SERVICE DATE – LATE RELEASE JULY 27, 2009

SURFACE TRANSPORTATION BOARD

DECISION

STB Docket No. 42088 (Sub-No. 1)

WESTERN FUELS ASSOCIATION, INC., AND
BASIN ELECTRIC POWER COOPERATIVE
v.
BNSF RAILWAY COMPANY

Decided: July 23, 2009

The Board finds that the defendant railroad has not established transportation rates in accordance with the rate prescription in STB Docket No. 42088. The Board therefore orders the railroad to establish maximum lawful rates in accordance with the methodology described in Oklahoma Gas & Elec. v. Union Pacific R.R., STB Docket No. 42111 (STB served July 24, 2009).

BY THE BOARD:

OVERVIEW

In the lead docket, No. 42088, Western Fuels Association, Inc. and Basin Electric Power Cooperative (collectively, WFA) challenged 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 WFA's Laramie River Station (LRS) coal-fired electric utility plant at Moba Junction, WY. In a decision served on February 18, 2009 (February '09 Decision), we found that BNSF has market dominance over those movements and that the challenged rates were unreasonably high. Accordingly, we ordered BNSF to pay reparations to WFA (with interest) for shipments dating back to the fourth quarter of 2004. In a further decision, served on June 5, 2009 (June '09 Decision), we modified the rate prescriptions to correct an error in certain density and variable cost calculations.

We must now resolve a dispute between WFA and BNSF over whether the rates BNSF established on March 20, 2009, exceed the maximum lawful levels prescribed in the February '09 Decision, as modified in the June '09 Decision. We find that BNSF has used the proper method in general for calculating the maximum lawful rates in 2009, but erred in its indexing approach. The rates it established therefore exceed the permissible maximum revenue-to-variable cost (R/VC) ratio for 2009.

Accordingly, BNSF is ordered to establish transportation rates that comport with our June '09 Decision. We have calculated, for the first two quarters of 2009, the maximum lawful rates from each of the 12 PRB mines embraced in the rate prescription. BNSF should in turn establish the proper rates for the third quarter of 2009, and adjust those rates quarterly in the manner described in Oklahoma Gas & Elec. v. Union Pacific R.R., STB Docket No. 42111 (STB served July 24, 2009).

Once BNSF establishes updated rates, WFA should calculate the precise amount of reparations due and submit its statement of damages to BNSF, in accordance with 49 CFR 1133.2. BNSF itself has estimated that it now owes WFA roughly $112 million in reparations, but this calculation is too conservative given our finding that BNSF has established rates in excess of those permitted by our February ’09 Decision and June ’09 Decision. If the parties cannot resolve the precise amount of reparations due, WFA may bring the dispute to our attention.

BACKGROUND

1. Prior Decision Finding Challenged Rates Unreasonable

This case involves a large rate dispute between WFA and BNSF over the reasonableness of the rates charged to haul 8 million tons of coal each year from mines in the PRB in Wyoming to the LRS generating plant. Because these are common carriage rates and BNSF possesses market dominance over WFA’s shipments to the LRS plant, we have both jurisdiction over the rates and authority to review their reasonableness when challenged.

In the February ‘09 Decision, we found that the challenged rates were unreasonably high and ordered BNSF to lower its rates and reimburse WFA for any overpayments, including interest. We did not, however, prescribe specific rates for transportation from the 12 PRB origin mines at issue. Instead, we ordered BNSF to maintain rates that did not exceed a prescribed R/VC ratio. After minor corrections in the June ’09 Decision, we prescribed the maximum lawful R/VC ratios that BNSF is permitted to charge WFA for transportation from these 12 PRB mines to the LRS plant (between 2004 and 2024) as follows:

Table 1
Maximum R/VC Ratio

Year	Maximum R/VC
4Q 2004	2.41
2005	2.47
2006	2.30
2007	2.38
2008	2.44
2009	2.41
2010	2.45
2011	2.46
2012	2.48
2013	2.50
2014	2.55
2015	2.68
2016	2.69
2017	2.65
2018	2.62
2019	2.61
2020	2.61
2021	2.60
2022	2.61
2023	2.60
2024	2.58

