

SURFACE TRANSPORTATION BOARD

DECISION

STB Docket No. 41191 (Sub-No. 1)

AEP TEXAS NORTH COMPANY

v.

BNSF RAILWAY COMPANY

Decided: May 27, 2008

In this proceeding, AEP Texas North Company (AEP Texas) challenges the reasonableness of the rates charged by BNSF Railway Company (BNSF) for movements of coal from origins in the Powder River Basin (PRB) in Wyoming to the Oklaunion Generating Station (Oklaunion) near Vernon, TX. In a decision served on September 10, 2007 (September '07 Decision), we found that AEP Texas had failed to establish that the challenged rates were unreasonably high but offered AEP Texas an opportunity to submit supplemental evidence.

AEP Texas and BNSF sought reconsideration of the September '07 Decision by petitions filed on October 22, 2007. (AEP Texas also stated that it did not intend to pursue the option of filing supplemental evidence to alter its SAC presentation, as permitted in the September '07 Decision.) Each party filed a reply to the other's petition on November 13, 2007. With the exception of one issue, on which additional evidence and argument is sought, both petitions for reconsideration will be denied.

BACKGROUND

AEP Texas challenged the reasonableness of BNSF's rates using the stand-alone cost (SAC) test. Under the SAC test, a "stand-alone railroad" (SARR) is hypothesized that could serve AEP Texas' coal traffic as well as other traffic. The SAC constraint limits the rates that BNSF may charge AEP Texas to what the SARR would need to charge to serve AEP Texas while fully covering all of its costs, including a reasonable return on investment.

AEP Texas designed a SARR, the Texas & Northern Railroad (TNR) that would serve unit-train coal traffic from the PRB, as well as other, non-coal traffic. The TNR's investment requirements and operating expense requirements (revenue needs) were projected for a 20-year period, reflecting anticipated changes in traffic, rate levels, and expenses over that time period. The resulting revenue needs were compared to the revenues that BNSF receives from serving the traffic selected by AEP Texas for those portions of the movements that would be replicated by the TNR. For all but four of the non-AEP Texas shippers included in the traffic group, the TNR would replicate only a portion of the move, and it would have to interchange this "cross-over" traffic with the residual BNSF system at various locations to complete the transportation.

After reviewing the record, the Board compared the best estimate of the costs associated with building and operating the TNR against the best estimate of the revenues to be generated by the traffic that would use the TNR. A present value analysis was used that takes into account the time value of money over the 20-year analysis period, netting the annual over-recovery or under-recovery of the revenue requirements of the TNR as of a common point in time. This analysis showed that the projected revenues from the transportation that the TNR would provide would not be sufficient over the 20-year period to allow the TNR to profitably serve the selected traffic. Therefore, the Board found that the record did not show that the challenged rate levels are unreasonably high.

DISCUSSION AND CONCLUSIONS

A party may seek to have the Board reconsider a decision by submitting a timely petition that demonstrates material error in the prior decision or identifies new evidence or substantially changed circumstances that would materially affect the case. 49 U.S.C. 722(c); 49 CFR 1115.3.

I. BNSF's Petition for Reconsideration

A. Permission for AEP Texas to Modify Its SAC Presentation

BNSF objects to our allowing AEP Texas an opportunity to revise the TNR's traffic group and submit supplemental evidence in order to take into account the effect of a new revenue allocation procedure—known as Average Total Cost or ATC¹—recently adopted in Major Issues.² However, as noted, AEP Texas declined the opportunity to revise its original SAC presentation. Therefore, this issue is moot and need not be addressed.

B. Refinement to ATC Methodology

In their supplemental evidence submitted in early 2007, the parties allocated the total revenues from the cross-over movements in accordance with the ATC procedure described in Major Issues. However, in applying ATC to this case in the September '07 Decision, we found it necessary to refine the procedure slightly so as to avoid an illogical and unintended result.

Because the TNR traffic group included considerable traffic generating revenue either below or barely above variable cost, and because the off-SARR segments of the movements have lower densities (meaning those segments are to be assigned a higher prorata share of the

¹ The ATC method develops the average total cost per segment of a move based on the defendant carrier's variable and fixed costs and the density and miles of each segment of the move. Revenues from cross-over traffic are allocated in proportion to the average total cost of the segments that are on- and off-SARR.

