

BEFORE THE
SURFACE TRANSPORTATION BOARD

EX PARTE NO. 715

233628

RATE REGULATION REFORMS

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REBUTTAL COMMENTS 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

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As in their opening comments in this proceeding, the railroads in their replies argue for the most part that the status quo should be preserved. To the extent that the railroads put forward any “reforms,” they are designed to exacerbate obstacles faced by captive shippers seeking relief from unreasonable rail rates. ARC, et al. urge the Board to reject the railroads’ arguments.

It should surprise no one when monopoly railroads claim that the best way to reform rate regulation is to have less of it. This is the perennial position of executives, lawyers, witnesses and lobbyists for railroads, most of which support economic regulation only to the extent that it involves barriers to competition.

After thirty years of mergers and acquisitions, Class I railroads face little competition from each other, and paper barriers and the economic weakness of short lines have minimized competition by Class II and III railroads. Moreover, when Class I railroads are able to compete, they often decline to do so. Accordingly, minimizing effective rate regulation is at the top of most major railroads’ priority lists.

The situation is reversed for captive shippers. Though captive shippers depend on railroads for essential transportation service, they too often find themselves with no alternative but to accept high rates and charges, poor service quality, and responsibility for costs and burdens formerly borne by railroads.

Though the Act appears to offer remedies, the practical effect of decisions made years ago by the ICC at a time when railroads were found to be well short of revenue adequacy (under ICC standards) has been to render such remedies more theoretical than real. During the 16-year period since the STB replaced the ICC, railroad financial health has continued to improve, to the point where most shippers believe the Class Is are earning higher profits than necessary to at-

tract capital, i.e., they are more than revenue adequate. However, little has changed on the regulatory front to rein in abuses of railroad market power.

No wonder the railroads defend the status quo. It is so hard for shippers to obtain relief that monopoly railroads are essentially unregulated, though they are quick to point to the STB as a reason for preserving their antitrust immunity. Shippers, meanwhile, face the worst of both worlds because of too little effective regulation and too little effective competition.

In their Joint Reply Comments, CSX and NS accuse ARC, et al. of calling for more effective rate regulation based on nothing more than the subjective determination of shippers that their rail rates are excessive. This charge is a corollary of the assertion by CSX and NS that a rail rate cannot be unreasonable unless it exceeds the stand-alone cost of the service in question.¹ There are several obvious problems with this argument.

First, while the stand-alone cost test, referred to in this proceeding as Full-SAC, has received judicial approval and has on occasion been applied in such a way as to afford relief to captive shippers, it is prohibitively expensive or otherwise unavailing for most shippers.

The Board assumes a litigation cost of \$5 million for Full-SAC rate cases.² Since no shipper is likely to spend \$5 million to recover \$5 million, Full-SAC makes economic sense only for captive shippers hoping for relief well in excess of \$5 million. If a captive shipper has a smaller dispute, Full-SAC offers no relief. Similarly, there are thousands of shippers that cannot bear \$5 million in legal and expert fees in addition to meeting their businesses' capital requirements. This problem is compounded when railroads impose rate increases that threaten to drive

¹ See their Reply Comments at 7: "Ultimately, the only rail rate reasonableness methodology that rests on sound economics is CMP and its SAC constraint."

² See Ex Parte No. 646 (Sub-No. 1), Simplified Standards for Rail Rate Cases, decision served September 5, 2007 at page 30. The \$5 million estimate was to be indexed for inflation and today's estimate would be higher.

shippers out of business during the pendency of STB rate litigation, as is all too often the case. Full-SAC rate cases can take years to resolve, and many shippers cannot wait that long for relief.

It may be suggested that railroad self-interest will prevent such high rates, but this thinking amounts to substituting assumptions about enlightened monopoly behavior for the statutory guarantee that rail rates on captive traffic “must be reasonable.” 49 U.S.C. § 10701(d)(1). More fundamentally, railroads are interested in maximizing the freight they haul, not the number of shippers they serve. Reducing the number of grain elevators served, for example, may be desirable for a railroad which subsequently transports the same amount of grain between fewer points.