2. Maximum Markup Methodology

The approach followed in this case to establish the maximum lawful R/VC ratios reflected the application of significant innovation in our rate procedures for handling large rail rate disputes. In Major Issues in Rail Rate Cases, STB Ex Parte 657 (Sub-No. 1) (STB served Oct. 30, 2006), aff'd sub nom. BNSF v. STB, 526 F.3d 770 (D.C. Cir. 2008) (Major Issues), we adopted an entirely new approach to calculate maximum lawful rates in such cases, called the "Maximum Markup Methodology" (MMM). Under MMM, we calculate a maximum R/VC ratio that limits the amount of demand-based differential pricing the defendant carrier can engage in for a given year. Under this new approach, we no longer prescribe fixed transportation rates for as many as 20 years, as was our practice in prior large rate cases, but instead we prescribe an R/VC ratio that permits the transportation rate to change from year to year (or from quarter to quarter) to reflect changes in the rail operating costs, such as fuel costs.

Accordingly, in this case we ordered BNSF to establish and maintain rates for movements of the issue traffic that do not exceed the maximum reasonable R/VC ratios in **Table 1**. The variable cost of the issue movements was to be calculated for this purpose using the Uniform Railroad Costing System (URCS), with no adjustments, and with indexing as appropriate.[1] If there was a dispute over how to calculate variable costs, WFA was directed to bring that dispute to our attention.[2]

3. Present Dispute Over Compliance

On March 20, 2009, BNSF established rates for 2009 to comply with our February ’09 Decision, which stated that the railroad could not charge rates that exceeded 240% of the variable costs of providing the transportation. (In our June ’09 Decision the prescribed R/VC ratio was adjusted slightly to 241%.) BNSF therefore had to calculate the variable costs to transport coal from the 12 origin mines to the LRS plant at Moba Junction, WY. It used the most recent URCS data available (2007) and then followed well-established precedent to index those 2007 costs to the first quarter of 2009 with a combination of the Association of American Railroad (AAR) index and the Producer Price Index (PPI). BNSF notified the Board of its purported compliance with the February ‘09 Decision.

On April 2, 2009, WFA filed a reply to BNSF’s notice, asserting that these rates did not comply with our order. WFA claimed that BNSF had failed to calculate the 2009 variable costs in accordance with our prior decision. Rather than use the actual variable costs (as reflected in the most recent URCS data), WFA maintained that BNSF was supposed to utilize the variable cost estimates used by the Board when it calculated the maximum markup levels. In this case, that would mean using 2004 URCS and a 2006 forecast of changes in rail cost (specifically the Board’s Rail Cost Adjustment Factor adjusted for productivity, or RCAF-A). Because the 2007 actual variable costs were higher than the 2006 RCAF-A forecasts used in our prior decision, the practical effect of using the method advocated by WFA would be to yield significantly lower transportation rates. **Table 2** depicts the rates established by BNSF and those sought by WFA.

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[1] February ’09 Decision at 31.

[2] Id.

Table 2
Disputed 2009 Rates

Mine Origin	**BNSF's Established Rates** ($/ton)	**WFA's Proposed Rates** ($/ton)
Antelope	$3.89	$2.74
North Antelope	4.07	2.83
Black Thunder	4.52	3.19
Jacobs Ranch	4.67	3.24
Cordero	4.95	3.49
Belle Ayr	5.10	3.62
Caballo Rojo	5.10	3.59
Caballo	5.17	3.65
Dry Fork	5.73	4.06
Rawhide	5.78	4.10
Eagle Butte	5.83	4.09
Buckskin	5.90	4.06

BNSF responded on April 15, 2009. It maintains that its rates comply with our order, and observes that WFA now seeks maximum lawful rates in 2009 that result in R/VC ratios dramatically lower than the 240% level prescribed in the February '09 Decision.

On April 21, 2009, WFA filed a motion to strike BNSF's entire pleading, claiming it was an improper "reply to reply." In the alternative, it sought permission to file a surreply that accompanied the motion to strike. BNSF filed in opposition to the motion to strike, stating that it must have a right to respond to the accusation raised by WFA for the first time in its pleading styled as a "reply." BNSF also objected to the surreply as duplicative of the earlier arguments.[3]

On May 28, 2009, WFA filed a letter with the Board and with numerous members of Congress complaining that BNSF is trying to deprive WFA of approximately one-third of the relief we forecasted in the February '09 Decision.