² Major Issues in Rail Rate Cases, STB Ex Parte No. 657 (Sub-No. 1) (STB served Oct. 30, 2006), aff'd sub nom. BNSF Ry. v. STB, No. 06-1372 et al. (D.C. Cir. May 20, 2008).

revenues under ATC), the practical effect would have been to drive the revenue-to-variable cost (R/VC) percentages of certain of the on-SARR movements below 100% (or, if the total revenue is already less than variable costs, even lower). Thus, the revenue allocation for the on-SARR portion of those movements would have been insufficient to cover the variable cost of handling traffic on the highest-density portion of the movement.

To avoid such an illogical result, instead of applying the ATC allocation procedure to total revenue, we applied the procedure to total revenue contribution (i.e., revenue in excess of variable cost). Accordingly, the revenue assigned to the on-SARR part of a cross-over movement would equal the variable cost to haul the traffic over the facilities replicated by the SARR plus the portion of additional available revenue contribution allocated in accordance with ATC.³

BNSF objects to this refinement, claiming that it reintroduces bias in favor of the heavy-density segments. To demonstrate its point, BNSF offers several examples. But its first example illustrates why the adjustment is necessary. BNSF posits a 100-mile movement that generates revenues of \$100, but for which the variable cost of providing service is also \$100. In such circumstances, there is not sufficient revenue to make *any* contribution to joint and common costs. If we were to prorate the total revenue as described in Major Issues, the share of revenue allocated to the heavy-density, on-SARR portion of the movement would be *less* than the operating costs for that segment. As explained in the September '07 Decision (at 15-16), that would not be rational.

BNSF argues that the SARR would be more efficient than the incumbent or, alternatively, that the complainant could drop all low-rated traffic from the traffic group.⁴ Neither argument is persuasive. The fairness of the revenue allocation method should not depend on either the complainant having to design a SARR that overcomes a revenue allocation that does not take into account operating expenses, or that requires the complainant to drop the traffic that the incumbent railroad presumably finds worthwhile to handle at the current rate.

We note that BNSF's position here is inconsistent with the position it took in the Xcel case,⁵ where it advocated a revenue allocation approach called the Density Adjusted Revenue Allocation (DARA). The first step of DARA would have been to allocate revenue associated with directly attributable costs as measured by the Board's Uniform Railroad Costing System (URCS). The second step would have involved allocating contribution (total revenue less total

³ For those movements in the traffic group where the total revenues do not exceed the total variable cost to haul the movement from origin to destination, we applied the same R/VC percentage to both the on-SARR and off-SARR portions of the movement.

⁴ See BNSF Pet. for Recon. at 18-20.

⁵ Public Service Company of Colorado d/b/a Xcel Energy v. The Burlington Northern & Santa Fe Railway Company, STB Docket No. 42057 (STB served June 8, 2004).

URCS operating costs) in accordance with economies of density.⁶ BNSF argued that its approach would have allowed complainants to take advantage of economies of density, but at the same time provide for an “even-handed” allocation of revenues. It explained that “[t]he even-handedness of DARA derives from the fact that *it assures that both on-SARR and off-SARR segments of cross-over movement will cover their attributable cost*, while giving both a comparable opportunity to cover their unattributable costs.”⁷ The refinement to ATC we adopted in this case is very similar. It provides an even-handed revenue allocation by ensuring that the revenue division for both on-SARR and off-SARR segments would cover variable (i.e., attributable) costs (calculated using URCS) before allocating any remaining revenue that would be available to cover fixed (i.e., unattributable) costs.

In sum, BNSF has failed to present new evidence or substantially changed circumstances that would materially affect the case or to show material error in the September ’07 Decision. 49 U.S.C. 722(c); 49 CFR 1115.3. Accordingly, its request for reconsideration is denied.

