BEFORE THE

SURFACE TRANSPORTATION BOARD

EX PARTE NO. 717

PETITION OF THE ASSOCIATION OF AMERICAN RAILROADS TO INSTITUTE A RULEMAKING PROCEEDING TO REINTRODUCE INDIRECT COMPETITION AS A FACTOR CONSIDERED IN MARKET DOMINANCE DETERMINATIONS FOR COAL TRANSPORTED TO UTILITY GENERATION FACILITIES

REPLY IN OPPOSITION TO AAR PETITION OF

ALLIANCE FOR RAIL COMPETITION
MONTANA WHEAT & BARLEY COMMITTEE
COLORADO WHEAT ADMINISTRATIVE COMMITTEE
IDAHO BARLEY COMMISSION
IDAHO WHEAT COMMISSION
MONTANA FARMERS UNION
NEBRASKA WHEAT BOARD
OKLAHOMA WHEAT COMMISSION
SOUTH DAKOTA WHEAT COMMISSION
TEXAS WHEAT PRODUCERS BOARD
WASHINGTON GRAIN COMMISSION
NATIONAL ASSOCIATION OF WHEAT GROWERS

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Alliance for Rail Competition ("ARC"), and the other shipper interests identified on the cover (collectively, ARC, et al.), hereby reply in opposition to the November 19, 2012 petition for a rulemaking proceeding filed by the Association of American Railroads ("AAR") and supported by Norfolk Southern Railway Company ("NS"). For many reasons, the petition should be denied.

ARC is an association of captive shippers that has, for many years, participated in STB and legislative proceedings affecting rail shippers. Several ARC members, including PPL, Otter Tail Power Company and Western Fuels, are directly affected by this proceeding because of their involvement with coal shipments to utility generating stations. ARC and other members of ARC, et al. that do not engage in utility coal shipments, including State committees and boards and the National Association of Wheat Growers, are nevertheless interested in this proceeding because of the dangerous precedent AAR seeks to set.

The AAR petition represents another in a long series of attempts by railroads to eliminate or limit their exposure to regulation by the STB. This goal can be achieved legitimately by charging rates below 180% of variable costs (because of the statutory presumption of no market dominance in 49 U.S.C. § 10707(d)(1)(A)), or by charging rates not too much above that level (because no shipper will file a rate case as to rates with R/VC percentages of 185%, 195% or possibly higher). However, that is not the approach the railroads have adopted.

Since the Staggers Act, railroads have sought to limit the scope of ICC and STB regulation, arguing for the most generous definition of revenue adequacy, the narrowest definition of market dominance, the greatest obstacles to shipper relief, etc. In Ex Parte No. 676, Rail Transportation Contracts under 49 U.S.C. 10709, the railroads called for self-effectuating contracts, i.e., service that would be deemed contractual whenever a shipper made a shipment pursuant to specified rail carrier tariffs. All such shipments would thereby become non-jurisdictional, and recourse to remedies under the Interstate Commerce Act would be lost. Similarly, the acquisition premium issue as to Berkshire Hathaway, if not handled properly, could render significant volumes of qualitatively captive BNSF freight non-jurisdictional. Railroads have shifted costs to shippers, and have imposed charges whose reasonableness is difficult to challenge under currently available procedures.

In Ex Parte No. 657 (Sub-No. 1), Major Issues in Rail Rate Cases (decision served October 30, 2006), aff'd. sub nom., BNSF v. STB, 625 F.3d 770 (D.C. Cir. 2008), the Board recognized the threat to the integrity of its processes that can be posed by gaming, and railroads' incentive to engage in gaming. Decision at 16. STB Docket NOR 42124, State of Montana v. BNSF, involves a challenge to the alleged use of shipment size limits to evade rate regulation, a practice that could be used by other railroads as to other commodities.