DISCUSSION AND CONCLUSIONS

It is settled that in 2009 BNSF may charge WFA no more than 241% of the variable costs

[3] We will deny WFA's motion to strike, but grant its request to file the surreply. WFA has the obligation to bring the dispute over variable costs to our attention, see February '09 Decision at 31, so we cannot preclude BNSF from replying even though WFA labeled its pleading as a "reply." And while WFA's surreply is itself a reply-to-reply, we will permit the pleading as BNSF has not argued it is prejudiced by consideration of the legal or technical arguments raised therein.

to transport coal from the 12 PRB mines to the LRM plant. But the parties cannot agree on how to calculate the variable costs for any particular movement in 2009. There is therefore a vast discrepancy between the prescribed rates advocated by each party.

WFA argues that the same approach used to calculate the variable costs for purposes of computing the maximum markups in the February ’09 Decision should be used to calculate the rate prescription. Because the maximum markups were derived using 2004 URCS figures and the 2006 forecast of RCAF-A, WFA urges us to calculate the 2009 variable costs by using 2004 URCS figures and then indexing those 2004 variable costs to present dollars by using a 2006 forecast of RCAF-A. WFA would use this same approach for every subsequent year as well. So in 2024, the prescribed rates would still be derived by using URCS data from 2004 (a full two decades earlier) and a 2006 forecast of RCAF-A.

BNSF argues that the point of prescribing R/VC ratios (rather than specific rates) was to permit the maximum lawful rates to adjust automatically with changes in actual operating costs, whereas the approach advocated by WFA would fail to do so.

Table 3 shows the actual variable costs in the first quarter of 2009, the rates BNSF and WFA would have us prescribe, and the resulting R/VC ratios. As shown, neither party is proposing rates that comport with our prior decisions setting the maximum lawful R/VC ratio at 241% of variable cost.

Table 3
R/VC Analysis (1Q ’09)

	Proposed Rates		**Variable Cost**	**R/VC Ratios**	
Mine Origin	**WFA** (1)	**BNSF** (2)	**STB** (3)	**WFA** (1)/(3)	**BNSF** (2)/(3)
Antelope	$2.74	$3.89	$1.46	188%	266%
North Antelope	$2.83	$4.07	$1.52	186%	268%
Black Thunder	$3.19	$4.52	$1.69	189%	268%
Jacobs Ranch	$3.24	$4.67	$1.75	185%	267%
Cordero	$3.49	$4.95	$1.85	189%	268%
Belle Ayr	$3.62	$5.10	$1.91	190%	267%
Caballo Rojo	$3.59	$5.10	$1.91	188%	267%
Caballo	$3.65	$5.17	$1.94	188%	267%
Dry Fork	$4.06	$5.73	$2.14	190%	268%
Rawhide	$4.10	$5.78	$2.16	190%	268%
Eagle Butte	$4.09	$5.83	$2.18	188%	267%
Buckskin	$4.06	$5.90	$2.21	184%	267%

WFA raises three core arguments for its position. First, WFA maintains that "the Board held in Major Issues that parties should use the same set of indexed base-year costs to calculate the maximum MMM R/VC ratios *and* the resulting prescribed maximum MMM rates."[4] WFA is incorrect. While we did adopt a method for indexing base year costs to calculate the maximum R/VC ratios, we then stated that the rate prescription "would be expressed as an R/VC ratio."[5] We further stated that, to calculate the prescribed R/VC ratio in each year of the SAC analysis period (here, 20 years), "the parties should project the initial (base-year) URCS variable costs forward, using the hybrid approach … for projecting the SARR's operating expenses."[6] But we did not state, nor was it our intent, that the resulting maximum lawful rates be fixed in place using the same variable cost estimates needed to implement MMM.

By expressing the rate prescription as an R/VC ratio, our MMM methodology allows the rates per ton charged for the issue traffic to adjust over time as actual costs change. This was an innovation introduced in Major Issues to address, in part, the concern that rate prescriptions that will remain in effect for years must be made based on a time-bound record and forecasts of future events. Expressing the rate prescription as R/VC ratios rather than as predetermined rates provides a flexible rate prescription methodology that allows the actual rates charged for the issue traffic to yield the same contribution prescribed by the Board as costs change. Such flexibility is particularly important in this case, where the rate prescription is to last for 20 years. Indeed, had we intended for the MMM approach to translate into fixed rates, without regard to actual variable costs, we could simply have specified the maximum rates per ton BNSF could charge, rather than describing the maximum lawful rates in terms of R/VC ratios.