II. AEP Texas’ Petition for Reconsideration

A. Indexing of Operating Expenses

In the September ’07 Decision, the Board used the “hybrid” approach for indexing of operating expenses that it adopted in Major Issues.⁸ In its petition for reconsideration, AEP Texas argues that the hybrid indexing approach is “arbitrary” and that failing to index operating expenses to account for productivity gains in the same manner that revenue is indexed results in operating expenses increasing at a faster rate than revenues, making the TNR not viable in the long term.⁹ According to AEP Texas, had the Board used AEP Texas’ methodology,¹⁰ BNSF’s rate would have been shown to be unreasonable. Thus, AEP Texas claims that it was material error for the Board to ignore AEP Texas’ alternative approach to indexing operating expenses.

⁶ Ultimately, the Board concluded that this second step was flawed in that it did not adequately account for economies of density—a flaw that we corrected with the ATC approach.

⁷ See STB Docket No. 42057, BNSF Stmt. of Clarification at 13 (filed Jan. 20, 2004) (emphasis added).

⁸ Under the hybrid approach, the Board uses the Rail Cost Adjustment Factor unadjusted for productivity (RCAF-U) exclusively in the base year of the DCF analysis, but incorporates the productivity gains projected in the Rail Cost Adjustment Factor adjusted for productivity (RCAF-A) incrementally, at a rate of 5% per year over a 20-year period. See Major Issues at 39-47.

⁹ AEP Texas Pet. for Recon. at 4; AEP Texas Reb. III-G-7-9.

¹⁰ AEP Texas’ approach was to use the same productivity factor that is included in the U.S. Department of Energy, Energy Information Administration (EIA) revenue forecasts throughout the 20-year period. See AEP Texas Open. Narr. III-G-9-13.

We did not ignore AEP Texas' proposal; rather AEP Texas abandoned its argument. In the Major Issues proceeding, the Board addressed the fact that three of the issues that the Board would examine in the rulemaking, including the indexing of operating expenses, had been raised in this case.¹¹ The parties were expressly advised that, whatever final rules were adopted would be applied to the pending cases, and therefore, "[i]f a party. . . wishe[d] to have a proposal that it has already submitted on any of these three issues considered in its case, it must submit its proposal as comments in the [Major Issues] proceeding."¹²

Despite this clear warning, AEP Texas did not submit in the Major Issues proceeding the methodology for forecasting operating expenses that it now argues should have been applied here. Rather, in Major Issues it joined with other coal shippers in suggesting that the Board modify its proposed method of indexing operating expenses to incorporate one-half of the current increase in railroad productivity in the SARR's first year, increasing to a full productivity adjustment by the end of 10 years. In its petition for reconsideration, AEP Texas acknowledges that it joined in the other shippers' proposal in Major Issues, but claims that in doing so, it "did not abandon the methodology that it tailored to this case."¹³ However, the Board's language in Notice of Major Issues could not have been clearer that any proposals presented in the pending cases should also be offered in the rulemaking. The Board did so in order to ensure that all interested parties to the rulemaking would be in a position to comment on all proposals.

If AEP Texas believed its proposal was superior to that offered by the shipping community, it could have easily submitted that proposal in Major Issues. But it chose not to do so and, in fact, expressly stated that it supported the adoption and application of the shippers' proposal in Major Issues to this case.¹⁴ AEP Texas cannot now change that choice after learning that the Board rejected the shipper's indexation proposal in Major Issues.¹⁵ By failing to advocate in the rulemaking the methodology that it now argues should have been considered here, it foreclosed the opportunity for the Board to obtain the benefit of public comment from all interested parties in Major Issues. It therefore waived any right to have that methodology considered in this proceeding.

In any event, AEP Texas' underlying contention—that the hybrid approach is flawed because the procedures used to index operating expenses and revenues should be the same—is incorrect. As the Board explained in Eastern Cases Recon., revenues for the railroad industry

¹¹ Major Issues in Rail Rate Cases, STB Ex Parte 657 (Sub-No. 1) (STB served Feb. 27, 2006) at 3 (Notice of Major Issues).

¹² Id.

¹³ AEP Texas Pet. for Recon. at 5 n.5.

¹⁴ Opening comments of AEP Texas in Major Issues at 18.

