up to 2003, requires that the methodology for allocating revenue to the SARR on cross-over traffic be a market-based

⁶⁵ UP Open. at 23-28.

⁶⁶ Id. at 30.

⁶⁷ Id. at 31.

⁶⁸ BNSF Open. at 49.

⁶⁹ Id. at 50-53.

approach reflecting real world divisions, and that the MSP/MMP approaches used by the Board are good proxies for real world divisions; (2) that a cost-based approach to determining revenue allocations on cross-over traffic is inconsistent with Guidelines and somehow undermines shippers' entitlement to the use of cross-over traffic; and (3) that the ATC approach has flaws, including the flaws that led the Board to reject DARA.

BNSF contends that AECC's proposal to provide the SARR with the full contribution over total variable costs realized by the incumbent on the entire through movement would be inconsistent with principles of contestability. BNSF further notes that WFA/Basin and AEP Texas oppose applying the ATC approach, if adopted by the Board, to their pending cases. BNSF construes WFA/Basin's opposition to ATC as an indication that it has used the MSP methodology to "game" the results of the SAC analysis by relying heavily on short-haul cross-over traffic to skew the SAC results in its favor.⁷⁰

Coal Shippers oppose the alternatives proposed by UP and BNSF. They contend that the Board should reject the avoidable cost methods proposed by BNSF and UP as contrary to Nevada Power, McCarty Farms,⁷¹ and Duke/NS, because SARR divisions should be based on projections of actual (market-based) divisions, and the ICC properly rejected the use of avoidable cost divisions.⁷² Western Fuels contends that the burden was on BNSF to demonstrate that it had a superior alternative to MSP in its case. Western Fuels also contends that Otter Tail supports the use of MSP in the Western Fuels proceeding.

AECC argues that UP's ECP method lacks validity and usefulness in the context of the SAC test.⁷³ AECC submits that ECP is merely an effort by UP to retain all of the monopoly profit. AECC also disagrees with BNSF that the SARR should receive no more than the avoidable cost of the incumbent for the "contested" portion of the cross-over traffic. AECC argues that BNSF's method provides no safeguard to ensure that the contribution retained by the residual incumbent would not exceed the amount needed to ensure adequate revenue on the segments used by the cross-over traffic.⁷⁴

Finally, PPL Montana (PPL) argues that the ICC properly rejected efficient component pricing in Nevada Power and that its adoption would unfairly minimize SARR revenues.⁷⁵

⁷⁰ BNSF Reply at 31.

⁷¹ McCarty Farms, Inc. v. Burlington N., Inc., 2 S.T.B. 460 (1997).

⁷² Coal Shippers Reb. at 20-22.

⁷³ AECC Open. at 8-10.

⁷⁴ AECC Reply at 10-11.

⁷⁵ PPL Reb. at 2-3.

4. Board Action

None of the commenting parties has convinced us that our analysis of the flaws inherent in the MSP and MMP methods of allocating revenues from cross-over traffic between the SARR and incumbent carrier is wrong. Thus, the question presented is whether ATC is a suitable methodology that meets the Board's stated goals of reflecting, to the extent practicable, the carrier's relative average costs of providing service over the two segments. We find that it is. We also find that none of the commenting parties has presented a superior alternative. We will therefore adopt the ATC methodology and will apply it in all pending and future rail rate cases.

The various arguments presented against the ATC method are discussed below.

a. Market-Based Versus Cost-Based Allocation

The principal challenge to this proposal by Coal Shippers is an attack on the very nature of cross-over traffic in a SAC analysis. As explained in the NPRM, "the goal in allocating revenue from cross-over traffic should be to ensure that a simplified SAC analysis using cross-over traffic will approximate a full SAC analysis, which provides origin-to-destination service for the entire traffic group." Major Issues NPRM at 17. Coal Shippers disagree that cross-over traffic should be viewed as a simplifying device. They contend that under Guidelines, complainants have an absolute right to use cross-over traffic and to choose any segment of the incumbent's market they wish the SARR to serve.⁷⁶ In other words, Coal Shippers contend that a full SAC analysis would not entail an examination of all of the investment and operating costs involved with serving the entire traffic group from origin to destination. Because in their view cross-over traffic is not a simplifying device, they argue that the SARR would negotiate a market division with the residual incumbent.

We do not share Coal Shippers' views of the nature of cross-over traffic. First, it is clear that the concept of cross-over traffic was not contemplated by the ICC when it adopted Guidelines. Indeed, the name of the test itself (the "stand-alone" cost test) reflects an implicit assumption that the SAC analysis would examine a stand-alone network designed to meet the transportation needs of the SAC traffic group. For any portion which the defendant carrier has not incurred the cost to construct and maintain, such as when non-issue traffic is interchanged with third-party carriers, that portion need not be replicate by the SARR. The use of cross-over traffic, however, results in a hypothetical SARR that would not stand alone in any meaningful sense, but rather would be dependent on the residual defendant carrier to provide the feeder network needed to sustain its operations. As the Nevada Power decision made clear, the use of cross-over traffic was permitted only to "allow shippers to make effective cases . . . using smaller hypothetical SARRs than would otherwise be required." Nevada Power II, 10 I.C.C.2d at 280 (Chairman McDonald, commenting).

⁷⁶ Coal Shippers Open. at 33-48.

More fundamentally, Coal Shippers' views are inconsistent with the objective of the SAC constraint, which is to simulate a competitive rate standard for non-competitive rail movements by determining the rate that would be available to shippers in a contestable market environment. This simulated competitive rate should not depend on how much cross-over traffic is included in the SAC analysis. If the SARR replicated the entire network needed to serve the traffic group, then the SAC analysis would compare the revenues earned by the railroad against the full stand-alone costs needed to serve the entire traffic group. If that SAC analysis showed that the challenged rate was not unreasonable, a SAC analysis using cross-over traffic to simplify the analysis should lead to a similar result. Some imprecision is inevitable with any simplifying measures. But the use of cross-over traffic is nothing more than a simplifying device and as such we must seek to make the analysis more manageable without introducing bias. Major Issues NPRM at 17.

Nor does the concept that a full analysis would examine the total costs of serving the selected traffic group represent a barrier to entry, as claimed by Coal Shippers. The Board has defined a barrier to entry as "any costs that a new entrant must incur that were not incurred by the incumbent."⁷⁷ Here, we are not imposing a cost on the SARR that the incumbent did not actually incur, as the need to allocate revenues from cross-over traffic only arises when the SARR does not replicate the costs the incumbent incurred to construct and operate the entire rail network needed to serve the selected traffic group. And Coal Shippers' argument that we should presume the SARR could exercise market power in setting revenue divisions because the incumbent exercises market power in the real world ignores the purpose of the SAC test, which is to simulate a competitive market rate in a contestable marketplace where market power and cross-subsidies would not exist.

With the goal of finding a non-biased method firmly in mind, it is clear that a market-based analysis for allocating revenue from cross-over traffic has no place in the SAC analysis. This issue has been debated and discussed in Duke/NS at 17-25, CP&L at 20-21, Duke/CSXT at 20-21, and Otter Tail at 13-15. Those decisions explain the policy and economic reasons for using a cost-based method for allocating revenue from cross-over traffic, and we continue to believe that a cost-based approach is superior to a market-based approach for the reasons set forth in Otter Tail at 13-15, the Board's most recent SAC case.

Coal Shippers contend that using a cost-based approach is an unexplained departure from the precedent set in Nevada Power. That case, however, does not provide unqualified support for the use of a market-based approach. In that decision, the ICC was faced with two questions. First, the ICC had to decide how to estimate the actual, real-world revenue division earned by the defendant carrier for traffic moved in interline service with third-party railroads.⁷⁸ Then, upon

⁷⁷ West Texas, 1 S.T.B. at 670.

⁷⁸ See Bituminous Coal – Hiawatha, Utah, to Moapa, Nevada, 6 I.C.C.2d 1, 45-46 (1989). In light of the rebuttable presumption established by Guidelines that the revenue

limited reopening and further discovery, the complainant in Nevada Power elected to include cross-over traffic in its analysis.⁷⁹ This created the second inquiry: how to allocate revenues from such hypothetical cross-over traffic. The ICC decided that, in the absence of any better evidence, “we will prorate the revenues attributable to the cross-over traffic among the SARR and incumbent carriers on a mileage basis, as proposed by [complainant]. This approach is consistent with the treatment in our staff’s preliminary analysis of historically interlined traffic for which actual (market-based) divisions are not available.”⁸⁰ But other than a perceived need for consistency (notwithstanding the different inquiries), the ICC offered no further analysis for why a market-based approach for allocating revenue from cross-over traffic would be proper.

In a series of more recent decisions, the Board has re-examined this issue in depth and concluded that a cost-based approach is superior.⁸¹ While it has utilized some form of a mileage-based allocation methodology since Nevada Power, the Board has not adopted a single preferred procedure for developing revenue divisions on cross-over traffic.⁸² But it has explained why a cost-based approach is the proper inquiry to facilitate the goals of the SAC test.⁸³ Accordingly, after more than a decade of exploring this issue, we conclude that the ATC approach provides a suitable and reasonable cost-based approach for allocating cross-over traffic revenues.

b. Accounting for Economies of Density

The ATC method is designed to take into account economies of density in allocating cross-over traffic by correcting the deficiency in the DARA alternative that had been proposed in

contribution of non-issue traffic (i.e., non-complaining shippers) would be at the level of their current rates, the actual real world divisions would have been used ordinarily. However, in that case, such divisions were not produced in discovery, forcing the agency to develop a methodology to estimate those actual real world divisions. It settled on a simple mileage-based approach.

⁷⁹ Nevada Power, 10 I.C.C.2d at 265 n.12. UP objected to the inclusion of cross-over traffic, but because UP had also objected to expansion of the SAC analysis to include all of the necessary infrastructure to handle an expanded traffic group, the ICC allowed the inclusion of cross-over traffic in the traffic group.

⁸⁰ Id. at 268.

⁸¹ See Duke/NS at 17-20; CP&L at 20-21, Duke/CSXT at 20-22; Xcel at 17-19; Otter Tail at 13-15. The agency has the authority to depart from prior precedent so long as it offers a reasoned analysis indicating that prior policies and standards are being deliberately changed. See, e.g., National Rural Elec. Coop. Ass’n v. SEC, 276 F.3d 609, 615 (D.C. Cir. 2002); Greater Boston Tel. Corp. v. FCC, 444 F.2d 841, 852 (D.C. Cir. 1970).

⁸² See, e.g., PPL, 6 S.T.B. at 293 n.14; Duke/NS at 17 n.27.

⁸³ Otter Tail at 15.

prior cases. Economies of density reflect how average total costs for a network of a given size initially decrease with increases in output. Accordingly, any approach that seeks to account for economies of density must examine the average total costs, rather than the average variable costs. The ATC method calculates the average total cost per ton associated with the segments at issue. It does so by first calculating the railroad's system-average variable cost per ton using unadjusted URCS. It then uses the URCS system-average fixed cost and system-wide route miles to derive a system-average fixed cost per route mile. This calculation, when combined with the actual route miles and traffic tons of the segment in question, is used to derive the average fixed cost per ton of that segment. The combination of the average variable cost and average fixed cost provides the average total cost per ton.⁸⁴ As BNSF demonstrates, the ATC method thus takes account of both economies of density and diminishing returns.⁸⁵ As such, continued use of the MSP approach would be on shaky ground. See BNSF Ry. v. STB, 453 F.3d at 484.

Coal Shippers object to the approach because it rests on a calculation of the relative average total cost to provide service. They cite a pre-URCS decision,⁸⁶ for the proposition that the attempt to allocate fixed costs to specific traffic movements using cost accounting devices is, by definition, arbitrary. Coal Shippers quote the beginning of a sentence pertaining to motor carrier costing: “[b]y definition constant or fixed costs are not allocable or assignable upon a cost of service basis. . . .”⁸⁷ But that sentence does not end there. It continues:

. . . nor traceable to particular units of output, for otherwise they would have been, in fact, variable and not constant. In this respect, they are somewhat similar to

⁸⁴ This is also consistent with Duke/NS and Xcel, where the Board stated that “[t]here may be merit to allocating revenues based on the relative variable cost and average fixed cost to haul traffic over each segment of the move, if those costs can be fairly approximated.” Duke/NS at 20; Xcel at 19.

⁸⁵ See BNSF Reply V.S. Klick at 19; BNSF Reb. V.S. Klick at 12-15. The argument by Coal Shippers that ATC shares the same deficiency as DARA is therefore misplaced. When DARA was first presented to the agency, the railroad offered minimal support for the approach. The Board rejected the alternative because of a perceived flaw that it “contains the initial assumption that light density lines have the same fixed costs per mile as heavy density lines.” Duke/NS at 29. Then in Xcel, after further briefing by the parties, the Board found on reconsideration that, because the first step of DARA requires the hypothetical division to cover each carrier's variable costs as calculated by URCS, the remaining fixed costs (i.e., costs that do not vary with output) would indeed be the same on average for light-density as for heavy-density lines. See Xcel Recon. at 10-11.

⁸⁶ Rules to Govern the Assembling and Presenting of Cost Evidence, 337 I.C.C. 298 (1970).

⁸⁷ Id. at 395.

joint and common costs which are not readily traceable to any specific portion of an indivisible operation, but are incurred in connection with the performance of the entire service involved. These costs have to be and are necessarily apportioned, and the problem, though complex and difficult, is essentially that of determining a reasonable and fair assignment of such costs.⁸⁸

Coal Shippers and UP also cite Guidelines for the proposition that fixed costs “cannot be assigned directly to specific movements by any conventional accounting methodology.”⁸⁹ But the ATC does not attempt to apportion fixed costs to a specific movement. Instead, it utilizes URCS fixed and variable costs on a system-wide basis for the defendant carrier, adjusted by the density and miles of the segment at issue, to establish the average total cost to own and operate a particular segment of a network. While it may be difficult to assign fixed costs to a particular movement, we believe that ATC will permit the agency to account for economies of density in the allocation of revenues from cross-over traffic.

c. The Effect of ATC Allocation.

Coal Shippers also object to ATC because it will allocate more revenue to lighter-density lines. They argue that Guidelines calls for shippers to design “least cost” SARRs that “maximize” traffic densities, but the ATC divisions will arbitrarily allocate disproportionate shares of SARR divisions to lower-density off-SARR lines. But as we have stated, the goal of allowing cross-over traffic is to simplify the analysis without introducing bias. A successful allocation of cross-over revenues would produce the same revenue-to-cost relationship as would be produced if the complainant modeled the entire movement. Rather than arbitrarily allocating revenue to low-density lines, the ATC method more accurately is keyed to the defendant carrier’s relative costs of providing service over the two segments.⁹⁰

We note the irony of this objection, as Coal Shippers elsewhere contend that it is difficult if not impossible for shippers located on light-density lines to prevail in a SAC analysis. One reason a shipper on a light-density line may not prevail is that the existing revenue allocation methodology does not reflect the higher average total cost to construct and operate those lines. As such, the existing methodology allocates too much revenue to high-density lines, and not enough to lighter-density lines. ATC will level the playing field by allocating costs according to a reasonable estimate of the relative costs to own and operate the various parts of the larger network.