Of course, the number of origins and destinations also affects the viability of the Full-SAC remedies that CSX, NS and other major railroads regard as the only legitimate limit on their pricing. Full-SAC plainly works most effectively in cases involving tens of millions of dollars, a shipper complainant able to bear very high rates for several years, and a manageably small stand-alone railroad. For shippers who must sell to or buy from 20 or more destinations or origins, the cost of designing a SARR quickly becomes prohibitive even when such a SARR, if it could be designed, would show that the challenged rates are far higher than stand-alone cost.

In addition, it must be remembered that the railroads have worked hard for many years to weaken the effectiveness of the only remedy they regard as acceptable. One approach to achieving this result has taken the form of fighting to limit or eliminate reliance on cross-over traffic, even though it has been recognized since CMP was adopted that “[w]ithout grouping, SAC would not be a very useful test, since the captive shipper would be deprived of the benefits of any inherent production economies.”³ To the extent the railroads’ effort succeeds, even shippers with deep enough pockets to afford SAC may get no relief.

³ Coal Rate Guidelines, Nationwide, 1 I.C.C. 2d 520, 544 (1985).

SAC has also been undermined by gaming, with rates set so high that the percentage reduction method of allocating relief meant railroads found in SAC cases to have charged unlawful rates were allowed to keep most of what they charged. See Ex Parte No. 657 (Sub-No. 1), Major Issues in Rail Rate Cases, decision served October 30, 2006, at 15-16, where the Board adopted changes intended to reduce gaming.

Of course, the simplest way to render SAC ineffective is to keep driving up its cost and complexity. This the railroads have also done, to the extent that many shippers are deterred from bringing cases after they learn what is involved, and how much time, money and effort will need to be expended dealing with discovery, market dominance and rate reasonableness issues.

Simplified SAC was intended to address these shortcomings in Full-SAC, but the Board's arguably good intentions have not produced benefits for shippers. ARC, et al. believe the Board has always underestimated SSAC litigation costs. Just analyzing and costing the existing traffic base of the defendant railroad is burdensome and expensive. SSAC will be even more costly if the Board adopts the changes it has proposed in this proceeding, with the result that shippers' recourse to regulatory remedies will be restricted at a time when relief needs to be expanded. SSAC has not been an effective constraint on rail rates in past years and is less likely to be effective if modified as the Board proposes, even assuming the relief cap is eliminated.

The foregoing discussion omits other, more indirect ways in which the railroads have managed to stack the regulatory deck in their favor, including revenue adequacy standards that ignore the financial strength obvious to Wall Street, the railroads' virtually unchecked ability to shift costs and burdens to captive shippers, their refusal to compete with each other or with short lines, their contracts of adhesion, etc. These issues may be beyond the scope of this proceeding, but should be remembered as the Board considers rate regulation reforms.

It is against this background that the comments of ARC, et al. must be judged. Our point is not that STB rate regulation must be reformed because the captive shippers we represent “feel” their rates are too high on some subjective level. It is rather that STB rate regulation as it exists today provides no effective relief, which is the same thing as providing no relief, for thousands of captive shippers. For captive shippers paying rates well above 180% of variable cost, who nevertheless cannot afford to bring Full-SAC or SSAC rate cases, the fact that courts have approved these methodologies as economically respectable and as reasonable under the statute provides no consolation. A great deal of attention has been paid to reasonableness standards that are, at best, workable for only a small minority of captive shippers, while the majority of captive shippers are effectively remediless.

In any event, Full-SAC and SSAC (and Ramsey Pricing) are tools (however imperfect) for preventing unreasonable differential pricing. But differential pricing is intended to permit railroads to achieve revenue adequacy, and should be constrained once that goal is attained. ARC, et al. recognize that it may be necessary to preserve some established differential pricing even after all Class I railroads are recognized to be revenue adequate, so there may be a place for SAC - based remedies in STB rate regulation for the foreseeable future. However, it is well-established under Constrained Market Pricing that further differential pricing of captive traffic, i.e., further rate increases for captive shippers, should not be allowed merely so railroads may earn revenues providing returns in excess of the cost of capital. Coal Rate Guidelines, Nationwide, supra, 1 I.C.C. 2d at 536.⁴

⁴ See also 1 I.C.C. 2d at 535-536: “In other words, captive shippers should not be required to continue to pay differentially higher rates than other shippers when some or all of that differential is no longer necessary to ensure a financially sound carrier capable of meeting its current and future service needs”.