¹⁵ The shipper community challenged the Board's rejection of its indexing approach, but the Board's decision was upheld in BNSF Ry. v. STB, see supra note 2, slip op. at 16-20.

and operating expenses for a SARR could well grow at different rates.¹⁶ While AEP Texas argues that the circumstances in this case are different from those in Eastern Cases Recon., it has not explained how the differing circumstances would affect the conclusion that the SARR's operating expenses and the incumbent's revenue would not grow at the same rate.

As the shipping community is well aware, a railroad's own costs and rate levels do not always move in lock step.¹⁷ The likelihood that the rate of change for a SARR's operating costs would mirror the rate of change for the incumbent carrier's rates is even more remote. A railroad's costs are determined based on the price and quantity of inputs used to provide service. Cost increases can be ameliorated by productivity gains that occur when a carrier is able to decrease the quantity of inputs or substitute a less costly input to produce the same service. In some instances, a portion of these cost saving are reflected in the rates shippers pay.

In a SAC case, we undertake two separate analyses, one involving the cost that the hypothetical SARR would incur to provide service and the other involving the rates the existing railroads charges for the service that the SARR would replicate. For the former, we estimate the operating costs that the hypothetical SARR would experience in a base year and then determine how those costs would change over the multi-year analysis period. As noted, we recognize that a SARR would experience some cost-limiting productivity gains in its early years of operations, but those gains would be less than those being experienced by the mature rail industry, as the SARR starts off with a more efficient operation than those of existing carriers.¹⁸

For rate levels over the SAC analysis period, we must determine what rates the incumbent carrier will charge in the future in order to determine whether such rates would provide the SARR with sufficient revenues to cover all of its costs. To do so, we look for the best projections of future rates. In cases involving the transportation of coal, parties have used, and we have accepted, rate forecasts developed by EIA, an independent statistical arm of the Department of Energy created by Congress for the express purpose of providing policy-neutral data and forecasts. Recognizing that some productivity gains are shared with shippers, EIA's projections takes into account the productivity gains experienced by the existing rail industry. But as we observed in Major Issues and Eastern Cases Recons., the productivity gains experienced by the existing rail industry, which EIA uses in its projections, and those that could be expected for a new, highly efficient carrier, like a SARR, are different. Thus, even had AEP Texas preserved its position on this matter, we would not have concluded that the rail industry's

¹⁶ Duke Energy Corporation v. Norfolk Southern Railway Co., STB Docket No. 42069; Duke Energy Corporation v. CSX Transportation, Inc., STB Docket No. 42070; Carolina Power & Light Co. v. Norfolk Southern Railway Co., STB Docket No. 42072 (STB served Oct. 20, 2004).

¹⁷ An assertion we often hear today is that rate increases are exceeding the cost increases that railroads are currently experiencing.

¹⁸ Major Issues at 42-44.

rates and a SARR's costs would move in lock step because of the different levels of productivity each could be expected to experience.

B. Cost of Capital

To estimate what it would cost a SARR to raise capital, the longstanding practice in SAC cases has been to use an average of the annual cost-of-capital figures for the rail industry as published annually by the Board, starting with the year in which construction of the SARR would have begun through the most recently available year. We recently revised our procedures for calculating the rail industry's cost of capital in Cost of Capital Methodology,¹⁹ replacing the single-stage discounted cash flow model (DCF) with a capital asset pricing model (CAPM). In its petition for reconsideration, AEP Texas argues that this change in our cost-of-capital methodology requires that the September '07 Decision be revised.

AEP Texas argues that it was material error for the Board to rely on the 2005 cost-of-capital figure produced under the DCF approach given that the Board had initiated the change in methodology prior to the September '07 Decision in part to address criticisms that AEP Texas had raised. AEP Texas argues that the Board's reasoning in applying the new rules from the Major Issues rulemaking to these cases requires that the DCF cost-of-capital figures be replaced with CAPM cost-of-capital figures based on the new procedure adopted in Cost of Capital Methodology.²⁰

As in Western Fuels,²¹ we will reserve judgment on whether to restate the rail industry's cost-of-capital figures using CAPM in the SAC analysis until the parties have an opportunity to fully argue and brief the merits of the issue of the propriety of using restated cost-of-capital figures in this case. In addition, each party should submit separate SAC calculations, one showing their cost-of-capital figures developed under the single-stage DCF approach through 2005, changing to a CAPM cost of capital in 2006, and a second showing their cost-of-capital calculations under CAPM for all years. Furthermore, should any of the revised SAC analyses show an over-recovery of revenue for the TNR, the parties should apply the "Maximum Markup Methodology" (MMM) adopted in Major Issues (at 9-24) to determine the extent of any rate relief to which AEP Texas would be entitled.