⁸⁸ Id.

⁸⁹ Guidelines, 1 I.C.C.2d at 526.

⁹⁰ See Duke/NS at 20.

Similar arguments advanced by UP relate to the propriety of accepting cross-over traffic in the first instance, rather than to the proposed methodology to allocate revenues between the SARR and the incumbent carrier.⁹¹ The Board's reasons for permitting cross-over traffic were set forth in Xcel at 13-17, and have been affirmed as reasonable and intelligibly explained, BNSF Ry. v. STB, 453 F.3d at 482. We will not now make an about-face and prohibit the use of cross-over traffic, as UP appears to advocate. To achieve the benefits of simplification of the SAC analysis that cross-over traffic allows, we must find a reasonable way to allocate the revenues from that traffic. Rather than biasing the result towards the over-assignment of contribution to the on-SARR segments, as claimed by UP, the ATC method will ensure that the result more closely aligns with what a larger, more cumbersome SAC analysis would show.⁹²

d. Efficient Component Pricing

BNSF and UP advocate alternative revenue allocation methodologies that are variants of the Efficient Component Pricing method considered and rejected by the ICC in Nevada Power. Under their alternatives, the revenue allocated to the SARR would only equal the incumbent's avoidable costs (as calculated by URCS) associated with that portion of the movement replicated by the SARR.⁹³ In other words, all the "profit" from the entire movement (i.e., revenue in excess of variable costs) would stay with the incumbent, no matter how much or little of the service it provides.

We will not adopt this alternative for three reasons. First, the approach assumes post-entry retaliation by the incumbent railroad, which conflicts with the basic precepts of contestable market theory. Second, even if the inquiry were to replicate the revenue allocation that would occur in a contestable market, ECP does not do so. Finally, and most importantly, the approach would inject bias in favor of the railroads and render cross-over traffic ineffectual in simplifying the SAC analysis. Indeed, BNSF agrees that, if one views cross-over traffic as a simplifying

⁹¹ UP Open. at 21-25; see also UP Open. V.S. Neels at 3 ("The Board's efforts to allocate contribution are doomed to fail.").

⁹² UP seeks to show the flaws in ATC by hypothesizing situations where the approach would not mimic that of a SAC analysis without cross-over traffic. UP Open. V.S. Neels at 10-14. Other examples could be hypothesized where use of ATC could lead to a rate being regarded as reasonable when a SAC without any cross-over traffic would find the rate unreasonable. The point is not that ATC is perfect, but rather that it is unbiased, because it allocates costs in relation to the average total costs of providing service over the parts of the network in question. The same cannot be said of either the existing mileage based approach or UP's alternative.

⁹³ BNSF Open. at 52; BNSF Open. V.S. Kalt at 40-46; UP Open. at 30-31.

device, as we do, then the ATC method is superior to the avoidable cost method proposed by both it and UP.⁹⁴ We elaborate on these points below.⁹⁵

ECP conflicts with CMP theory and was properly rejected in Nevada Power. It reflects the misguided belief that the SAC analysis should include an inquiry into post-entry behavior of the SARR and residual incumbent. The purpose of the SAC constraint is to simulate a competitive rate standard for non-competitive rail movements by determining the rate that would be available to shippers in a contestable market – that is, a market free of barriers to entry and exit. But as explained in Nevada Power, “to determine the rates that would be available to shippers if rail markets were contestable, we cannot take account of any post-entry responses by incumbents.”⁹⁶

UP and BNSF both deny that their approaches reflect a post-entry response by the incumbent.⁹⁷ The theory underlying these proposals, however, is that there would be no diversion of traffic unless the rate offered by the SARR were less than the avoidable costs of the incumbent. But that would only be true if the incumbent were to respond to entry and seek to retain the traffic by lowering its rate to the level of its avoidable cost. How else could the incumbent prevent diversion of the traffic over those lines? That is precisely the kind of post-entry pricing response that cannot be taken into account under a contestable market analysis.⁹⁸ In conducting our SAC analysis, we do not view the SARR as a competitor of the incumbent, but rather as “a replacement carrier that steps into the shoes of the incumbent carrier for the segment of the rail system that the SARR would serve.”⁹⁹

Alternatively, UP argues that, even if the SARR were viewed as a replacement, the incumbent would always remain free, in a contestable market, to threaten to re-enter the market

⁹⁴ BNSF Reb. at 18.

⁹⁵ AECC’s proposal suffers from the same defect in reverse. It is based on the notion that the SARR and the incumbent would try to “capture” contributions from cross-over traffic and that the incumbent should only retain enough revenue to cover its variable costs. AECC Open. at 10. It would thus over-allocate revenue in favor of the SARR.

⁹⁶ Nevada Power, 10 I.C.C.2d at 267.

⁹⁷ BNSF Reb. at 21-22; UP Reb. at 27 (“UP’s avoided cost approach is not predicated on a theory of ‘competitive response’ or ‘price retaliation’ or alternation of ‘pre-entry prices’ by the incumbent.”). But see UP Reb. at 26 (conceding that its approach asks how “an incumbent would react in a contestable scenario to the situation in which the SARR wanted to replace the incumbent for a portion of a movement that the incumbent handled end-to-end.”) (emphasis added).

⁹⁸ See Nevada Power, 10 I.C.C.2d at 267.

⁹⁹ West Texas at 670.

and provide end-to-end service.¹⁰⁰ UP concludes that the SARR could therefore never obtain a division in excess of the incumbent's avoidable costs.¹⁰¹ However, this concept (which itself appears to be another form of post-entry response) does not support the proposal advocated by UP. If the incumbent railroad had to rebuild the infrastructure, then the "avoidable costs" would need to include a reasonable return on that entire investment, including all threshold expenses, which UP's URCS-based variable cost method does not consider. Moreover, the SARR could make the same threat to provide end-to-end service. UP has failed to explain how the result of such negotiations – where either party could threaten to build additional infrastructure and provide end-to-end service – would somehow permit the incumbent to enjoy the lion's share of revenue.¹⁰²

We offer the following example to illustrate our practical concerns with the approach advocated by both BNSF and UP. Consider the following hypothetical, where a complainant seeks to include a move in its traffic group that generates \$20 per ton in revenue. The variable cost of the move is \$10 per ton, such that it has an R/VC ratio of 200%. Assume the SARR replicates half of the movement from the mine to a fictional interchange, with an URCS variable cost of \$5 per ton. The residual defendant would transport the movement the remaining distance from the interchange to the power plant. The question is how to allocate revenues to the facilities replicated by the SARR from such a cross-over movement. In this example, the approach advocated by UP and BNSF would allocate \$5 to the facilities replicated by the SARR and \$15 to the non-SARR segment. They both claim that this is the likely outcome in a contestable market.¹⁰³

But if one holds everything constant, and switches the position of the parties, the outcome flips inexplicably. Under the theory espoused by UP and BNSF, if the SARR now provided service from the interchange to the power plant, it would receive only \$5 of the total revenue and the lion's share would shift to the party providing service from the mine to the fictional interchange. How would this be the outcome in a contestable marketplace, where the parties are

¹⁰⁰ UP Reply at 21.

¹⁰¹ Id.

¹⁰² Alternatively, BNSF contends that the incumbent should be treated as an additional customer of the SARR and be left no worse off as a result of entry. Its approach, however, makes the incumbent better off by permitting the incumbent to keep all contribution in excess of URCS variable cost for itself, no matter how much infrastructure it would need to provide the residual service.

¹⁰³ See, e.g., BNSF Open. V.S. Kalt at 45; UP Open. V.S. Neels at 16.

otherwise similarly situated? How can the outcome depend on the identity of the party providing service, rather than on the service provided? UP and BNSF provide no reasoned explanation.¹⁰⁴

Finally, and most importantly, this alternative plainly fails to achieve the goal of an unbiased result. ECP would limit a SARR's revenue from cross-over traffic to the existing carrier's avoidable cost (as calculated by URCS) of providing service on the lines the SARR would hypothetically replace. This result is inherently biased in favor of the incumbent, as the cross-over traffic could not provide any contribution to the threshold, joint and common costs.¹⁰⁵

III. Indexing Operating Expenses

1. Background

A contested issue in all recent SAC cases has been how the Board should index the SARR's base-year operating expenses over the SAC analysis period, with the parties most often taking diametrically opposite positions. They generally agree on using projections that are based on some form of the rail cost adjustment factor (RCAF). The RCAF was established in the Staggers Rail Act of 1980 as a quarterly index intended to track changes in railroad costs. Initially, the ICC determined not to adjust the RCAF price index to reflect productivity, but rather, to measure only the change in the prices of inputs, such as labor and fuel, used to produce railroad services.¹⁰⁶ In 1989, the ICC began to include changes in railroad productivity.¹⁰⁷ Productivity is measured as the change in the ratio of the output index (based on a composite,

¹⁰⁴ We also note a further incongruity in UP's and BNSF's approach. As the SARR replicates an increasing share of the total movement, its share of the revenue does not approach 100%. Rather, in the example above, even if the SARR replicated 99% of the movement, the approach would allocate only 50% of the revenue to those facilities. BNSF and UP claim that, if the SARR were to replicate all of the movement, then all the revenue would be allocated to the facilities replicated by the SARR. Yet they offer no reason why the revenue division should be limited to the incumbent's avoidable costs if the SARR were to replicate 99% of the facilities, but no such limit should apply if the SARR were to replicate 100% of the facilities.

¹⁰⁵ BNSF's arguments to the contrary, BNSF Open. at 52, are unpersuasive. BNSF observes that URCS includes some return on road property investment. But URCS variable costs do not, by definition, include any threshold costs. As such, limiting the revenue division to URCS variable cost would require the issue movement (and other local movements) to pay for all threshold costs, depriving captive shippers of the benefits of grouping traffic held out to them in Guidelines. See Duke/NS at 19.

¹⁰⁶ See Railroad Cost Recovery Procedures, 364 I.C.C. 841 (1981), aff'd sub nom. Western Coal Traffic League v. United States, 677 F.2d 915 (D.C. Cir. 1982).

¹⁰⁷ See Railroad Cost Recovery Procedures-Productivity Adjustment, 5 I.C.C.2d 434 (1989), aff'd sub nom. Edison Electric Institute v. ICC, 969 F.2d 1221 (D.C. Cir. 1992).

revenue weighted, average of the year-to-year changes in ton-miles for various segments of traffic in the Waybill Sample) over the input index (as measured by the total freight expenses calculated using depreciation accounting, plus fixed charges). The annual measurement of productivity trend is based on a 5-year moving average.¹⁰⁸ In SAC cases, shippers generally urge the Board to use forecasts of RCAF adjusted for industry-wide productivity improvements (RCAF-A). Railroads generally urge the Board to use forecasts of the RCAF with no productivity adjustment (RCAF-U).

Facing a choice between one or the other, the Board has historically chosen RCAF-U. The Board has recognized that use of RCAF-U is imperfect, particularly in the more distant years of a 20-year analysis.¹⁰⁹ But the Board has concluded that it is better to use RCAF-U than RCAF-A, which would overstate the SARR's anticipated productivity in every year of the analysis. Because the SARR is designed to be an efficient replacement for the railroad, it would not be able to realize the same productivity gains as the rest of the industry, particularly in the early years. For example, railroads realize productivity gains in locomotives as they replace old locomotives with newer technologies. The SARR would not experience those same productivity gains in the short term, because it would begin its operations with all new locomotives.

2. Board Proposal

The Board believed it would be reasonable to assume that the productivity of a hypothetical SARR would converge with that of the railroad industry in 20 years. In the NPRM, it noted that the rail productivity gains measured by RCAF-A take two forms. There are infrastructure efficiencies associated with increased use of existing rail infrastructure and abandonment of unprofitable lines. And there are operating efficiencies associated with technological improvements and increasing labor productivity. The Board suggested that the SARR and the rest of the rail industry would, by year 20, be using the same types of locomotives and railcars, with a comparable mix of depreciated and new equipment. And as the railroad industry continues to shed any excess or inefficient infrastructure, the Board proposed that it might be reasonable to assume that within the next 20 years the infrastructure utilization of the rail industry would be similar to that of the SARR.

The Board therefore proposed to use a hybrid of the two indexes, starting with RCAF-U and phasing in the productivity gains projected in RCAF-A incrementally over a 20-year period. Specifically, the Board proposed to use 100% of RCAF-U to project the SARR's operating expenses in the first year. The next year's index would be based on 95% of RCAF-U and 5% of RCAF-A. This pattern would continue, switching over in 5% increments each year.

¹⁰⁸ See, e.g., Quarterly Rail Cost Adjustment Factor, STB Ex Parte No. 290 (Sub-No. 5) (2006-4) (STB served Sept. 20, 2006). The most recent average productivity change rate was computed as 1.019 (1.9% per year).

¹⁰⁹ See, e.g., Otter Tail at 21-22.

3. Public Comments

The railroads oppose the proposal to use a hybrid index and to phase in RCAF-A. They argue that we should continue to use RCAF-U, at least during the early years of the SAC analysis period.¹¹⁰ The carriers contend that the SARR would not have the opportunity to realize any productivity gains because it would be an optimally efficient carrier at inception and thus would not face the inefficiencies of incumbent carriers.¹¹¹ The carriers also argue that the proposed hybrid index is arbitrary and lacks evidentiary support.¹¹² However, all of the railroads concede that productivity gains may be possible for the SARR towards the end of a 20-year period.¹¹³ Several railroads argue that, if potential sources of productivity exist, complainants should be required to present evidence specifically identifying those sources.¹¹⁴ In addition, the carriers contend that any calculation of the possible benefits from productivity improvements must take into account the costs associated with such improvements.¹¹⁵ Some of the carriers argue that, if a productivity adjustment were applied to SARR operating expenses, a comparable adjustment to the inflation of capital assets should also be applied.¹¹⁶ Finally, the carriers suggest that shortening the SAC analysis period to 10 years would render moot the Board's concern regarding productivity in later years.¹¹⁷

The shipper community generally supports the Board's proposal. They agree that productivity gains should be included in forecasting SARR operating expenses, but they do not believe that the Board's proposal goes far enough.¹¹⁸ First, they argue that, contrary to the Board's assumption, a SARR could benefit from productivity improvements in its first year of operation.¹¹⁹ Second, they disagree with the Board's assumption that a SARR's ability to benefit from productivity gains in a manner comparable to the rail industry would not be fully achieved until the 20th year of the SARR's operations.¹²⁰ Coal Shippers request that we modify the

¹¹⁰ BNSF Open. at 55; Canadian Pac. Ry. (CP) Open. at 4-5; NS/CSXT Open. at 9; UP Open. at 31-35.

¹¹¹ BNSF Open. at 57; CP Open. at 3; NS/CSXT Open. at 9; UP Open. at 32.

¹¹² BNSF Open. at 55; CP Open. at 4-5; NS/CSXT Reply at 16.

¹¹³ BNSF Open. at 58-59; CP Open. at 5; NS/CSXT Open. at 10-11; UP Open. at 35.

¹¹⁴ BNSF Open. at 56; NS/CSXT Open. at 10-11; UP Reply at 25.

¹¹⁵ CP Reply at 6; NS/CSXT Reply at 15; UP Reply at 33-35.