Assuming Full-SAC and SSAC served their purpose as constraints on monopoly railroads' ratemaking during the years of revenue inadequacy (and ARC, et al. believe far too few shippers have been well-served by these methodologies), the era of primary reliance on SAC-based remedies may be ending. If so, the Board should devote more attention to new approaches, and less attention to refining stand-alone cost for the dwindling number of shippers that can afford to bring SAC cases.

The Three Benchmark test is better than nothing, or than Full-SAC and SSAC as the only options, and raising the Three Benchmark relief cap to \$2 million is better than leaving it at just over \$1 million. However, these are inadequate responses to a growing national problem. STB rate regulation offers little or no hope to most captive shippers paying rail rates with R/VC percentages far above jurisdictional levels. The Three Benchmark test is too difficult to meet, and too easily neutralized by market dominant railroads, to be the only answer to the statutory requirement for "a simplified and expedited method for determining the reasonableness of challenged rail rates in those cases in which a full stand-alone cost presentation is too costly, given the value of the case" 49 U.S.C. § 10701(d)(3). Three Benchmark is, at best, a way of addressing exceptionally high rail rates charged to a handful of shippers unable to afford SAC or SSAC. What is needed is a remedy that is not limited to rare "outliers" but will help when larger numbers of captive shippers must pay too much.

CSX and NS are joined by UP, BNSF and AAR in opposing more effective rate regulation, but it is particularly offensive for CSX and NS to contend that the regulatory status quo is too generous to captive shippers. No other railroads have contended that, instead of raising the relief cap for Three Benchmark cases, the Board should reduce the relief cap from \$1.2 million to \$200,000. This is clear confirmation that the goal is to reduce to a minimum the number of

shippers able to challenge rail rates as unreasonably high. As for NS, it appears to be the railroad that has, to the greatest degree, exceeded revenue adequacy (even under the too conservative standards of the STB) in most of the last 10 years.

Assuming that it made sense to give the benefit of the doubt to financially weak railroads in the years following the 4R Act and Staggers Act, when current rate, practice and competition policies were adopted, a new look at those policies is long overdue. The major railroads are financially strong and their future is bright. Established rate regulation and competition policies and current regulation of unreasonable railroad practices no longer serve the public interest, assuming they ever did.

In this proceeding, there are limits set by the APA on how much progress the Board can make. ARC, et al. urge the Board to eliminate any relief cap in Three Benchmark as well as SSAC cases, and to increase the interest rate on reparations for those shippers who are awarded rate relief, for reasons set forth above and in our previous comments. The Board should not adopt proposals (its own or the railroads') to restrict the use of cross-over traffic. Nor should it adopt its proposed Alternative ACT procedure, or its proposed RPI changes, which would weaken Full-SAC and SSAC remedies that already cost too much and do too little.

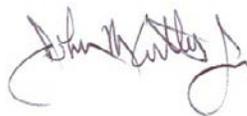
Looking beyond this proceeding, the Board's goal of improved regulation is commendable, but better ways of achieving that goal are needed. Among other initiatives, the Board should consider how to implement its long-awaited revenue adequacy constraint, and should intensify its efforts to ensure that small and isolated shippers, including shippers of agricultural commodities represented by ARC, et al., are not accorded second-class regulatory status, with such limited

recourse that the strongest railroads are encouraged to charge the most and do the least for their most vulnerable customers.

Respectfully submitted,



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CERTIFICATE OF SERVICE

I hereby certify that I have this 4th day of January, 2013, caused copies of the foregoing document to be served on all parties listed on the STB service list by first-class mail, postage prepaid.



John M. Cutler, Jr.