In the context of market dominance determinations, during the years between 1979 and 1998, railroads often sought to avoid being found market dominant based on allegations of product and geographic competition. Most of these allegations involved potential or theoretical competition and contestable market theory, rather than competition actually constraining rates to levels at or near the jurisdictional threshold.

Contestable market theory suggests that sole providers in markets that might be subject to competition may refrain from abusing their market power for fear that doing so would attract new entrants. In comments filed in Ex Parte No. 705, Competition in the Railroad Industry, we learned of the problematic obverse of contestable market theory, i.e., shippers served by two railroads that do not compete with each other by offering better rates or service. Neither potential nor actual access to an alternative carrier is legally relevant unless it is "effective" competition within the meaning of the statute. The danger to shippers is even greater when the alleged competition is indirect.

In 1998, the Board decided to exclude consideration of product and geographic competition from market dominance determinations in Market Dominance Determinations – Product and Geographic Competition, Ex Parte No. 627, 3 S.T.B. 937 (1998), aff'd. sub nom. AAR v. STB, 306 F.3d 1108 (D.C. Cir. 2002). The Board took this step for two reasons. One reason was the statutory focus on direct competition in the form of "other rail carriers or modes of transportation" providing effective competition. 49 U.S.C. § 10707(a). Product and geographic competition are, at best, indirect competition. 3 S.T.B. at 945-46.

In addition, the Board noted that consideration of product and geographic competition frequently involved extensive and expensive antitrust-type proceedings that served to deprive shippers of regulatory recourse. These analyses also burdened the agency, forcing it to consider issues beyond its expertise and to second-guess shipper management as to product sourcing, environmental compliance, and plant design and operation. 3 S.T.B. at 946-948.

In its petition, AAR argues that the considerations summarized above, which led the Board to impose the burden of proof as to indirect competition on railroad defendants, and then to eliminate evaluation of indirect competition in market dominance determinations, should be reversed, at least as to utility coal rate cases, based on the importance of natural gas as a boiler fuel in electric generation and sales of electric power. AAR as much as admits that the changes it seeks could eliminate "nearly two thirds of the rate cases brought before the Board." AAR Petition at 5.

The AAR Petition is long on economic analysis and short on legal analysis. Though AAR discusses (as it must), the Board's 1998 decision in Market Dominance Determinations --

Product and Geographic Competition, AAR completely ignores the Board's discussion of the statutory focus on direct competition from other railroads or transportation modes.

While AAR does acknowledge the Board's desire to avoid costly antitrust-type proceedings, it attempts to brush aside concerns about adverse impacts on captive shippers, discussed at length in the STB decision, with a brief citation to dicta in the court of appeals decision. Petition at 9.

Instead, we are told that market dominance determinations will be easy if evidence of indirect competition is readmitted due to the availability of power supply and capacity factor curves for the wholesale electricity market, as well as news reports of increased use by utilities of natural gas.

While natural gas use by utilities has risen (due in part to high delivered coal prices driven by market dominant railroads' rate increases), the simplest way to test whether indirect competition from gas-fired generation is effective competition within the meaning of the statute does not require reintroduction of evidence of indirect competition in market dominance determinations. It is rather to recognize that non-captive shippers simply do not file STB rate cases.

The AAR conceded this simple truth in its comments in Ex Parte No. 627. As the Board's Decision explained:

> Many shippers acknowledge that product and/or geographic competition can effectively constrain a railroad's rates, especially when such competition provides a direct transportation alternative. However, in such circumstances, AAR agrees that rate complaints are unlikely to be filed with the Board, because rate litigation is a time-consuming and thus ineffective means of obtaining competitive rates when actual competitive options give shippers negotiating leverage.

3 S.T.B. at 944-45, emphasis added, footnotes omitted. Remarkably, AAR's own admission in Ex Parte No. 627 is also ignored in AAR's petition in Ex Parte No. 717.