¹¹⁶ BNSF Open. V.S. Baranowski at 19-20; UP Reply at 37.

¹¹⁷ BNSF Open. at 56; CP Open. at 5; NS/CSXT Open. at 9.

¹¹⁸ Coal Shippers Open. at 69; Western Fuels Open. at 28.

¹¹⁹ Coal Shippers Open. at 73-82.

¹²⁰ Id. at 86-88.

proposed hybrid index to apply 50% RCAF-U and 50% RCAF-A in Year 1 and then to increase RCAF-A in a linear manner until the index reaches 100% RCAF-A in Year 10.¹²¹

4. Board Action

The parties' comments support a conclusion that the rate of productivity growth of a SARR would converge with that of the industry at some point, and that the most practicable and realistic method to incorporate that convergence is to phase in the use of RCAF-A smoothly year-by-year. Moreover, none of the comments have persuaded us that the 20-year mark is not a reasonable period to use. Therefore, we will adopt our proposal to use 100% RCAF-U to project the SARR's operating expenses in the first year and then to phase in the RCAF-A in 5% increments each year thereafter.

There has long been controversy and disagreement between railroads and shippers about how to measure the rail industry's historical productivity gains.¹²² This underscores the even greater difficulty in forecasting the hypothetical SARR's productivity growth into the future. But all of the parties agree that the SARR would likely experience some productivity growth, at least in the outward years of a SAC analysis.¹²³ Thus, we cannot ignore this difficult task and continue to overstate a SARR's operating expenses by using RCAF-U throughout the SAC analysis period if a more appropriate measure is readily available.

There are several recognized sources for productivity growth in the railroad industry, as evidenced by the parties' comments: (1) changes embodied in expensed, short-lived assets that introduce the latest available technology; (2) changes embodied in new investment in plant and equipment;¹²⁴ (3) changes resulting from pruning excess lines and concentrating traffic into fewer routes;¹²⁵ and (4) disembodied productivity change, i.e., gains that derive from more

¹²¹ AEP Texas Open. at 18; Coal Shippers Open. at 70; Western Fuels Open. at 28-29 (urging the Board to modify its proposal by adopting the 0.59 RCAF-U index presented in the Western Fuels case, or in the alternative, to adopt Coal Shippers' proposal).

¹²² See Productivity Adjustment – Implementation, 1 S.T.B. 739, 741 (1996).

¹²³ See, e.g., BNSF Reply V.S. Baily at 3; CP Open. at 4-5; NS/CSXT Open. at 10.

¹²⁴ Coal Shippers point out that new technology can be introduced by adaptations and extensions without waiting for wholesale plant and equipment replacements (e.g., building longer sidings to accommodate longer trains made possible with more powerful locomotives). Coal Shippers Open. V.S. Caves at 6.

¹²⁵ Coal Shippers Reb. V.S. Caves at 12; BNSF Open. V.S. Baranowski at 5.

efficient use of existing assets, such as improved management techniques, more flexible work rules and learning by doing.¹²⁶

A SARR is hypothesized as an efficient replacement for the incumbent carrier and, therefore, a SARR is presumed to begin the analysis period at a higher productivity level than the industry as a whole. Thus, some of these sources of productivity changes would be available to the SARR in the early years of operation, whereas some of them would not. A SARR would be unlikely to prune excess lines, particularly in the early years, and therefore could not reasonably expect to match the industry's productivity gains as a result. Similarly, increasing traffic densities cannot serve as an adjustment to RCAF in a SAC analysis because the discounted cash flow (DCF) procedures, specifically the growth in revenues due to traffic growth set against a static real level of investment, automatically reflect the impact of growing density over time. Thus, to reflect this impact in an RCAF adjustment during the DCF period would be to double count it. See Xcel at 34; Duke Energy Corp. v. Norfolk S. Ry., STB Docket No. 42069, slip op. at 17 (STB served Oct. 20, 2004).

But we would expect a SARR to experience some modest productivity growth, even in the early years, from disembodied productivity change, i.e., where gains derive from more efficient use of existing assets such as improved management techniques, more flexible work rules and learning by doing. For example, coal dust fouling a railroad's right-of-way is a source of maintenance expenses for railroads. Railroads and coal shippers are exploring ways to reduce the amount of coal dust lost in transit, such as altering the shape of car loads or spraying agents on the coal, thereby reducing the amounts necessary to be spent on maintenance.¹²⁷ We would also expect some productivity growth that is embodied in expensed, short-lived assets that introduce the latest available technology, and productivity change that is embodied in new investment in plant and equipment. Information technology equipment, software and advances in car and locomotive construction are areas where a SARR could improve productivity. For example, contract terms and the economic life of IT equipment and software tend to be in the 3-5 year range.¹²⁸ Freight car equipment and locomotives, on the other hand, can have lease terms of up to 20 years. Thus, the SARR could expect a rate of productivity growth beyond the RCAF-U, as short-lived assets are replaced. And we would expect that rate to grow over time as the SARR would come to resemble the industry as a whole.

¹²⁶ Coal Shippers Open. V.S. Caves at 6, V.S. Brennan at 7-8; Coal Shippers Reb. V.S. Caves at 10-12, V.S. Brennan at 11-16.

¹²⁷ Coal Shippers Reb. V.S. Brennan at 11, citing Thomas Kraemer, "Increasing the Capacity of PRB Coal Delivered to Power Plants is a Priority," Coal Power Magazine, Spring 2006, at 7.

¹²⁸ Coal Shippers Open. V.S. Caves at 6, V.S. Brennan at 14-15.

In indexing a SARR's expenses into the future, the relevant inquiry is not only what is the SARR's initial productivity level, but at what rate would its productivity increase. The productivity change one can expect from a railroad's expenditures on new assets embodying technical change depends on the divergence between the new vintage of technology being introduced and the average vintage under which the railroad industry is operating. In a typical SAC case, the SARR would have technology that is much newer than that of the industry. Investment in assets incorporating new technology will have a greater impact on a real world railroad's output than for a SARR whose vintage of technology is much younger. Thus, in the early years of a SAC analysis, the industry's rate of productivity growth will be greater than the SARR's.

But as the industry replaces its assets, the difference between the rates of growth will decline. And as the SARR approaches the industry's vintage of technology over time, both the productivity level and the rate of growth for the industry and the SARR would converge. As the railroad industry continues to shed any excess or inefficient infrastructure, it is reasonable to assume that over a 20-year period the infrastructure utilization of the rail industry will be similar to that of the SARR. Thus, over 20 years, the rate of productivity growth of a SARR with brand new technology in year one and the industry as a whole would converge.

Having concluded that the difference between the rate of the SARR's productivity growth and that of the industry would diminish over a roughly 20-year timeframe, the question presented is how that convergence will occur. To assume that that convergence would occur suddenly at the end of 10 years, as advocated by the carriers, would be contrary to the weight of the evidence submitted in this proceeding. Some of the identified areas of productivity growth would occur in the first years of operation. A firm can learn by doing in the early years, and thus see some small productivity growth. As technology and assets are replaced, greater productivity growth can reasonably be expected to occur. And as the industry replaces assets and technology, so that the SARR and the industry would become more similar, the rates of productivity would converge. We acknowledge that the SARR productivity would not steadily approach that of the rail industry in a perfectly smooth fashion, but would more likely be a step function, with different productivity in each year, but with steady movement towards convergence with the productivity of the rail industry. For practicality, we will assume that convergence would occur smoothly year by year. This would overstate productivity in some years, understate it other years, but provide a suitable forecast for productivity of operating expenses over the SAC analysis period. Thus, smoothly factoring a small amount of productivity growth over the SAC analysis period is a reasoned and workable approach.

5. Other Criticism by the Parties

In their comments, both the shippers and the railroads criticize various aspects of the Board's proposal. First, the shippers argue that the SARR should register some productivity change during the first year because disembodied productivity change would kick in

immediately.¹²⁹ But the SAC analysis already incorporates disembodied productivity changes, such as learning by doing, that would occur during the first year. The SARR's workforce is assumed to be equally capable as the residual incumbent's in dealing with and learning from assets embodying current technology. Giving the SARR credit for disembodied productivity changes during the first year would imply that the SARR's workforce is somehow more capable than the residual incumbent's. But the SARR would experience some disembodied productivity change in the initial years, as workers learn to better use the technology.

Second, the railroads argue that because all productivity change is associated with some kind of expenditure, complainants in SAC proceedings should be required to provide for those expenditures in their SAC analysis if they are to claim productivity benefits.¹³⁰ That argument is only persuasive where the source of productivity is capitalized assets. However, expensed assets, not capitalized assets, make up the relevant set of assets to which the productivity is applied.¹³¹ And the historical RCAF-A series subsumes the expensed items required to bring about productivity change, because the productivity component of RCAF-A is calculated as an output index divided by an index of deflated expenses.¹³²

Third, the railroads insist that complainants should be required to present specific evidence of the type of productivity change, the timing and the categories of outlays.¹³³ Based on our experience in recent SAC cases, we agree with the shippers that this would be unreasonably burdensome. Productivity change that arises from the introduction of new technology is by its nature unpredictable. For example, it is not clear when recognized innovations, such as positive train control, will be adopted. Dramatic and controversial work rule changes present similar forecasting challenges. Moreover, it is difficult to pin down the timing of changes that require industry-wide acceptance or that involve complicated interactions among different types of rail property and equipment, such as longer trains or heavier cars. Under the circumstances, we conclude that it is reasonable to draw inferences from long-term trends and instead focus on when and how the SARR would come to look like the rest of the railroad industry in terms of productivity growth.

¹²⁹ Coal Shippers Open. at 73-86.

¹³⁰ CP Reb. at 6; NS/CSXT Reply at 15; UP Reply at 33-35.

¹³¹ Expensed assets, as opposed to capitalized assets, are assets for which the payments are included in operating expenses in a SAC analysis (rather than in road-property investment) even though they provide useful service for several years. An example would be locomotives, which are typically leased.

¹³² Coal Shippers Reply at 41.

¹³³ BNSF Open. at 55-56; NS/CSXT Open. at 10-11; UP Reply at 25.

BNSF raises a final point regarding capital asset productivity. It argues that, if the SARR were to experience productivity gains in operating expenses, then the SARR should also experience productivity in capital inputs.¹³⁴ BNSF then posits that the capital price indexes in the DCF analysis should be reduced to reflect capital productivity, which it claims would have an offsetting effect on operating productivity. Coal Shippers agree that BNSF has made a valid observation, that as technology and material science improve, the replacement of rail assets would become more efficient. The parties disagree, however, on how to implement such capital asset productivity.¹³⁵

The record is not sufficiently developed on this novel idea of capital asset productivity to warrant addressing the issue within this rulemaking, as neither party appears to have developed an acceptable way to implement such capital asset productivity. We note, however, that if a SARR could be expected to experience capital asset productivity, and thus reduce the cost to replace rail assets as they depreciate, the effect should be to make the SARR more efficient and reduce SAC costs. It would not appear, as BNSF argues, to offset operating productivity but rather to complement it. BNSF's proposed solution would have the opposite effect, raising the SAC costs in the early years by lowering the capital price indexes. The approach advocated by Coal Shippers, increasing the expected life of the rail assets, would seem to have the correct general effect on the SAC analysis, but is a seemingly cumbersome and inaccurate way to model capital asset productivity.

We acknowledge the roughness of our hybrid approach, but the inquiry itself, while necessary, is highly speculative in nature. Just as quantifying historical productivity was a challenging undertaking, predicting productivity of the existing rail industry is far more difficult, and predicting productivity of a hypothetical SARR even more so. Yet the record supports the conclusion that a hypothetical, optimally efficient SARR would achieve future productivity improvements, even modest productivity in the short term. It is the attempt to quantify the precise amount of such productivity in each year of the analysis that produces the broad array of conflicting expert testimony witnessed in this proceeding. At some point, an elaborate and expensive search for a more precise estimate of future productivity must give way to the need for a uniform, manageable approach. Predictability in regulation is an important goal. It serves the public good by permitting carriers to conform their conduct to a set of rules and assisting captive shippers in judging whether a particular rate could be challenged as unreasonably high. Having reviewed the testimony on this issue, and given our experience with similar evidence submitted in prior and pending SAC cases, we conclude that the benefits of fixing a reasonable (if rough) methodology for forecasting future productivity of a SARR outweighs the substantial costs to the parties and unlikely benefits of quantifying a more precise estimate in an individual proceeding.

¹³⁴ BNSF Open. V.S. Baranowski at 19-20; UP Reply at 37.

¹³⁵ Compare Coal Shippers Reply V.S. Crowley at 6-13 with BNSF Reb. V.S. Baranowski at 14-17.

In sum, we conclude that the SARR would have similar rates of productivity growth after 20 years and would begin realizing some of those gains in the first few years of operation. To ignore these gains would overstate the SARR's operating expenses. In the proposal we adopt here, the progression towards RCAF-A is gradual and incremental over that timeframe, which we conclude is a reasonable approach for these purposes.

IV. Movement-Specific Adjustments to URCS

1. Background

Under ICCTA, the Board has jurisdiction to determine the reasonableness of a challenged rail rate only if the carrier has "market dominance" over the traffic involved. Market dominance is presumed not to exist where the carrier shows that its revenues for transporting the movements at issue are less than 180% of its variable costs of providing that service. The variable costs associated with the traffic at issue also determine the floor for rate relief, because the Board cannot prescribe a rate that is below the jurisdictional floor.

The Board uses the Uniform Rail Costing System (URCS) to determine a carrier's variable costs. URCS is a "general purpose costing system for all regulatory costing purposes," designed to measure system-wide average variable costs.¹³⁶ Congress mandated the use of URCS, and indicated that adjustments to it may be made where the Board finds appropriate.¹³⁷ Thus, in this jurisdictional inquiry, Congress instructed the parties to use "unadjusted" URCS costs, with the decision whether to permit movement-specific adjustments committed to the agency's discretion.

The URCS model determines, for each Class I railroad, the portion of each category of costs shown in the carrier's Annual Report to the Board (STB Form R-1) that represents its system-average variable unit cost for that cost category for that year. URCS consists of a series of computer programs and manual procedures organized into three phases. Phase I compiles the raw data provided by the carriers into a useable format, and then uses statistical estimation procedures to determine the proportion of specific expense account groupings that vary with changes in the volume of activity (such as running track maintenance, which varies with gross ton-miles). In Phase II, these cost/volume relationships are then used to develop the unit variable

¹³⁶ See Adoption of the Uniform Railroad Costing System As A General Purpose Costing System For All Regulatory Costing Purposes, 5 I.C.C.2d 894, 899 (1989) (Adoption of URCS).

¹³⁷ See 49 U.S.C. 10707(d)(1)(B) ("[V]ariable costs for a rail carrier shall be determined only by using such carrier's unadjusted costs, calculated using the Uniform Rail Costing System cost finding methodology (or an alternative methodology adopted by the Board in lieu thereof) and indexed quarterly to account for current wage and price levels in the region in which the carrier operates, with adjustments specified by the Board.") (emphasis added).

costs that allow costing of specific rail movements. Finally, in Phase III, these variable cost units are applied to specific movements via an interactive computer program that permits the user to enter data for the specific movements under consideration.