WFA's second argument is that use of the actual variable costs will violate a fundamental SAC principle that traffic group revenues be reduced to equal the SAC requirements of the hypothetical SARR.[7] To illustrate, WFA uses an example of an issue movement from the Dry Fork mine. In calculating the maximum R/VC ratio for the first quarter of 2009, the MMM analysis forecast the maximum rate for the Dry Fork mine at $4.06 per ton. Substituting actual variable costs for the forecasts in the record at the time would raise the maximum rate level to $5.16 per ton. WFA maintains that this would result in a windfall for BNSF, as BNSF would be able to collect more than the SAC costs from the traffic group, and thus violate core SAC principles.

We reject WFA's premise that using actual variable costs (rather than forecasts from the record) to set the maximum lawful rate is improper or will provide a windfall to BNSF. Forecasts play a significant role in SAC cases. Our analysis relies heavily on forecasts of

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[4] WFA Reply at 14 (emphasis added).

[5] Major Issues at 14.

[6] Id. at 14 n.19. In this case, we modified the forecasting approach used to calculate the maximum R/VC ratios, replacing the hybrid approach described in Major Issues with a forecast of RCAF-A.

[7] See WFA Reply at 16.

revenues, traffic flows, operating expenses, cost indices, and cost-of-capital figures. In this case, those forecasts extended for 20 years, until the year 2024. To instruct BNSF on the maximum lawful rate it may charge until the year 2024, we must use those multiple, long-term forecasts to issue rate prescriptions. Rather than cast rates in stone, however, we decided in Major Issues to provide for more flexibility in our approach to rate prescriptions. Thus, we express rate limits as R/VC ratios, so that if operating expenses increase or decrease unexpectedly, as is the case here, the maximum lawful rates will respond automatically and immediately.

There is no basis on which to conclude that this approach will provide BNSF an expected windfall. In this case, operating expenses for 2009 are much higher than previously forecasted. Short of reopening the entire case and updating *all* the forecasts used therein, it is impossible to determine *a priori* what amount BNSF would be permitted to charge if a new SAC analysis were undertaken.[8] But we cannot be constantly unraveling and reweaving our earlier work whenever actual events prove different from those previously forecasted. Thus, there is a need for flexibility in rate prescriptions so that they can be self-adjusting as operating expenses change, while continuing to provide a reasonable constraint on the pricing of the railroad.

We believe that the approach of setting the maximum R/VC ratios based on the best forecast of record – but then letting the actual maximum lawful rates adjust with changes in actual operating expenses – provides the appropriate balance of competing concerns. Consider for example what will happen in the year 2024. Under the approach adopted in Major Issues, the maximum lawful rate will be prescribed at 258% of variable costs, based on the record and forecasts in our original decision. If circumstances change, either party can seek to reopen that decision to have the maximum R/VC ratio changed. But the actual maximum lawful rate will depend on actual 2024 variable costs, not on URCS data from two decades earlier and a nearly two-decade old forecast of RCAF-A.[9]

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[8] WFA recalculated the MMM R/VC calculation for 2009 using actual variable costs (rather than the forecasts in our February '09 Decision) for all members of the traffic group. See WFA Surreply at 16-17. However, this calculation does not properly depict how the maximum R/VC ratios prescribed in our decision would change as a result of the higher than anticipated operating costs. To calculate the maximum lawful R/VC level for 2009, a critical input for the MMM approach is the 2009 SAC cost. This figure was $224 million as calculated in our February '09 Decision (Table 3 at 29). This $224 million figure reflects the total revenues that the hypothetical railroad would need to earn to recover its *forecasted* operating costs and earn a reasonable return on investment. The sharp increase in *actual* operating costs since the close of the record would increase the SAC costs above those forecasted in our decision. WFA, however, is only selectively updating our February '09 Decision and has kept constant the 2009 forecasted operating costs of the hypothetical railroad. (Nor has WFA updated the slew of other forecasts used to derive the 2009 SAC costs.) We conclude that the selective updating by WFA to recalculate new maximum R/VC ratios is inappropriate. We therefore disagree with WFA that, if we use actual variable costs to calculate the maximum lawful rates, all traffic group variable costs should be recalculated and the MMM model rerun. See WFA Surreply at 17.