There is a fundamental asymmetry between the position of shippers and railroads in market dominance determinations. A false negative, i.e., an erroneous finding no market dominance, not only results in the shipper being denied even the opportunity to argue rate unreasonableness, but also results in the railroad being free to raise the challenged rates, further penalizing a shipper wrongly denied STB recourse.

In contrast, a false positive, i.e., an erroneous finding of market dominance, is unlikely to injure a defendant railroad in any significant way. If challenged rates are subject to real but unrecognized competition, they will by definition be reasonable, and the railroad will win the rate case.

Railroads frequently complain about rate case litigation costs, but this is a red herring. Shippers have often lost rate cases, but to bring a frivolous rate case on the theory that a railroad will settle to avoid producing discovery responses would be irrational. Railroads fight meritorious rate challenges every inch of the way, partly to deter other potential complainants. They never fold in the face of meritless challenges.

Indeed, to the extent that gas competition threatens the competitiveness of coal fired-generation in the wholesale market for electricity power, STB recourse for utilities may be more necessary than ever for utilities. The utilities' survival may be jeopardized if market dominant railroads miscalculate as to the maximum amount of monopoly rents they can extract.

Is the AAR suggesting that economic regulation by this Board should occur only when a railroad's rates are so high that they threaten the viability of shippers and markets? AAR Witness Reishus argues (V.S. at 8) that "railroads have no economic incentive to set their rates at levels that would cause them to lose business entirely or to reduce profits through loss of traffic and associated revenues." While this may be true in theory, railroads can make mistakes. In addition, railroads care more about how many tons they transport, and how their trains are routed, than about how many shippers or markets they serve. Driving individual or smaller shippers out of business but maintaining freight volumes, because bigger survivors pick up the business of smaller shippers that go under, could be advantageous for a railroad.

For this reason, and for other sound policy and legal reasons, market dominance determinations cannot be based on the principle Witness Reishus offers above. That would amount to deregulating monopolies based on no more than the assumption that they will avoid superficially self-defeating behavior.

Market dominance determinations must be based instead on whether there is "an absence of effective competition from other rail carriers or modes of transportation for the transportation to which a rate applies." And competition is effective only when and to the extent that it prevents excessive rail rates. See Arizona Public Service Co. v. United States, 742 F.2d 644, 651 (D.C. Cir. 1984):

> [T]he mere existence of some alternative does not in itself constrain the railroads from charging rates far in excess of the just and reasonable rates that Congress thought the existence of competitive pressures would insure.

AAR claims that its goals are modest, and that it "does not contend that coal transportation rates for every coal-fired generation facility are effectively limited by indirect competition exerted in the wholesale power market." Petition at 2. However, this is false modesty. Nine pages later, AAR urges the admission of evidence which "could quickly identify cases where effective indirect competition can safely be presumed to exist and there is accordingly no warrant for a full rate reasonableness analysis." Petition at 11, emphasis added.

ARC, et al. underscore the word "presumed" in the AAR petition to emphasize that the railroads seek not to return to procedures under which they had the burden of proof as to effective product and geographic competition, pursuant to an ICC decision in 1985. Market Dominance Determinations – Product and Geographic Competition, 3 S.T.B. at 941.[1] Rather, the railroads evidently want the Board to presume that natural gas for power generation constrains rail rates on coal because some utilities have generated some electricity with natural gas which has replaced coal in boilers, and that rail rates on unit train coal are therefore non-jurisdictional.

Note, too, that the AAR seeks to broaden the scope of market dominance determinations from transportation to competition in the larger economy for the sole-served shipper's output in downstream markets. The ICC and STB learned, from painful experience detailed in Ex Parte No. 627, how complex and difficult this task can be. The Board would once again face issues concerning power production economics, environmental externalities and the functioning of the transmission grid like those it cited in that decision as one of many grounds for refusing to consider alleged indirect competition in market dominance determinations.