Calculating variable costs using unadjusted URCS system-wide averages is a quick and administratively simple process. The advance work is performed by the Board annually. The Board then offers the Phase III computer program to the public at a minimal cost.

In nearly all SAC proceedings, however, parties have advocated the use of variable cost units different from the URCS system-wide average figure. These adjustments are known as “movement-specific” adjustments. Shippers typically advocate movement-specific adjustments that would reduce the carrier’s variable costs and increase the resulting revenue/variable cost (R/VC) ratios, while railroads advocate adjustments that would increase variable costs and reduce the resulting R/VC ratios. In response to these requests for deviation from URCS averages, the Board evaluates whether the party proposing to use a different figure has shown that its proposed figure would better reflect the variable costs of serving the particular traffic at issue than the URCS system-average figure. Substantial resources are expended by the parties in advocating and by the Board in analyzing movement-specific adjustments to URCS.

2. Board Proposal

The Board proposed the discontinuation of movement-specific adjustments to the system-average unit costs in all rate reasonableness cases. Although it has been the longstanding practice of the Board, and the ICC before it, to permit such adjustments, the Board stated that these adjustments may not serve a useful public purpose for a variety of reasons.

First, the analysis of proposals for movement-specific adjustments is complex, expensive, and time consuming. Second, the Board believed that Congress intended, in adopting the 180% R/VC limitation on Board rate review, to create an administratively quick and easy-to-determine regulatory safe harbor for the railroads. Third, the URCS program already tailors the variable cost calculation to the movement at issue. Fourth, disallowing movement-specific variable cost adjustments would eliminate substantial uncertainty in the current rail rate adjudication process. Fifth, railroads do not consistently keep certain types of information that shippers have relied on for favorable movement-specific adjustments. Sixth, adjustments to URCS may not provide more reliable results than using the system-average expenses. Finally, piecemeal or incomplete adjustments to URCS are suspect. See Major Issues NPRM at 23-27.

3. Public Comments

BNSF and UP conditionally support our proposal to disallow movement-specific adjustments to URCS.¹³⁸ Both parties recognize the costly, complex issues that arise in litigation

¹³⁸ BNSF Open. at 60-64; UP Open. at 35-36.

over movement-specific adjustments, particularly in dealing with issues relating to variability percentages in URCS.¹³⁹ They note that such a burdensome process is seldom justified, ultimately having little impact on the jurisdictional threshold calculation, or cannot be judged superior to system-average costs.¹⁴⁰

BNSF and UP recognize the need for and encourage the use of a simplified costing system, they, along with carriers who oppose our proposal,¹⁴¹ contend that disallowing of movement-specific adjustments to variable costs would result in lower jurisdictional thresholds,¹⁴² could significantly affect the accuracy, integrity, and reliability of SAC analyses and results,¹⁴³ and would be a departure from the longstanding practice of allowing for such adjustments.¹⁴⁴ Rather than disallowing all adjustments, carriers propose that we allow for a limited number of adjustments, including the cost of third-party payments,¹⁴⁵ certain cost categories that vary most substantially from URCS system costs (e.g., fuel costs, equipment ownership, crew wages, mine loading times, car mileage allowances, payments to mines or other transportation providers),¹⁴⁶ and movement-specific inputs of items easily determined in staff-supervised technical conferences (e.g., tare weights, empty miles, number of locomotives, railroad and private line car costs).¹⁴⁷ Carriers also propose procedural alternatives that they claim would allow parties to realize substantial savings of time and expense, while preserving the accuracy of variable cost calculations.¹⁴⁸

The proposal to discontinue movement-specific adjustments to system-average costs is opposed by shippers,¹⁴⁹ who express concern that the principal effect of disallowing movement-specific cost adjustments would be to raise the jurisdictional threshold rate level and rate

¹³⁹ BNSF Open. at 60-64; BNSF Reply at 40; UP Reply at 47-49.

¹⁴⁰ UP Reply at 48.

¹⁴¹ CP Open. at 6; NS/CSXT Open. at 11.

¹⁴² NS/CSXT Open. at 17; UP Open. at 36.

¹⁴³ BNSF Open. at 60; CP Open. at 7; NS/CSXT Open. at 11.

¹⁴⁴ CP Open. at 6-8; NS/CSXT Open. at 12.

¹⁴⁵ BNSF Open. at 64; CP Open. at 8; NS/CSXT Open. at 17; UP Open. at 37.

¹⁴⁶ NS/CSXT Open. at 17.

¹⁴⁷ BNSF Open. at 66-67; CP Reply at 7-8; UP Open. at 41.

¹⁴⁸ NS/CSXT Open. at 15-16.

¹⁴⁹ AECC Open. at 22; AEP Texas Open. at 19; Albemarle Open. at 7; Coal Shippers Open. at 91.

prescription floor.¹⁵⁰ Shippers argue that the reasons offered by the Board for disallowing movement-specific adjustments are insufficient to justify a departure from the longstanding practice of permitting such adjustments.¹⁵¹ Shippers propose an alternative to address the concern regarding inconsistent recordkeeping among carriers, suggesting that we allow for discovery of internal management costs and special studies.¹⁵² They also argue that our concern regarding variability percentages relies entirely upon a density-related variability theory that applies only to road property investment.¹⁵³ Shippers also argue that, contrary to the assertion in the NPRM, URCS does not include certain factors that significantly affect cost¹⁵⁴ and fails to reflect the full efficiencies of unit train coal service.¹⁵⁵

4. Board Action

Based on our knowledge and experience of how URCS is used and the adjustments that parties advocate, we must balance the costly burden and complexity created by movement-specific adjustments against any improvements in the resulting variable cost, and we find that, notwithstanding our past allowance of these adjustments, such expense and complexity are not justified.

First, the analysis of proposals for movement-specific adjustments is complex, expensive, and time consuming. Massive discovery is required. Detailed adjustments to the URCS program are needed and exhaustive analysis of the reliability of the evidence is performed, even if the final result, after all adjustments are made, would be a variable cost estimate that closely mirrored the unadjusted URCS calculations.¹⁵⁶ Neither party dares rest its case on an unadjusted URCS calculation, lest there be a lopsided adjustment in favor of the other party. In addition, disputes over variable costs force parties (and the Board) to divert resources from the core issue in these cases – whether the challenged rate is unreasonable.¹⁵⁷

¹⁵⁰ Coal Shippers Open. at 92.

¹⁵¹ Albemarle Open. at 6-7; Coal Shippers Open. at 90-101.

¹⁵² Coal Shippers Open. at 93-95.

¹⁵³ Albemarle Open. at 6-7; Coal Shippers Open. at 94.

¹⁵⁴ AECC Open. at 20.

¹⁵⁵ Coal Shippers Open. at 100.

¹⁵⁶ See BP Amoco Chemical Co. v. Norfolk S. Ry., STB Docket No. 42093, slip op. at 9 (STB served June 6, 2005) (BP Amoco).

¹⁵⁷ Coal Shippers do not agree that the “core” issue in rate reasonableness proceedings is whether the challenged rate is reasonable, noting that the maximum rate can be set at the jurisdictional floor. See Coal Shippers Open. at 97-98. Coal Shippers misunderstood our

Indeed, litigating movement-specific adjustments has cost parties over \$1 million, or nearly one-third of the cost of an entire SAC presentation. For instance, UP noted that discovery costs in Northern States Power,¹⁵⁸ in which parties litigated only variable costs, was more than half the cost of the discovery in WPL,¹⁵⁹ in which the parties litigated the full range of SAC issues. UP also reported that the total cost for litigating Northern States Power was over \$1 million, which was roughly one-third the total cost UP incurred to litigate the WPL case. BNSF also notes the significant expense in calculating variable cost, typically requiring each party to a rate case to file three rounds of evidence on variable cost issues, more evidence than on any other issue in a SAC case.¹⁶⁰

The immense costs and complexity of such adjustments to URCS conflicts with what Congress intended in adopting the 180% R/VC limitation on Board rate review: to create an administratively quick and easy-to-determine regulatory safe harbor for the railroads. The R/VC ratio was first announced in the Staggers Act of 1980 as a way to “simplify rate regulation by setting forth a clear threshold test . . .”¹⁶¹ The Commerce Committee report stated that the new rate provisions, including the R/VC test, provide “simpler threshold tests than existing law” and serve the goals of “administrative feasibility and timely regulatory action.”¹⁶² We believe that Congressional intent was that, if a railroad chooses to price its traffic within this safe harbor, it should not need to worry about regulatory intervention. This goal is ill-served by allowing exhaustive discovery, volumes of evidence, significant consulting fees, and months of effort before parties can determine whether the Board has jurisdiction to consider the reasonableness of a rate.

Second, we do not believe that the use of movement-specific adjustments leads to a more accurate result than using the URCS system-wide average. There are several underpinnings to this conclusion. First, as a matter of econometric theory, piecemeal or incomplete adjustments to URCS are suspect. There are hundreds of individual expense categories that URCS uses to estimate the variable cost of a movement and the parties do not seek to adjust all of them.

meaning. We did not suggest that the SAC level will exceed the jurisdictional threshold. Rather, we meant that our core regulatory responsibility when a rate over which we have jurisdiction is challenged is to determine the maximum lawful rate a carrier can charge while still earning a reasonable return.

¹⁵⁸ STB Docket No. 42059, Northern States Power Co. Minnesota d/b/a Xcel Energy v. Union Pac. R.R.. In that proceeding, the parties had stipulated that the maximum reasonable rate was at the 180% R/VC level, but they disagreed as to how to measure that level.

¹⁵⁹ Wisconsin Power & Light Co. v. Union Pac. R.R., 5 S.T.B. 955 (2001).

¹⁶⁰ BNSF Reply at 44.

¹⁶¹ S. Rep. No. 96-470, at 7 (1979).

¹⁶² Id. at 18.

Indeed, many of the expense categories could not be changed, because movement-specific information is unavailable. Yet selective replacement of system-average costs with movement-specific costs may bias the entire analysis, rendering the modified URCS output unreliable.

Also, railroads do not consistently keep certain types of information that shippers have relied on for favorable movement-specific adjustments.¹⁶³ Such an imbalance between the accounting practices of the railroads risks biasing the result of our jurisdictional inquiry in favor of a railroad that decides not to gather or keep the information. Yet requiring all railroads to maintain the necessary information would not comport with Congress's directive to minimize the need for Federal regulation¹⁶⁴ and to minimize the burden on the railroads of developing and maintaining the costing information needed to ensure accuracy in regulatory proceedings.¹⁶⁵ Railroads are already required to maintain extensive cost information, which is audited by the Board and is the foundation of our annual URCS calculations.

Moreover, to account for differences in movements, the URCS program already tailors the variable cost calculation to the movement at issue. To determine the variable cost of a particular movement, the user inputs a number of operating characteristics of the shipment.¹⁶⁶ Thus, numerous movement-specific operating characteristics are already incorporated into the URCS analysis. Moreover, URCS has an adjustment that reduces the cost of unit-train shipments to reflect the efficiencies of such movements.

Both railroad and shipper commenters criticized the proposal to disallow movement-specific adjustments altogether, and have offered competing proposals that they argue would

¹⁶³ Compare Xcel at 136 (using railroad's investment data for individual line segments to develop movement-specific adjustment) with CP&L at 127 (using URCS system-average costs because the railroad did not keep comparable line-specific investment data).

¹⁶⁴ See 49 U.S.C. 10101(2).

¹⁶⁵ See 49 U.S.C. 10101(13).

¹⁶⁶ URCS Phase III requires the user to input nine types of information about the particular movement: (1) the railroad; (2) loaded miles (which should include loop track miles); (3) shipment type (local, originated delivered, bridge, received terminated); (4) number of freight cars; (5) tons per car; (6) commodity (for loss and damage expense only); (7) type of movement (single, unit, multiple); (8) car ownership (railroad or private), and (9) type of car. There are a number of adjustments or calculations URCS Phase III then makes to estimate the cost of a specific shipment based on the nine user inputs noted above. These include, but are not limited to, the calculation of round trip miles, the number of locomotives, switching costs, clerical cost, way train miles, tare weight of the car, and railroad and private line car costs. URCS also calculates the additional costs required to move trailer-on-flatcar traffic, such as the cost and weight of the container, tie and untie cost, and pickup and delivery cost. This is also true for costs associated with other types of specialized services.

better alleviate our concerns. We have considered these comments and alternatives and we respond to each category below.

a. Critiques of the Board Proposal

First, some railroad commenters argue that disallowing movement-specific adjustments would result in lower jurisdictional thresholds, while shippers argue it would raise the threshold. We believe that this new policy will simply standardize the method by which jurisdictional thresholds are established, as intended by Congress when it mandated a “uniform” costing system for determining variable costs.

As a practical matter, most of the movement-specific adjustments accepted by the Board to date have resulted in very small overall changes to the R/VC calculation. For example, in Xcel, each party proposed movement-specific adjustments that would have lowered or raised the variable cost of the challenged movement by roughly 15-20%. Once the Board determined which adjustments it would accept, the differential between the unadjusted URCS costs and the movement-specific adjusted costs was only 1-3%.¹⁶⁷ Although it is possible that a case could arise where the movement-specific adjustments accepted by the Board determine the jurisdictional question, the possibility of this does not warrant continuation of a highly burdensome practice that does not appear to produce more accurate results.

Second, some commenters argue that the Board’s proposal will affect the accuracy, integrity and reliability of the SAC analysis and results. Our experience has proven that these adjustments, while extremely expensive to prove, do not necessarily generate a more accurate result than URCS system-wide averages. It is the Board’s opinion that the cost involved in allowing movement-specific adjustments far outweighs any benefit of generating a variable cost of questionable improved accuracy.