[9] We also note that, under WFA's approach, the prescribed R/VC ratios in our decision would be pure fiction. They would not reflect the *actual* R/VC ratios the carrier may charge.

(continued . . .)

WFA's third argument is that using actual variable costs will deprive WFA of over 1/3 the value of the relief forecast by the Board. But any estimate of the total relief based on a 20-year prescription is necessarily speculative. This is a massive rate dispute with huge volumes of traffic over the 20-year period. Thus, even minor changes to the transportation costs will correspond to a change in the maximum lawful rate and cost one side or the other millions of dollars. In the February '09 Decision, we sought to provide the general public with an understanding of the magnitude of the dispute and the predicted relief. Our initial forecast of relief ($345 million over 20 years) was premised on forecasts of rail costs using the best information in the record at that time. Whether or not our initial forecast of the relief proves to be understated or overstated will only be known when the 20-year period nears completion. That initial forecast now appears overstated in light of actual market developments since the record closed. The drop is not attributable to any wrongdoing or improper conduct by BNSF, but to rising transportation costs. And as the carrier's operating costs have risen more than expected, so too must the prescribed rates rise or BNSF would not earn a reasonable return on the facilities used to serve WFA.[10]

Should actual future transportation costs fall below those forecast in our decision, WFA may receive more relief than we originally forecast. But in either event, the proper approach is to let the actual operating costs dictate the maximum lawful rates BNSF may charge WFA and thus the total amount of rate relief WFA ultimately receives. In short, WFA has not established a basis to depart from the approach adopted in Major Issues.

While we find BNSF's basic approach to calculating variable costs correct, the railroad has made some significant technical errors in its variable cost calculations. WFA correctly observed that BNSF has not applied the proper indexing approach to develop the variable costs for the first quarter of 2009. We have corrected that error, following our established indexing practice. We also use, as the best evidence of record, respectively, the total mileage submitted by BNSF (which properly includes loop miles) and its tons per car, but we rely on the number of cars submitted by WFA. Our variable cost calculations and the resulting maximum lawful rates are shown in **Table 4**.

(. . . continued)
The actual R/VC ratios the carrier could charge would be a secret shared only by the defendant carrier, the complainant, and their consultants and lawyers. This result is contrary to the need for transparency in our rate regulations to foster private negotiation and settlements.

[10] See BNSF Reply at 14.

Table 4
Results

	Variable Cost 1Q09	Variable Cost 2Q09	Maximum Lawful Rate 1Q09	Maximum Lawful Rate 2Q09
Antelope	$1.46	$1.46	$3.51	$3.52
North Antelope	$1.52	$1.53	$3.67	$3.68
Black Thunder	$1.69	$1.69	$4.08	$4.08
Jacobs Ranch	$1.75	$1.75	$4.21	$4.22
Cordero	$1.85	$1.85	$4.46	$4.47
Belle Ayr	$1.91	$1.91	$4.60	$4.60
Caballo Rojo	$1.91	$1.91	$4.60	$4.60
Caballo	$1.94	$1.94	$4.67	$4.67
Dry Fork	$2.14	$2.15	$5.16	$5.17
Rawhide	$2.16	$2.16	$5.21	$5.22
Eagle Butte	$2.18	$2.18	$5.25	$5.26
Buckskin	$2.21	$2.21	$5.33	$5.33

We will make our workpapers available to BNSF and WFA upon request. BNSF is instructed to establish rates on a quarterly basis for the remainder of the rate prescription period, following the approach described in Oklahoma Gas & Elec. v. Union Pacific R.R., STB Docket No. 42111 (STB served July 24, 2009).

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

It is ordered:

1. WFA's motion to strike is denied and its motion to file surrebuttal is granted.

2. BNSF is instructed to reestablish, within 30 days, transportation rates that comport with this decision, and then update those rate prescriptions quarterly as new variable cost information and indices become available, following the methodology described in Oklahoma Gas & Elec. v. Union Pacific R.R.

3. This decision is effective on August 26, 2009.

By the Board, Acting Chairman Mulvey, and Vice Chairman Nottingham.

Anne K. Quinlan
Acting Secretary