¹⁹ Methodology to be Employed in Determining the Railroad Industry's Cost of Capital, STB Ex Parte No. 664 (STB served Jan. 17, 2008).

²⁰ The September '07 Decision used the average cost of capital from the years 1998 through 2005. AEP Texas notes that the 2006 cost-of-capital figure using the new CAPM is now available. Our policy is to use the most up-to-date cost of capital data when issuing final decisions in rate cases. Accordingly, the recently issued 2006 cost-of-capital figure will be used in the SAC analysis.

²¹ Western Fuels Association, Inc. and Basin Electric Power Cooperative v. BNSF Railway Company, STB Docket 42088 (STB served Feb. 29, 2008) (Western Fuels).

We also direct the parties to address whether: if the pre-2006 cost-of-capital findings are not restated, we should forecast the cost of capital in succeeding years by taking an average of the 1998 through 2006 cost-of-capital figures (as has been our practice in prior SAC cases), or instead use only the 2006 cost-of-equity figure, which is based on the more current CAPM. A procedural schedule for the submission of these filings is set forth in the ordering paragraphs.

C. Amortization of Debt

In September '07 Decision (at 107), the Board rejected AEP Texas' procedure of amortizing the debt of the TNR over the weighted average life of the TNR's assets (50 plus years) and instead, applied the 20-year amortization period that has been used consistently in prior SAC cases. AEP Texas argues that rejection of its 50 plus year amortization period was material error, because it had presented sufficient evidence demonstrating that use of an amortization schedule longer than 20 years was consistent with the practices of real-world railroads.

AEP Texas has failed to show material error in this regard. AEP Texas provided no evidence to support its break from longstanding precedent until its rebuttal.²² Moreover, as noted in September '07 Decision, AEP Texas' *own* evidence showed that the weighted average amortization of fixed-income issuances for Class I railroads was only 13 years and the non-weighted average was less than 11 years. Thus, the use a 20-year amortization period was generous. In addition, AEP Texas' evidence showed that, of the 71 examples AEP Texas presented of Class I railroad financing, only 10 issuances were for periods longer than 20 years, and of those 10 issuances, the longest financing period was 31 years. Thus, although AEP Texas' evidence showed that financing longer than 20 years has been utilized in some (though not many) instances, that evidence does not show that financing for 50 plus years is feasible or that any real-world railroad obtains financing for such an extended period of time.²³ That is not to say that a complainant in a future SAC case could not introduce different evidence to show that financing over a longer term would be reasonable.

For the reasons provided above, BNSF's petition for reconsideration is denied in full and AEP Texas' petition for reconsideration is denied in part. We reserve judgment on the issue of whether the Board's newly adopted cost-of-capital procedure should be used to develop the various cost-of-capital figures used in determining the outcome of this case.

²² Our policy is not to consider evidence submitted for the first time on rebuttal. Thus, we rejected similar evidence as inappropriate rebuttal in Western Fuels, and should have done so in this case. In any event, as we explain, AEP Texas' argument on this issue is unpersuasive.

²³ AEP Texas argues that long-term financing is consistent with other "far-horizon elements" of the railroad industry, such as 100-year leases and easements, and 100-year flood designs. But those are apples-to-oranges comparisons with respect to financing.

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

It is ordered:

1. BNSF's petition for reconsideration is denied.
2. AEP Texas' petition for reconsideration is denied in part, as discussed above. The Board requests supplemental evidence regarding the issues pertaining to the cost-of-capital figures that should be used in this case.
3. The following procedural schedule is established for the submission of supplemental evidence on the issue of cost of capital:

The parties' opening submissions are due by June 30, 2008.

The parties' reply submissions are due by July 14, 2008.

4. This decision is effective on its service date.

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

Anne K. Quinlan
Acting Secretary