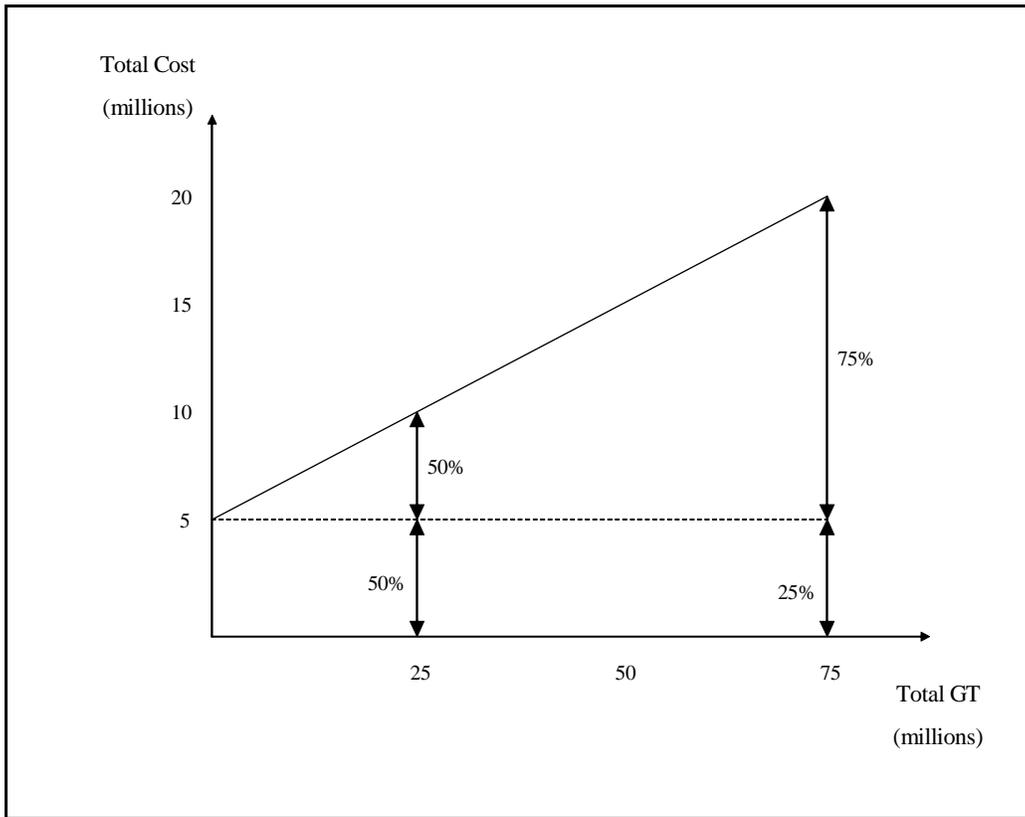
A brief explanation of how URCS is designed to work illustrates one reason why allowing movement-specific adjustments may skew the results. The regression models in URCS provide estimates of the percent of each expense category that is variable. That variability parameter is then combined with the total expense category to estimate the variable component.¹⁶⁸ Although parties routinely seek to substitute a movement-specific cost in place of a system-average cost, they apply the system-average variability parameter to calculate the proposed movement-specific adjustment. Such an approach seems improper, as the variability parameter will increase when traffic increases on a network. In other words, for movements over high-density segments, the variability percentage should be higher than for the “system-average” movement. But such adjustments to the variability percentage are not made when parties submit proposed movement-specific adjustments.

¹⁶⁷ See BP Amoco at 9.

¹⁶⁸ See generally Otter Tail at 26-27.

This theoretical concern was presented to the agency in the Xcel case, where the railroad properly noted that the variability factor that is applied to an expense category such as return on road property investment is premised on system-average density. The railroad explained that, because URCS costs assume a linear relationship between total costs and traffic volume, the proportion of total cost that is variable increases as density increases. The following graph was offered by the railroad to illustrate the conceptual error in permitting movement-specific adjustments.

Variability Factor



This chart depicts a linear cost function in which costs are 50% variable at the system-average density of 25 million tons. On a segment with a density of 25 million tons, the average variable cost would be 20¢ per ton (\$10 million in total cost, multiplied by the 50% variability factor, and divided by 25 million tons). However, on a segment with three times as much traffic, variable costs would represent 75% of total cost. If the variability factor were adjusted to 75% to reflect this relationship, then the average variable cost at the 75 million ton density would be the same (20¢ per ton) as at the 25 million ton density. But if no adjustment were made to the variability factor, the movement-specific adjustment would yield a variable cost per ton of 13.3¢ per ton, distorting the actual average variable cost per ton. The railroad noted that, assuming a linear

relationship between the expense category and output, which is the specification used in URCS, the average variable cost per ton would not change as traffic levels increase (although the average total cost would fall with increasing output until economies of density were exhausted). The Board recognized this conceptual disconnect in the Xcel case, although it did not permit the railroad to use this argument as a weapon to attack the movement-specific adjustments proposed by the shipper, because the railroad itself sought movement-specific adjustments that appeared to suffer the same analytical flaw.¹⁶⁹

The shippers maintain that the concern with applying the system-average variability parameter to a movement-specific cost adjustment should not be a basis for excluding all future movement-specific cost adjustments because the concern relates only to road property and depreciation expense.¹⁷⁰ It is certainly true that the railroads have expended more resources advocating against road property adjustments, because it is the most significant of the shipper-advocated adjustments with the potential to result in substantially lower variable costs than an URCS-generated system-wide average. However, contrary to shippers' assertions, most factors are subject to the variability parameter to some degree, not just road property investment.

Coal Shippers also argue that URCS does not include sufficient factors that capture the cost savings created by unit train coal service. While URCS does not, by design, reflect the actual costs and efficiencies associated with each specific unit-train coal movement, several URCS factors integrate the enhanced efficiencies of such movements. For example, URCS takes into account the size of the movement and assumes certain cost savings with unit trains and multi-car movements. Also, a local unit-train shipment will be costed more efficiently than a multi-car shipment with significant switching costs. To the extent that shippers believe that URCS does not go far enough in accounting for the average efficiencies of unit-train coal movements, they may petition for a separate rulemaking proceeding to enhance URCS.

Both shipper and rail commenters argue that the Board's departure from its longstanding practice of allowing movement-specific adjustments is either not justified, not properly explained, or lacks an evidentiary basis. When the ICC adopted URCS, it did indicate that alternative cost-estimating procedures would be allowed in rate reasonableness proceedings "where their superiority is proven."¹⁷¹ We now have far more knowledge and experience as to how URCS is used in these proceedings and the kinds of adjustments advocated by both parties. As discussed above, we now know the extent to which such adjustments complicate these proceedings, and we are not persuaded that the increased cost and complexity created by these adjustments is justified. Although it represents a major change from prior policy, we must be

¹⁶⁹ See Xcel at 136-37.

¹⁷⁰ See Albemarle Open. at 6-7; Coal Shippers Open. at 96.

¹⁷¹ See Adoption of URCS, 5 I.C.C.2d at 894.

prepared “to undertake appropriate reconsideration and fine tuning [of our regulation] in light of experience.”¹⁷²

Contrary to the suggestions of Canadian Pacific Railway Co. (CP), NS and CSXT, the fact that a majority of, or even all, commenters take issue with the proposed rule does not mean that the rule itself lacks an evidentiary basis or sufficient support in the record. Here the factual record contains evidence that movement-specific adjustments are inordinately expensive and time-consuming to litigate, do not appear to contribute to the accuracy of the result, and often have no significant impact on the outcome of the jurisdiction determination. Moreover, our decision is based in part upon our interpretation of Congressional intent and our theoretical misgivings about the propriety of substituting movement-specific adjustments for URCS system-wide averages on a piecemeal and incomplete basis, and without corresponding changes to the system-average variability parameters.

b. Alternative Proposals

To address the Board’s concerns regarding the expense and time associated with advocating and analyzing movement-specific adjustments, carriers and shippers offer various procedural alternatives. We discuss those proposals below and indicate why we do not believe they will alleviate the problems created by allowing movement-specific adjustments.

NS/CSXT propose to change the rate reasonableness procedural schedule, so that if a carrier elects not to contest market dominance at the outset of a SAC case, parties conduct discovery and present evidence regarding only the SAC analysis.¹⁷³ Under this procedure, no party would be allowed to urge the substitution of movement-specific adjustments for URCS system-average variable costs unless the Board first finds that the challenged rates exceed a maximum reasonable level.¹⁷⁴ NS/CSXT note that this alternative would “eliminate entirely the need to do variable cost presentations in many cases,” resulting in “a substantial savings of time and expense that would otherwise have been devoted to unnecessary variable cost evidence and analysis.”¹⁷⁵ We recognize that this procedural schedule change, along with other suggested alternatives,¹⁷⁶ could reduce the burden on the parties in some circumstances; however, merely postponing the presentation of variable cost evidence does not address the issue of how to perform the analysis when the inquiry is necessary.

¹⁷² Western Coal Traffic League v. United States, 719 F.2d 772, 780 (5th Cir. 1983), quoting Atchison, Topeka & Santa Fe Ry. v. ICC, 580 F.2d 623, 640 (D.C. Cir. 1978).

¹⁷³ NS/CSXT Open. at 15.

¹⁷⁴ Id.

¹⁷⁵ Id. at 15-16.

¹⁷⁶ AECC Open. at 21; BNSF Open. at 61, 65-67.

To address the Board's concern regarding inconsistent recordkeeping by carriers, shippers propose that we permit discovery into internal management cost data in situations in which a given defendant claims that it does not maintain certain requested data for regulatory purposes,¹⁷⁷ and that we revisit Board policy regarding "special studies," directing the defendant to generate requested data.¹⁷⁸ The Board has consistently disallowed discovery of a railroad's internal management costing system. Because URCS is the exclusive methodology used by the Board for developing variable costs, proprietary costing systems are irrelevant.¹⁷⁹ Furthermore, requiring railroads to generate or assemble more data for the sake of litigation goes against the Congressional directive to minimize the need for Federal regulation¹⁸⁰ and to minimize the burden on railroads of developing and maintaining the capability of providing such information.¹⁸¹ Therefore, we find that requiring carriers to maintain and provide additional cost information would not be in the public interest.

Some parties urge us to allow for a limited number of movement-specific adjustments, rather than a total disallowance of movement-specific adjustments. First, carriers argue that we should continue to include in variable cost calculations the payments made to third parties or shippers who provide services related to issue traffic. Such payments might include payments to third parties who provide terminal switching, who load trains that carry the issue traffic at the mine or unload them at the shipper's facility, or who complete a haul, even though the defendant retains ultimate responsibility for providing the service. Carriers note that these costs are not reflected as expenses in Schedule 410, and thus not captured as costs by URCS.¹⁸² Accordingly, carriers suggest that the use of a third-party transportation service provider should be added to the URCS Phase III list of nine operating characteristics.¹⁸³ Carriers also note that accounting for third-party charges in variable cost calculations is well-established Board precedent.¹⁸⁴ In opposition, shippers argue that such payments should be treated as a revenue offset, not as a variable cost.¹⁸⁵

¹⁷⁷ Coal Shippers Open. at 94.

¹⁷⁸ Id. at 95.

¹⁷⁹ See, e.g., Kansas City Power & Light v. Union Pac. R.R., STB Docket No. 42095 (STB served Feb. 15, 2006).

¹⁸⁰ See 49 U.S.C. 10101(2).

¹⁸¹ See 49 U.S.C. 10101(13).

¹⁸² BNSF Open. at 65; UP Open. at 37.

¹⁸³ BNSF Open. at 64.

¹⁸⁴ BNSF Open. at 65; UP Open. at 38.

¹⁸⁵ Coal Shippers Reply at 52.

Second, carriers advocate the use of the actual number of locomotives, rather than the system-average number of locomotives per train, because the system-average consist size for unit trains often understates the consist size used for coal shipments.¹⁸⁶ Carriers state that including this operating statistic in the URCS Phase III model could be done without undermining the Board's objectives, as the information is readily ascertainable and routinely agreed upon by the parties.¹⁸⁷

Third, carriers propose that the Board allow parties to submit the actual number of total miles or empty miles.¹⁸⁸ URCS calculates round-trip miles for train-load shipments by doubling loaded miles, but this presumes that the number of loaded miles, which are inputted by the user, is the same as empty miles. Carriers note that this is often not the case, as carriers may use a longer route for empty trains returning to the origin so as to increase efficiency, service to the shipper, and operational fluidity.¹⁸⁹ Carriers argue that actual empty miles are easily ascertainable, readily agreed upon by the parties, and could be included in URCS Phase III.

While we recognize the carriers' desire to have the URCS calculation reflect more accurately the actual cost of moving the issue traffic, we find that such piecemeal adjustments would tend to bias the results in favor of the railroads. As discussed above, selective replacement of system-average statistics – which tend to benefit the railroads – without allowing for counterbalancing adjustments that benefit shippers – which often require information not maintained in sufficient detail or at all by the railroads – may bias the entire analysis, rendering the modified URCS output unreliable. Shippers note this potential for unfairness and bias in their reply.¹⁹⁰

Carriers also argue that actual car rental costs should be allowed in variable cost calculations.¹⁹¹ When a party inputs private car ownership into URCS for a specific movement, URCS calculates a system-wide private car allowance and then allocates that allowance over all movements. The model does not know, however, whether a carrier has chosen to actually pay a private car allowance or simply to lower the rate for the movement to reflect private car ownership. While we recognize this limitation in URCS, we are concerned that allowance of actual car rental costs in URCS would be subject to manipulation by the carriers. Carriers determine whether to offer an allowance at all or whether to adjust rates to reflect a shipper's car ownership. Thus, one method of accounting for private car ownership would be deemed a "cost"

¹⁸⁶ BNSF Open. at 60 n.46 & 66-67; UP Open. at 41-43.

¹⁸⁷ BNSF Open. at 67; UP Open. at 42.

¹⁸⁸ BNSF Open. at 66-67; UP Open. at 41-42.

¹⁸⁹ BNSF Open. at 66.

¹⁹⁰ Coal Shippers Reply at 55-58.

¹⁹¹ UP Open. at 44.

in URCS while the other would not. Only railroad discretion would determine how to account for this expense.¹⁹²

We have considered the various evidentiary and procedural options suggested by the parties as alternatives to total discontinuance of movement-specific adjustments. We conclude that these suggestions fail to address all the concerns we have weighed in choosing to adopt our proposal. We are guided and bound by Congress' directive, calling for "expeditious handling of challenges to the reasonableness of railroad rates," particularly in the discovery and evidentiary phases of such proceedings.¹⁹³ This goal is not served by continuing a process of allowing for movement-specific adjustments that has proven to be costly, complex, and time-consuming,¹⁹⁴ often resulting in a variable cost near-equal to the unadjusted URCS calculation.¹⁹⁵ And in proposing to include additional inputs in URCS Phase III, or more generally, that we reexamine the entire URCS system,¹⁹⁶ the carriers request a change to the URCS program. That should only be considered in a separate rulemaking proceeding, where the specific proposal(s) would be subjected to public comment and, if adopted, uniform application.

c. Conclusion

In the past few years, we have heard complaints from almost every constituency of the rail industry regarding the expense of bringing a SAC case to the Board. With this action alone, we reduce the expense of litigating before the agency by as much as one-third, or over \$1 million per party, per case.¹⁹⁷ We do so by removing an inquiry of questionable value and using instead our URCS model to expedite and reduce the expense of the jurisdictional inquiry. We note that URCS itself is already a complex costing model, adopted and refined through rulemakings, that is based on sophisticated econometric analysis and elaborate cost information filed with the agency by the carriers and audited on an annual basis. Therefore, we conclude that disallowing movement-specific adjustments other than those required by URCS brings us closer to what Congress intended for a procedure to expeditiously handle rail rate challenges.

¹⁹² See BP Amoco Open. at 4-5.

¹⁹³ 49 U.S.C. 10704(d).

¹⁹⁴ UP Reply at 40.

¹⁹⁵ BNSF Reply at 43-44 (noting that as coal shipments constitute an increasing proportion of total car miles, a significant portion of system-average costs reflect unit-train operations).

¹⁹⁶ U.S. Department of Transportation (DOT) Reb. at 14.

¹⁹⁷ Coal Shippers argue that the \$1 million expended to present variable cost evidence is not a "principal cost driver" in SAC cases. Coal Shippers Reb. at 47. But any factor that accounts for one-third of total litigation costs is significant.

We recognize that the disallowance of movement-specific adjustments is a reversal of position from prior cases where such adjustments have been allowed. But it is only after years of analyzing movement-specific adjustments that we have gained enough experience to determine that their inclusion in URCS variable costing analysis clearly consumes an inordinate amount of resources of the parties and the agency, and may bias the entire variable cost calculation.