Is it really credible for AAR to assert that the danger to railroads of frivolous rate cases brought by utilities whose rates are constrained by effective competition is greater than the danger to shippers of frivolous allegations of indirect competition by monopoly railroads seeking to avoid defending the reasonableness of their rates? Is it really credible that those utility rail shippers are going to bring rate complaints on rail rates to this Board when they have competitive alternatives utilizing natural gas? The answer is no.

Finally, this proceeding, though assertedly limited to coal rate cases brought by utilities, plainly has implications for shippers of other commodities. See, in this regard, Market Dominance Determinations – Product and Geographic Competition, 3 S.T.B. at 947:

[1] The Board there observed (id. at footnote 26) that this burden shift "has not been entirely successful," citing FMC Corp. v. Union Pacific RR Co. as a case in which the railroad had used discovery to shift the burden of developing evidence onto the shipper.

> The need to delve deeply into industrial operations that are far removed from the transportation industries that we regulate, in order to properly consider product and geographic competition, is not limited to the utility industry. For example, the ICC's market dominance analysis in one case turned upon the ability of a paper manufacturer to alter its production process to use locally available wood rather than the wood brought in by railroad. Similarly, in two cases involving the transportation of aluminum, the agency examined whether end users of the shipper's aluminum containers could switch to plastic or glass containers.

AAR claims that its only target is coal rate cases brought by utilities, which constitute a majority of challenges to rail rates and involve the largest amounts of alleged overcharges. However, nothing in the AAR's reasoning would preclude a railroad from making similar arguments as to any other commodity sold in a competitive marketplace.

Many of the members of ARC, et al. are producers of grain that is shipped by rail. To take an obvious example, wheat from origins in the upper great plains is transported by rail to the Pacific Northwest and sold to buyers in Asia, subject to pricing in the wholesale market.

BNSF and UP could argue that the need to price wheat so as to make it salable to foreign buyers constrains their ability to charge excessive rail rates on shipments from Montana, North Dakota, etc., to the PNW. They could also argue that evidence of wholesale market price caps for wheat to Asia, like market clearing pricing for electric power generation "could quickly identify cases where effective indirect competition can safely be presumed to exist and there is accordingly no warrant for a full rate reasonableness analysis."[2]

The Board would have to grapple with the substitutability of types and producers of wheat, other agricultural commodities, and other commodities. To what extent are rail rates on Honda Accords constrained because, if excessive, buyers of family sedans will shop for a Toyota

[2] But see Grain Car Supply - Conference of Interested Parties, 7 I.C.C.2d 694, 723 (1991), stating "Montana grain shippers selling export grain through the Pacific Northwest are captive".

Camry? To what extent should railroads be able to charge more for a carload of hybrid cars, because some buyers value high gas mileage and low emissions, reducing elasticity of demand in the sedan market?

AAR is inviting the STB to substitute a slippery slope for a simpler test that imposes fewer costs and burdens on shippers and on the Board itself. And it makes this request not to simplify but to complicate rate challenges, with the effect (and no doubt the goal) of deterring such challenges.

To reiterate, if competition from natural gas as a boiler fuel provides effective competition for coal shipments by rail, reducing rail rates to reasonable levels, the railroads will not be sued even if AAR's petition is denied.

If competition from natural gas alleged by a defendant railroad to establish its lack of market dominance does not constrain rail rates to reasonable levels, the competition will not be effective within the meaning of the statute and market dominance should be found even if the AAR petition is granted. However, in the latter hypothetical, litigation costs and delays are likely to be far greater, along with burdens on the shipper and Board, and many shippers who can barely afford rate cases today may be forced to pay unlawful rail rates and lose revenues or business.

For the foregoing reasons, ARC, et al. urge the Board to deny AAR's petition.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that I have this 14th day of January, 2013, caused copies of the foregoing document to be served on all parties of record by first-class mail.

John M. Cutler, Jr.

S:ARC/EP 717 Reply in Opposition to AAR Petition