Our decision to end the use of movement-specific adjustments is not inconsistent with Rail Transportation Policy (RTP) 13.¹⁹⁸ This provision requires the Board “to ensure the availability of accurate cost information in regulatory proceedings, while minimizing the burden on rail carriers of developing and maintaining the capability of providing such information.” RTP 13, already a balancing test, must further be considered in light of the RTP 15 direction for “expeditious handling and resolution of all proceedings.”¹⁹⁹ In administering ICCTA, the Board must weigh and balance the various elements of the RTP and “arrive [] at a reasonable accommodation of the conflicting policies.”²⁰⁰ Based on our experience in rate cases, and the evidence in this proceeding, we are persuaded that the use of movement specific-adjustments is inordinately complex, time consuming, and expensive, and does not necessarily result in more reliable results than using the URCS system averages.

Therefore, for all the reasons set forth above, we will limit the parties to the use of the unadjusted URCS Phase III movement costing program and disallow movement specific adjustments other than those automatically made by URCS. The variable costs used in rate reasonableness proceedings will be the system-average variable cost generated by URCS, using the nine movement-specific factors inputted into Phase III of URCS.²⁰¹ The only adjustments allowed to the URCS Phase III program would be those adopted in Ex Parte No. 431 (Sub-No. 2).²⁰² The inputs will not be refined further by using the URCS “detailed parameters.”²⁰³

¹⁹⁸ 49 U.S.C. 10101(13).

¹⁹⁹ Section 10101(15) was added in 1996 because Congress “recognize[d] that timely action by the Board is necessary, particularly when providing remedies to protect captive shippers against market abuse.” H. Rep. No. 104-422, at 166 (1995).

²⁰⁰ Association of Am. R.Rs. v. STB, 306 F.3d 1108, 1111 (D.C. Cir. 2002), citing Baltimore Gas & Elec. Co. v. United States, 817 F.2d 108, 115 (D.C. Cir. 1987).

²⁰¹ URCS Phase III User’s Manual 7.3.

²⁰² See Review of the General Purpose Costing System, 2 S.T.B. 659 (1997). Those adjustments include the so-called “270” volume shipment adjustments, the make-whole adjustments, TOFC/COFC adjustments, and RoadRailer adjustments. In addition, the circuitry factor is always set to one when actual miles are used to calculate the variable costs.

²⁰³ URCS Phase III User’s Manual 7.3.1.

If a party believes that URCS could be improved, or better tailored to particular movements, it may request a separate rulemaking in which it offers its specific proposal and the proposal is subjected to public comment and, if adopted, uniform application. That is how URCS has evolved since its initial adoption in 1989. In an individual rate reasonableness proceeding, we will use our existing URCS model, without further movement-specific adjustment, to make the jurisdictional inquiry and to set the floor for rate relief.

V. SAC Analysis Period

1. Background

In SAC cases, the agency uses a multi-year analysis in lieu of a single-year analysis. See Guidelines, 1 I.C.C.2d at 545.²⁰⁴ It does so to deal with taxes, which are a function of the flow of revenue over the analysis period and permissible deductions under state and Federal tax laws, and to accommodate the impact of business cycles.²⁰⁵ Thus, the Board uses a DCF analysis to compare the revenue requirements of the SARR against the total revenues to be generated by the traffic group over the full SAC analysis period. An illustration and description of the DCF analysis can be found in recent SAC cases.²⁰⁶ The Board has never, however, prescribed the number of years that should be included in this multi-year DCF analysis.

Historically, the parties have used a 20-year analysis period. There have been instances, however, where parties have asked the Board to shorten the analysis period. In one such instance, railroads advocated a 1-year analysis period,²⁰⁷ and in another case a shipper asked the Board to truncate the analysis period once forecast revenue fell below the revenue requirements of the SARR.²⁰⁸

²⁰⁴ The Railroad Accounting Principles Board endorsed the use of a multi-year SAC analysis period. See Railroad Accounting Principles Board – Final Report, Vol. 2., pp. 67-70 (Sept. 1987). That Board was established by Congress to evaluate issues associated with rail costing and to propose principles to govern the estimation of such costs. See former 49 U.S.C. 11161-11163 (1995).

²⁰⁵ See Coal Trading, 6 I.C.C.2d at 411.

²⁰⁶ See, e.g., Otter Tail at E1-E6; see also Nevada Power, 10 I.C.C.2d at 274-77.

²⁰⁷ See UP/BNSF Joint Motion for Limited Consolidation, STB Docket Nos. 42054, 42056, 42057, 42058 (filed July 5, 2001).

²⁰⁸ See Duke Energy Corp. et al. v. Norfolk S. Ry. et al., STB Docket Nos. 42069, 42070, 42072, slip op. at 18-19 (STB served Oct. 20, 2004).

2. Board Proposal

The Board proposed to require the use of a 10-year analysis period in SAC cases for several reasons. First, as a practical matter the benefits of a 20-year analysis and potential rate prescription are illusory. Rate prescriptions have tended to endure no longer than 10 years because of inevitable and substantial changes in circumstances. The logistics industry is dynamic, with changes in market conditions rendering obsolete the underlying assumptions in older SAC analyses well before the 20-year analysis period has ended. This, in turn, would require that parties either relitigate SAC cases on reopening or petition the Board to take the more drastic measure of vacating the outdated prescription altogether. For example, the railroad in APS sought to have the rate prescription vacated within 10 years of the initial decision; and the shipper in West Texas sought the same relief within 10 years of that decision. There is no reason that future rate prescriptions will be less prone to obsolescence for one reason or another. Thus, the added value (to the shipper or railroad) of a rate prescription scheduled to include from Year 10 to Year 20 is questionable.

Second, a 20-year analysis period is not necessary either to address taxes or to capture an average business cycle. In all recent cases, the hypothetical SARR would have begun paying full taxes within 10 years of the base year.²⁰⁹ And a 20-year analysis period is twice what is needed to incorporate the effects of a business cycle. There have been 32 business cycles between 1854 and 2001, with an average cycle of 55 months (4.5 years).²¹⁰ Since 1960, the average length of a business cycle was 82 months (about 7 years). Although business cycles have become longer (July 1981 – July 1991, July 1991 – March 2001), a 10-year analysis should still capture a full business cycle.

Third, a shorter SAC analysis period would reduce both the expense and complexity of the SAC analysis by limiting disputes over forecasted trends for traffic volumes, revenues, and operating expenses. Reducing the expense of making a SAC presentation could make use of the SAC test available to more shippers. Moreover, by shortening the analysis period, the maximum lawful rate would depend less on predictions of distant events and more on known market conditions.

Fourth, a shorter period for our SAC analysis and shorter duration of the resulting rate prescriptions would conform our regulatory process to the trend in the rail industry towards shorter contract terms. When rail transportation contracts were first sanctioned in the Staggers Rail Act of 1980,²¹¹ parties entered into contracts for terms as long as 20 years. However, as

²⁰⁹ See, e.g., Otter Tail (tax credits exhausted by Year 9); Xcel (Year 8); CP&L (Year 7); TMPA (Year 7).

²¹⁰ Information on business cycles in the American economy is available publicly from the National Bureau of Economic Research. See <http://www.nber.org/cycles/cyclesmain.html>.

²¹¹ Pub. L. No. 96-448, 94 Stat. 1895 (1980).

noted in a recent Congressional Budget Office (CBO) report, in recent years “as both railroads and electric companies have been buffeted by regulatory and market changes, they have been more reluctant to enter into such lengthy contracts.”²¹²

Fifth, this proposal would remove the need for shippers to hypothesize a SARR with sufficient infrastructure to handle traffic forecasts that might not be realized until decades later. In recent SAC cases, complainants have constructed SARRs with sufficient capacity to handle the peak week of the peak year of a 20-year analysis period. Because demand for rail transportation service is forecast to increase over that time period, the peak period forecast is often two decades in the future. But for practical reasons – given the difficulty and considerable expense of designing and modeling incremental capital investments in each year – shippers have chosen to design a SARR with sufficient capacity in Year 1 to handle a level of traffic that may not be realized until Year 20. As the Board has stated, it is plainly unfair to force today’s ratepayers to pay for costs that may not be accurately calculated, and that would be generated, if at all, by service to ratepayers 20 years in the future.²¹³

3. Public Comments

The proposal to limit the SAC analysis period to 10 years is supported by the railroads. The railroads note that a reduction from 20 years to 10 years might eliminate some of the inherent uncertainty in forecasting so far into the future.²¹⁴ Well-founded predictions can become highly inaccurate as time goes on, as real world developments can cause a serious divergence from speculative SAC forecasts.²¹⁵ Further, the railroads agree that the shorter time frame could reduce some of the expense in litigating a SAC case.²¹⁶ The railroads also state that a shorter analysis period is more consistent with the reality of fluctuating markets.²¹⁷ Among the railroads, only NS/CSXT offer an alternative to the Board’s proposal. NS/CSXT suggest that we presume that a SAC analysis period should be 10 years, but allow parties to show that a different

²¹² Congressional Budget Office, Freight Rail Transportation: A Review of the 2004 Experience at 12 (May 2005). See also Congressional Budget Office, Freight Rail Transportation: Long-Term Issues at 15 n.75 (Jan. 2006) (same finding).

²¹³ West Texas Util. Co. v. Burlington N. R.R., STB Docket No. 41191, slip op. at 4 (served June 25, 1996) (declining to extend the SAC analysis beyond 20 years); see also FMC Wyoming Corp. v. Union Pacific Railroad Co., 4 S.T.B. 669, 741 (2000) (“[W]e do not believe that it would be fair or proper to set the rates that [a railroad] can now charge based on economies of density and revenue contributions that do not yet exist.”).

²¹⁴ NS/CSXT Open. at 18.

²¹⁵ UP Reply at 50.

²¹⁶ NS/CSXT Open. at 19.

²¹⁷ UP Open. at 45.

time period would be more appropriate in a particular case.²¹⁸ The railroads asked that we clarify that use of a 10-year SAC analysis period would mean that any resulting rate prescription would also be limited to at 10 years.²¹⁹

Coal Shippers commented in favor of a 10-year SAC analysis period, but argued for a change to Table E in the DCF model and assurances that rate prescriptions could extend beyond that period.²²⁰ In regards to the length of the rate prescription, Coal Shippers argue for an indefinite period, and for placing the burden on the railroads to demonstrate the need to modify or vacate the rate.²²¹ Other shippers commented that the SAC analysis period should be determined on a case-by-case basis.²²²

4. Board Action

After considering the comments, we will limit the analysis period for SAC cases to 10 years and clarify that any resulting rate prescription will last no longer than the 10-year time period used for the SAC analysis.

We believe that a 10-year SAC analysis period strikes the most reasonable balance. It covers an average business cycle but removes unreliable distant forecasts from our core analysis. This is not to suggest that the revenue requirements of a SARR over the 10-year period would need to recover the full capital investment, often billions of dollars, within that 10-year window. Just as has been done in a 20-year analysis,²²³ we would continue to calculate a “terminal value” at the end of the shorter SAC analysis period. We will address the alternative proposals of the shippers and railroads.

Coal Shippers argue for a 10-year analysis period with an indefinite rate prescription. They would have us place the burden on the railroads to demonstrate a material change in circumstances necessary to alter or vacate the prescription.²²⁴

This suggestion runs counter to the spirit of the Board’s proposal. We are attempting to instill a greater level of practicality and certainty into our ratemaking process. One way to do this is to shorten the time periods we use during a SAC analysis. Moreover, indefinite rate

²¹⁸ NS/CSXT Open. at 19.

²¹⁹ BNSF Open. at 70.

²²⁰ Coal Shippers Open. at 102-03.

²²¹ Id. at 104.

²²² Albemarle Open. at 8; Guam Open. at 9.

²²³ See, e.g., Otter Tail at E1.

²²⁴ Coal Shippers Open. at 104.

prescriptions run afoul of the RTP to foster the railroads' ability to establish reasonable rates and minimize Federal regulatory control.²²⁵ Indefinite rate prescriptions leave the possibility of unending Federal regulation over a carrier's rates. The best policy is to tie the length of the rate prescription to the length of the SAC analysis. A 10-year analysis period will therefore mean no more than a 10-year rate prescription, should a railroad's rates be deemed unreasonable.

Coal Shippers also suggest a change to Table E of the DCF model. Table E contains a 20-year amortization schedule of assets purchased with debt capital.²²⁶ Coal Shippers suggest that the involved interest payments be amortized over the life of the asset, rather than the period of the model, regardless of the length of the DCF model.²²⁷ This suggestion, however, is beyond the parameters of this rulemaking, as use of a shorter DCF period does not necessitate the adjustment in how debt is treated, i.e., amortization over the life of the asset versus amortization over the DCF period.²²⁸ The only changes to Table E necessary to accommodate a shorter 10-year analysis period are: (1) the elimination of forecasts for operating expenses in years 11 through 20 and (2) changing the netting calculations to compute the cumulative underage or overage at the end of year 10, instead of year 20.²²⁹

AECC opposes a 10-year SAC analysis period, and urges us to maintain the current 20-year period. AECC cites to statistical data for U.S. coal production that shows significant out-year growth for the years 2016-2026 that are greater than the projections for the next 10 years.²³⁰ AECC asserts that railroads rely on those robust projections to support greater capital investment.²³¹ AECC argues that a 10-year analysis period would undermine the ability of a SARR to match the defendant carrier's ability to rely on such long-term growth expectations.²³²

We disagree that the financial position of the SARR would be weakened by a 10-year analysis period. It is precisely this type of speculation that we seek to avoid. Rather than debating the accuracy of distant production forecasts, the parties should focus their efforts and resources on forecasts more closely tied to present production numbers. As the Board stated in the NPRM, the benefits of the 20-year period are illusory. Rates rarely, if ever, go beyond the

²²⁵ See 49 U.S.C. 10101(1) and (2).

²²⁶ Coal Shippers Open. at 103.

²²⁷ Id.

²²⁸ BNSF Open. at 71; BNSF Reb. at 43; UP Reply at 53 n.52.

²²⁹ BNSF Open. V.S. Baranowski at 22.

²³⁰ AECC Open. at 22-23.

²³¹ Id.

²³² Id.

first 10 years of the prescription. Therefore, the benefits of including an additional 10 years are negligible.

Two shippers, Albemarle Corporation (Albemarle) and The Government of the Territory of Guam (Guam), argued in favor of a case-by-case approach to the duration of the SAC analysis period.²³³ Albemarle states that a 10-year period would not provide sufficient prospective relief where a case takes many years to resolve.²³⁴ Guam's opposition centers on the effect on its pending rate complaint against water carriers operating in the noncontiguous domestic trade.²³⁵ While the cases cited by Albemarle did involve evidentiary records that closed more than 10 years after the proceedings began, the proposals the Board made in the NPRM will lead to faster, more efficient resolution of rates cases. Maintaining the 20-year SAC analysis period simply for the possibility that a lengthy rate case may occur in the future is not sound policy when the vast majority of our cases are not so cumbersome, and when considerable gains can be made in the efficiency and cost of litigating such cases by implementing the various proposals adopted here. As for Guam's concerns, the NPRM was tailored specifically to the Board's railroad rate regulation, and not the noncontiguous domestic trade. The issues raised by Guam are pending before the Board, and will be addressed if necessary in that proceeding.

The NS/CSXT suggestion to establish a presumptive length for the SAC analysis attempts to strike a balance between the cost saving measures of a shorter 10-year period and the perceived benefit that a longer period may avoid short-term changes in costs, revenues, and other SAC assumptions that could skew the accuracy of the overall SAC analysis.²³⁶ Their proposal would allow parties to present evidence to demonstrate that a different (shorter or longer) period was more appropriate in a particular case.²³⁷

We believe that a uniform SAC analysis period, whether it is for 20 years or 10 years, provides certainty to the parties before a SAC case begins. The approach suggested by NS/CSXT would add another layer of complexity and cost by forcing the parties to spend time and money presenting evidence on the appropriate SAC analysis period – two expenditures we seek to eliminate here.

²³³ Albemarle Open. at 8; Guam Open. at 9.

²³⁴ Albemarle Open. at 8.

²³⁵ Guam Open. at 1.

²³⁶ NS/CSXT Open. at 19.

²³⁷ Id. at 19-20.

VI. Uniform Standard for Reopening, Vacating & Filing a New Case

1. Background

a. Reopening a SAC Proceeding

The basic standard for reopening a Board proceeding is set forth in 49 U.S.C. 722(c), which requires a showing of material error, new evidence, or substantially changed circumstances.²³⁸ In deciding whether a litigant has justified the reopening of a SAC case, the Board balances concerns of fairness, accuracy and repose, taking into account the considerable time and expense required to adjudicate the reasonableness of a rate under the SAC test, as well as the fact that the SAC test relies substantially on long-range forecasts. The Board has reopened a SAC case to correct an obvious error,²³⁹ or to update and revise the record regarding the long-term forecasts used,²⁴⁰ but it has declined to reopen a SAC case to address short-term, year-to-year fluctuations that do not undermine the long-term projections that were used.²⁴¹

If the Board determines that a reopening is warranted, a further question is raised regarding the scope of the reopening. The Board has sought to confine a reopened SAC case to addressing the basic SAC analysis that was originally presented in the case.²⁴² Parties have not been allowed in a reopened proceeding to expand the geographic scope of the SARR on which the SAC analysis was based, or to alter substantially the composition of the traffic group used in the SAC analysis.

b. Vacating a Rate Prescription

When a railroad seeks to have a rate prescription vacated, it must first demonstrate that the standard in section 722(c) for reopening the prior case has been met. And to justify vacating

²³⁸ See also 49 CFR 1115.4.

²³⁹ See West Texas Util. Co. v. Burlington N. R.R., 6 S.T.B. 919 (2003) (West Texas-May 2003).

²⁴⁰ See Arizona Pub. Serv. Co. v. Atchison, Topeka & Santa Fe Ry., 6 S.T.B. 851 (2003) (APS-May 2003).

²⁴¹ See Arizona Pub. Serv. Co. v. Atchison, Topeka & Santa Fe Ry., 3 S.T.B. 70, 75 (1998).

²⁴² See APS-May 2003 at 5-6; Arizona Pub. Serv. Co. v. Atchison, Topeka & Santa Fe Ry., STB Docket No. 41185, slip op. at 4-6 (STB served Oct. 14, 2003) (APS-Oct. 2003); West Texas-May 2003 at 4; West Texas Util. Co. v. Burlington N. R.R., STB Docket No. 41191, slip op. at 6 (STB served June 27, 2003) (West Texas-June 2003); West Texas Util. Co. v. Burlington N. R.R., STB Docket No. 41191, slip op. at 3 (STB served July 23, 2003) (West Texas-July 2003).

the rate prescription – rather than reopening the case to recalculate the rate prescription – the railroad has been required to demonstrate that the factual and legal underpinnings of the original prescription no longer continue to have validity. San Antonio, Tx. v. Burlington N., Inc., 364 I.C.C. 887, 896 (1981).

In contrast, when a complaining shipper seeks to have a rate prescription vacated, the Board’s policy has been to grant the request without requiring a particular showing. In West Texas Util. Co. v. Burlington N. R.R., STB Docket No. 41191, slip op. at 3 (STB served Mar. 19, 2004) (West Texas-Mar. 2004), the Board explained that, as “the proponent and beneficiary of the rate prescription, the complaining shipper should be entitled to have that prescription vacated upon request, without having to show that the prescription is now defective.” The Board reasoned that this policy appropriately “ensured that a captive shipper who prevails on its rate complaint in the first instance does not later end up in a worse position – by having to bear a higher rate than would be justified under a new SAC analysis.” Id.

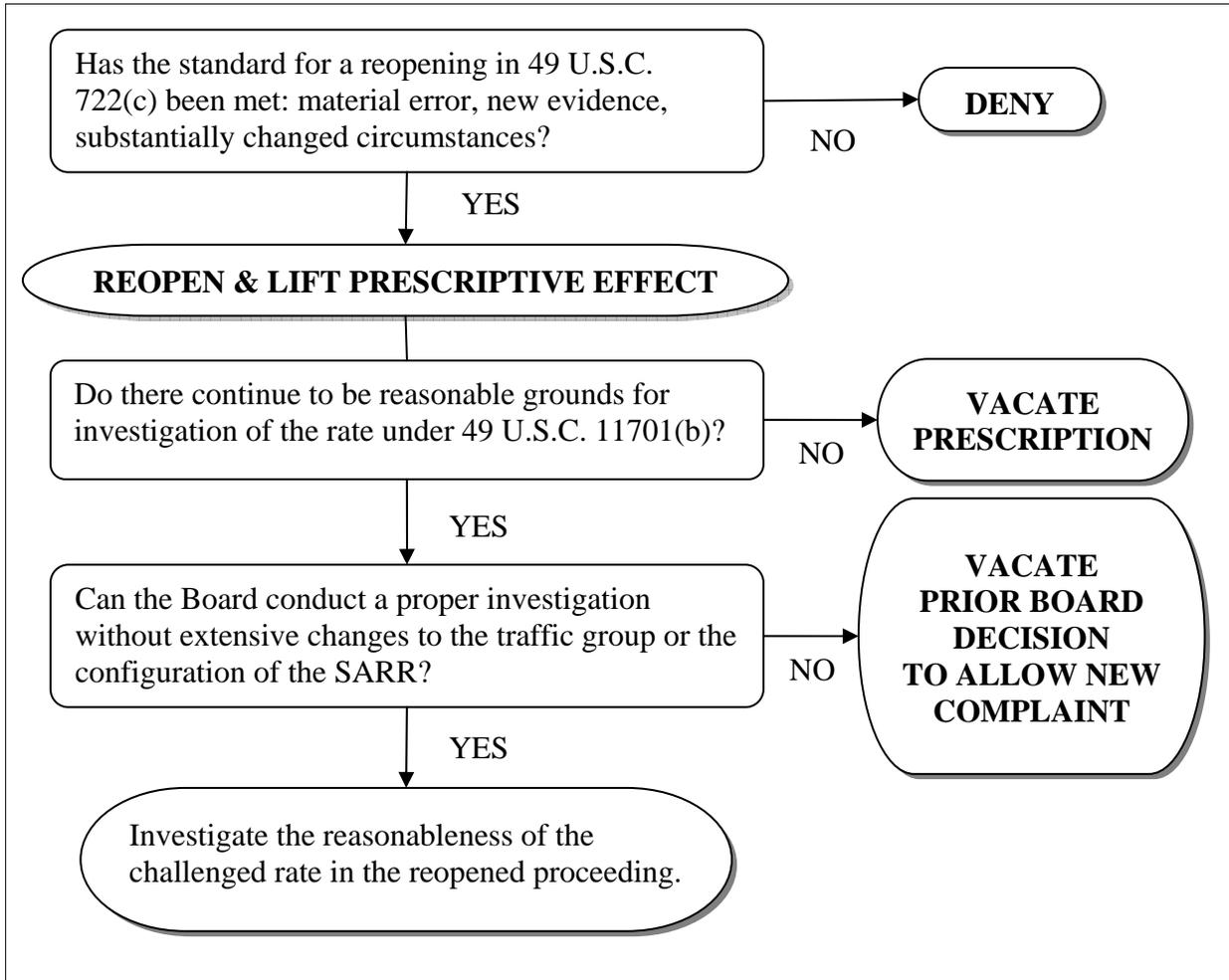
c. West Texas Remand

The railroad challenged the Board’s decision in West Texas-Mar. 2004 to vacate the rate prescription without first determining that the shipper had satisfied the reopening standard of section 722(c). It argued that a carrier also benefits from the certainty afforded by a rate prescription and that the Board should not have different standards for vacating a prescription depending upon which party requests the action.

The court agreed with the railroad that both the carrier and shipper are protected by a rate prescription. West Texas Remand, 403 F.3d at 776. The court concluded that the Board had not justified applying different standards depending upon which party requested the vacatur. Id. at 777-78. And the court rejected the argument that requiring an evidentiary showing by the shipper that had obtained the prescription would result in unequal treatment vis-à-vis a shipper that had been unsuccessful in an earlier rate complaint. Rather, the court cited agency precedent for the proposition that an unsuccessful litigant may not bring a new rate complaint without making the showing that would be needed to reopen a prior case. Id. at 778. Accordingly, the court vacated the West Texas – Mar. 2004 decision and remanded that case to the Board. Id. at 778.

2. Board Proposals

The flowchart below depicts the steps the Board proposed to take when either a shipper or a railroad seeks to reopen or vacate a SAC proceeding. The details of and rationale for the proposal follow.



Having considered the court’s decision in West Texas Remand, the Board adopted the holding that either party should be required to demonstrate that reopening is warranted based on the standard set forth in section 722(c) (material error, new evidence, or substantially changed circumstances) when seeking either to reopen a proceeding or to vacate an existing rate prescription. Similarly, an unsuccessful litigant should have to make that showing before it may reopen a case or have the prior decision vacated so that it may file a new complaint challenging the same common carrier rates it had previously challenged.

Once a party has justified reopening a rate case under section 722(c), the Board would then consider whether the changes can be reasonably addressed in a reopened proceeding, or if the further step of vacatur is required. The Board would first consider whether there continues to be reasonable grounds for investigation of the rate under 49 U.S.C. 11701(b). For example, if the new evidence shows that the carrier no longer has market dominance over the transportation at issue, there would be no basis for the Board to review the level of the rate. In that

circumstance, any outstanding rate prescription would need to be vacated, because the legal underpinnings of the rate prescription no longer have validity.

Where there continue to be reasonable grounds for a rate investigation, the Board would examine the factual underpinnings of the prior SAC analysis (and any resulting rate prescription) to determine if it could suitably conduct the investigation within the framework of the old SAC analysis (in a reopened proceeding), or if a new SAC analysis (after vacatur) would be needed. Some types of changes can be integrated into an old SAC analysis without undue complications and without compromising the integrity of the SAC analysis. Examples would be updating revenue forecasts or adjusting the indexes used to inflate the operating expenses and road property investment of the SARR. Other kinds of changes may be ill-suited to working within the framework of an old SAC analysis. For example, extensive changes to the SARR configuration would require analysis of significant additional investment and new track construction costs. And extensive changes to the traffic group could affect the SAC analysis in a fundamental way, requiring the submission of a new operating plan for the SARR. In such instances, extensive discovery may be required.²⁴³ The Board concluded, however, that at some point, attempting to interweave the old and new SAC presentations would be so complicated and convoluted that it would be preferable to vacate the old decision and permit the complainant to design a new SARR in a new SAC proceeding. In that circumstance, a new SAC analysis would be less complex and would yield a more reliable result.

Therefore, the Board proposed to vacate the old rate decision (and any resulting rate prescription) upon reopening if it concludes that extensive changes to the traffic group or the configuration of the SARR would be needed to conduct a proper investigation into the challenged rates. Similarly, an unsuccessful litigant would be permitted to file a new rate complaint, and present a new SAC analysis, if the Board were to conclude that extensive changes to the traffic group or SARR configuration were needed to conduct a proper investigation into the challenged rates. Because the Board expected that changes substantial enough to warrant vacatur would entail in nearly all instances extensive changes to either the traffic group or SARR configuration, the Board focused its proposed vacatur standard upon these two core components of a SAC analysis.

Finally, the Board proposed that, upon reopening a proceeding, it would lift the prescriptive effect of the rate prescription. As in APS-May 2003, the railroad would be instructed to maintain the status quo, the parties would be directed to keep account of the amounts paid during the pendency of the rate investigation, and, upon completion of the investigation, one party would then be required to make the other party whole. The Board proposed to take this step to avoid causing irreparable harm to either party during the pendency of the reopened proceeding.

²⁴³ See APS-Oct. 2003 at 6 n.7.

3. Public Comments

We received numerous comments on these proposals. A number of railroads expressed support for all aspects of the proposal.²⁴⁴ Many believe that the proposal is reasonable, efficient and consistent with prior Board precedent.

While Xcel supports the Board's proposal to maintain the status quo during any investigation of the preexisting rate upon reopening, it raises concerns regarding the reopening and vacatur standard.²⁴⁵ Xcel contends that a railroad request to vacate should be subject to a stricter standard than a request by a complainant.²⁴⁶ In addition, Xcel contends that the Board's rules should favor working within the existing SAC model, unless the complainant seeks to vacate the prescription.

Coal Shippers, AEP Texas and PPL object to the standards and procedures proposed by the Board.²⁴⁷ The primary focus of their objections is on the Board's proposal to lift the prescriptive effect of a rate order pending a hearing, and to apply any changes to the prescription retroactive to the date of the reopening.²⁴⁸ They contend that, under Arizona Grocery Co. v. Atchison, Topeka & Santa Fe Ry., 284 U.S. 370 (1932), the prescription must remain in effect until the Board holds a full evidentiary hearing setting a new rate. Coal Shippers also contend that the Board's proposed policy is inefficient and unfair to shippers. They oppose the Board's concept of what they contend will be multiple levels of evidentiary hearings in favor of a single evidentiary hearing in which both parties submit all evidence concerning the changed circumstances or new evidence, at the conclusion of which the Board would determine whether the prescription should be affirmed, revised or vacated.²⁴⁹

Finally, Coal Shippers urge the Board to clarify its intentions regarding reopening a prescription on the basis of updated forecasts or adjusted indexes.²⁵⁰ Similarly, AECC asks the Board to adopt a heightened sensitivity to the likelihood that the inevitable changes over time in market conditions will, at times, require changes to past decisions.²⁵¹

²⁴⁴ BNSF Open. at 72-73; NS/CSXT Reply at 25; UP Open. at 45.

²⁴⁵ Xcel Open. at 3-8.

²⁴⁶ Id. at 4-5. Xcel's argument was raised by the Board in support of the disparate treatment of shippers and carriers in the West Texas appeal, and rejected by the court.

²⁴⁷ AEP Texas Open. at 20; Coal Shippers Open. at 104-17; PPL Open. at 8.

²⁴⁸ Coal Shippers Open. at 106-114.

²⁴⁹ Id. at 109-114.

²⁵⁰ Id. at 114-115.

²⁵¹ AECC Open. at 24-25.

4. Board Action

We will adopt the uniform standard for reopening, vacating and filing a new case proposed in the NPRM. We address below the concerns expressed by some commenters.

First, some commenters requested that we clarify whether the proposed standard would disturb our current practice not to reopen a rate proceeding on the basis of minor or short-term changes in an index or forecast.²⁵² We do not intend for the standard adopted here to change our longstanding policy that we will not reopen a SAC case to address short-term, year-to-year fluctuations that do not undermine the long-term projections relied upon in a SAC case.²⁵³ While we recognize that, due to the length of a rate prescription, there inevitably will be changes to forecasts and projections, we will be vigilant in ensuring that the standard we put in place today does not become a mechanism for serial reopening based on updated figures.

Second, Coal Shippers contend that when a petition is filed a “single, evidentiary proceeding should ensue in which both parties may submit all relevant evidence concerning the changed circumstances or new evidence”²⁵⁴ They express concern that the proposal creates a multi-layer proceeding that will be inefficient and unfair.²⁵⁵ We believe this concern misses the mark. There is only one evidentiary submission required to reopen or vacate a rate prescription. Even if a proceeding is reopened, further evidence may not be required. For example, updating certain neutral forecasts that proved in the long term to be substantially in error would likely not require a further evidentiary proceeding. If a prescription is vacated, another evidentiary hearing will be held only if the shipper chooses to challenge the carrier’s new rate in a new complaint.

Coal Shippers suggest that if a railroad filed a petition to vacate or revise a prescription on the grounds that anticipated SARR traffic did not in fact materialize, the shipper should be entitled to respond with, for example, evidence of how its SARR design or traffic group would have differed from the original had it been known at the outset that the traffic in question would not be available to the SARR.²⁵⁶ Under the standard adopted today, Coal Shippers would be permitted to make such an argument in response to the petition to reopen. But if the Board reopened the proceeding, it would likely vacate the prescription because the evidence to be

²⁵² Coal Shippers Open. at 114; UP Reply at 55.

²⁵³ APS, 3 S.T.B. at 75.

²⁵⁴ Coal Shippers Open. at 110.

²⁵⁵ Id.

²⁵⁶ Id.

considered would involve extensive changes to the traffic group or the configuration of the SARR.²⁵⁷

It would not, as some commenters urge, be appropriate to permit broader evidentiary changes within the context of a reopened proceeding (rather than to reopen and vacate). As the Board explained in APS, and was mindful of when developing the standard adopted here, making changes in the configuration of a SARR and its traffic group would be comparable to making a new SAC case. APS-Oct. Decision at 6, n.7. Reasonable boundaries on the scope of the evidence that could be presented on reopening strike an appropriate balance between the interests of fairness to all parties and administrative finality and repose. APS, 3 S.T.B. at 75. Significant changes to the SARR and its traffic group should be made in a new case in order to avoid an inevitable mix-and-match problem between the old and new SAC evidence.

The most strenuous objection to the Board's proposed standard is directed at our proposal to reopen and lift the prescriptive effect of the rate prescription. We continue to believe, however, that such relief is based on the statute, prevents irreparable harm to the parties, and is beneficial to both shippers and carriers.

The Board's ability to grant this type of relief is firmly rooted in statute. The Board has the express authority under 49 U.S.C. 721(b)(4) to prevent irreparable harm. We believe that the Board also has the implicit authority under 49 U.S.C. 722(b) and 10704(a)(1) to lift the prescriptive effect of a rate prescription (the imposition of which was discretionary in the first place) once there has been a showing of new evidence, substantially changed circumstances, or material error that calls into question the SAC analysis upon which the prescription was based.

We are not persuaded by the comments that this procedure is inconsistent with Arizona Grocery. There, the Supreme Court held that the ICC could not award reparations to a complaining shipper with respect to past shipments that had moved under previously approved and prescribed rates. The Court reasoned that the rate prescription was an action that was legislative in nature and thus had the force of a statute in establishing the lawful rate. 284 U.S. at 386-87. The ICC was bound to recognize the validity of the rule of conduct approved by it and could not repeal its own enactment with retroactive effect. Id. at 389. In other words, "the carrier is entitled to rely upon the declaration as to what will be a lawful, that is, a reasonable, rate." Id. Thus, the lawfulness of rates approved and prescribed pursuant to 49 U.S.C. 10704(a)(1) cannot be challenged with respect to traffic that has moved prior to the date of a reopening. But the evidence that justifies a reopening will also raise genuine questions about the proper rate prescription for the future.

²⁵⁷ Thus, if APS were decided under this standard, the Board would likely determine that vacatur is the appropriate remedy. The shipper would have filed the evidence it sought to introduce on reopening in a new proceeding instead.

Arizona Grocery was not meant to force the Board to maintain a rate prescription – and thereby continue to declare what is the maximum lawful rate – when the evidence that justified a reopening indicates that the rate prescription is no longer appropriate or correct. Instead, it was meant to ensure notice of the rate to be applied. Our decision here places the parties on notice that, when a proceeding is reopened, the prescriptive effect of the rate prescription will be lifted. The Board can then lawfully change the rate prescription, as of the date of the reopening, without violating the prohibition against retroactive ratemaking. This is consistent with the body of law that the rule against retroactive ratemaking does not extend to cases in which the parties have adequate notice that resolution of some specific issue may cause a later adjustment to the rate being collected at the time of service. Oxy USA, Inc. v. FERC, 64 F.3d 679, 699 (D.C. Cir. 1995); Cost Ratio for Recyclables – Determination, 3 I.C.C.2d 407, 420 (1985). Notice transforms the “ratemaking into a functionally prospective process.” Natural Gas Clearinghouse v. FERC, 965 F.2d 1066, 1075 (D.C. Cir. 1992), quoting Columbia Gas Transmission Corp. v. FERC, 895 F.2d 791, 797 (D.C. Cir. 1990).

Thus, the situation on reopening would be analogous to the implicit power of the Board to change retroactively a rate prescription when the agency’s order is reversed by a reviewing court. Cf. United Gas Improvements Co. v. Callery Properties, 382 U.S. 223, 229 (1965); Iowa Power & Light Co. v. United States, 712 F.2d 1292 (8th Cir. 1983). Just as a carrier or shipper cannot “rely upon the declaration as to what will be a lawful, that is, a reasonable, rate” (Arizona Grocery, 284 U.S. at 389) until the administrative and judicial review process has been exhausted, similarly the parties would be on notice that they could no longer rely on a rate prescription as a declaration of what is lawful once the Board reopens the case.

The proposed relief is narrowly tailored and whether it will benefit the shipper or the carrier depends on the outcome of the reopening. This relief will be imposed only if a case is reopened and additional evidence is needed to conduct the reopening.²⁵⁸ In this scenario, it is likely that submitting and evaluating the evidence will take some time. During that time, we believe it is in the interest of all parties that the carrier’s rate controls. In that way, if a new rate that is prescribed is lower than the previously prescribed rate, the shipper is able to obtain reparations for the pendency of the reopening, while if the new rate that is prescribed is higher than the previously prescribed rate, the carrier is able to obtain the increased rate for the time period of the pendency of the reopening. If the prescription were to remain in place, neither of these results would be possible. The purpose of the proposed keep account is to enable the shipper to pay the same rate in the meantime as it had been paying, so that it will not be forced to pay an immediate large increase if the carrier’s rate were to control. The benefits of this

²⁵⁸ If a case is reopened and the prescription vacated, there is no need for this relief. If a case is reopened and the changes are merely updating, there will rarely be a need for this relief, as the updating could in many instances be accomplished when the case is reopened, based upon the evidence submitted to support reopening. See West Texas—May 2003.

approach far outweigh any perceived harm from lifting the prescriptive effect prior to a new rate being put into place to replace the previously prescribed rate.

Finally, we have been asked to preclude reopening based upon the methodological changes made in this case. We do not believe that is an appropriate determination to make in this proceeding. Instead, we will make that determination on a case-by-case basis, based on the specific facts and arguments raised in any petition to reopen.

In sum, we believe the Board should maintain the flexibility needed to respond promptly to changed circumstances, yet ensure that we do not create incentives for parties to drag out proceedings to prolong the benefits of a rate prescription that appears to be too high or low. We conclude that our proposal achieves these dual purposes and conforms with the statute, the recent court remand, and Arizona Grocery. We observe, however, that the likelihood of a reopening is much less likely given our decision to shorten the SAC analysis period from 20 to 10 years.

VII. Application of Changes

1. Pending Cases

In the NPRM, the Board advised parties in the pending AEP Texas²⁵⁹ and Western Fuels²⁶⁰ cases that it did not intend to shorten the DCF period from 20 to 10 years in their cases. The parties had already designed SARRs with sufficient rail capacity to handle projected traffic growth through 20 years, and shortening the DCF period would require the parties to redesign their entire SAC presentation. All parties to those pending cases agreed with the Board. Accordingly, we will use a 20-year analysis period (and order 20-year rate prescriptions if necessary) in those two cases. Parties in the other pending rail rate cases, where discovery has not yet closed, should prepare their evidence using a 10-year SAC analysis period.

With respect to the other proposed changes, the Board invited parties with rate cases pending before the agency to address the equities of applying the proposed changes to their cases. See Major Issues NPRM at 2. Having reviewed those comments, we have decided to apply the other changes regarding the proper application of the SAC test to all pending cases. With regard to the final action on the percent reduction, revenue allocation for cross-over traffic, and hybrid approach for indexing operating expense, the parties were well aware when they litigated the pending cases that these issues were in dispute and that the agency could craft a solution such as these in their individual cases. Thus, we are not setting aside any settled expectations by applying these final changes to the pending cases. Moreover, as these changes

²⁵⁹ See STB Docket No. 41191 (Sub-No. 1), AEP Texas North Company v. BNSF Ry. Company.

²⁶⁰ See STB Docket No. 42088, Western Fuels Association, Inc., and Basin Electric Power Cooperative, Inc. v. BNSF Ry. Company.

are designed in large part to improve the reliability of our SAC analysis, and given the possibility of rate prescriptions of nearly 20 years in two of those cases, we conclude it is proper to apply these changes to all pending rail rate cases.

Whether to permit movement-specific adjustments in the AEP Texas and Western Fuels cases presents a more complex question. In those proceedings, the parties have already incurred the significant expense of litigating such movement-specific adjustment for past movements. Also, in contrast to the other issues presented in this rulemaking, parties were not cautioned in prior SAC cases that the Board was considering using unadjusted URCS in order to reduce the complexity of the jurisdictional inquiry in individual cases. Despite this, we conclude that disallowing movement-specific adjustments in the AEP Texas and Western Fuels cases will lead to the best result for several reasons.

The AEP Texas and Western Fuels cases were delayed to ensure that the Board's SAC methodology would establish an unbiased and accurate result. For the reasons set forth above, disallowing movement-specific adjustments will serve that goal. Further, even if we were to accept movement specific adjustments for historical movements, we would still be left with the potential problem of rate prescriptions into the future. Where the maximum lawful rate is set at the jurisdictional floor for historical movements, the Board has required the parties to calculate the rate floor for later periods in a manner consistent with the procedures and findings in the decision. *See, e.g., WPL*, 5 S.T.B. at 985 n.84. Here, while the parties have already incurred the costs for making movement-specific adjustments for historical movements, they have not yet done so for future movements. And because we will use a 20-year SAC analysis period in the AEP Texas and Western Fuels cases, rate prescriptions could in theory extend for almost two decades. Thus, deciding to make movement-specific adjustments in the pending cases would perpetuate a flawed approach long into the future.

2. Future Cases

Several commenters urge the Board not to set the methodology to address the issues discussed in this proceeding, but to instead permit the parties in future individual cases to continue to advocate other changes. For example, Coal Shippers ask that parties to a particular case be able to advocate alternative methods to the Maximum Markup Method. Similarly, carriers argue that they must be permitted to challenge the use of ATC to allocate cross-over traffic in a particular case. Similar arguments could be made with regard to the hybrid approach adopted for forecasting operating expenses of the SARR.

We believe that further debate of these three issues within the context of an individual case would defeat much of the purpose of this rulemaking. With respect to replacing the percent reduction approach, it is important that the agency apply a uniform approach so that with the possibility of future challenges to other rates in the SAC traffic group, the carriers may earn adequate returns.

With respect to the appropriate methodology for allocating cross-over traffic, keeping open the issue for future cases leaves complainants in the same situation they are in now: having to defend the existing approach against attack from a defendant railroad. Railroads argue that a defendant must be permitted to show that the ATC is not resulting in an unbiased approach in a particular case. The Board does not expect that any approach could perfectly replicate the results of a SAC analysis without any cross-over traffic in all circumstances. But we believe that applying the simplifying device of cross-over traffic in conjunction with the ATC method for allocating cross-over traffic is a reasoned way to simplify the inquiry and will result in an unbiased result on average. If we permitted a carrier to argue against the ATC approach where the allocation favored the complainant, we would also need to permit a complainant to argue against the approach when it favored the railroad.²⁶¹ If subsequent experience reveals that the approach is systematically biasing one party or another, the affected party may file a petition to institute a rulemaking proceeding (or we may do so on our own initiative) so that the broader affected public is again provided an opportunity to comment on the proposal before changes of industry-wide importance to our ratemaking methodology are implemented.

Finally, as discussed, we believe that the value of setting a uniform methodology for indexing the operating expenses of the SARR outweighs the value of permitting parties to submit more expert testimony to seek a more precise estimate. All interested parties have had an opportunity to comment fully on the hybrid approach, and we conclude that the best policy is to apply this approach in future rail SAC cases.

VIII. Conclusion

We conclude by addressing briefly the concerns raised by the U.S. Department of Transportation, the AAR, and UP over the anticipated increase in demand for rail transportation and the need for further capital improvements to meet that demand. We are aware of these forecasts, and of the broad public benefits from further capital investment by the carriers and others to meet that anticipated demand. We must balance these legitimate concerns against the rights of captive shippers to challenge a rate as unreasonable. We believe that the changes herein achieve an appropriate balance by reducing the complexity and expense of the SAC analysis in certain areas, while improving the reliability of the SAC test by addressing widespread concerns with the continued use of the percent reduction method, MSP, and RCAF-U in recent SAC cases.

This action will have no significant economic impact upon a substantial number of small entities, within the meaning of the Regulatory Flexibility Act (5 U.S.C. 601 et seq.). To the extent that small entities may be affected, the impact should be beneficial, because these changes

²⁶¹ Carriers argue that a complainant always has the option to construct a larger SARR and provide origin-to-destination service for all movements in the traffic group. But as the Board has observed, such an effort would be dauntingly complex and entail considerable added expense. Xcel at 13-17.

will resolve several contentious issues in SAC proceedings and simplify the jurisdictional inquiry.

This action will not significantly affect either the quality of the human environment or the conservation of energy resources.

It is ordered:

1. The Board will be guided in individual rail rate reasonableness determinations by the methodological and procedural changes set forth in this decision.
2. This decision will become effective on November 29, 2006.

By the Board, Chairman Nottingham, Vice Chairman Mulvey, and Commissioner Buttrey.

Vernon A. Williams
Secretary