BEFORE THE
SURFACE TRANSPORTATION BOARD

DOCKET NO. EP 722
RAILROAD REVENUE ADEQUACY

SUPPLEMENTAL COMMENTS OF

ALLIANCE FOR RAIL COMPETITION
MONTANA WHEAT & BARLEY COMMITTEE
USA DRY PEA AND LENTIL COUNCIL
COLORADO WHEAT ADMINISTRATIVE COMMITTEE
IDAHO BARLEY COMMISSION
IDAHO GRAIN PRODUCERS ASSOCIATION
IDAHO WHEAT COMMISSION
MONTANA FARMERS UNION
NORTH DAKOTA GRAIN DEALERS ASSOCIATION
NEBRASKA WHEAT BOARD
OKLAHOMA WHEAT COMMISSION
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I. INTRODUCTION

Pursuant to the decision served by the Board in this proceeding on July 30, 2015, Alliance for Rail Competition and the other captive shipper interests listed on the cover ("ARC, et al.") hereby submit these post-hearing further comments.

Thirty-five years ago, the ICC adopted Constrained Market Pricing, with its four constraints – SAC, revenue adequacy, management efficiency and phasing. Since then, CMP has been cited consistently by the ICC, the STB and the courts as the basis for regulation of maximum reasonable rail rates.

In 1996, pursuant to a Congressional mandate, the Board attempted to address the fact that only one of the CMP constraints – SAC – was operative, leaving the vast majority of rail rates effectively unregulated. However, Simplified SAC and Three Benchmark, which were adopted to fill the regulatory gap, have proved to be of little use to captive rail customers.

All but a handful are unable to afford SAC, for which a litigation budget of $5 million or more must be considered a prerequisite. SSAC, which costs at least $1 million and may cost two or three times that much, necessarily produces higher rates than SAC (even though there is no economic justification for rates exceeding stand-alone cost). Three Benchmark is even less helpful. In US Magnesium, the "winning" shipper got relief only to the extent that rates could not exceed 350% of variable cost, and the R/VCcomp benchmark serves to preserve differential pricing and protect regional rate structures.

It is for these reasons that ARC, et al. have called, before the Board and before Congress, for alternatives to the regulatory status quo, including arbitration in general and final offer arbitration in particular. Final offer arbitration has been successful in Canada for many years, and its availability has enabled countless shippers to negotiate reasonable resolutions of rate disputes with railroads, something captive shippers in the US can do rarely.[1] We note that Canadian-style final offer arbitration was put forward as a promising option in the recent Report of the TRB, <u>Modernizing Freight Rail Regulation</u>. Implementation of an effective revenue adequacy constraint represents another means of addressing serious shortcomings in current maximum rail rate regulation.

If there is a silver lining to the status quo, it is that the barriers to regulatory recourse that made shipper protections more apparent than real have helped the major railroads gain unprecedented financial strength. They consolidated, abandoned trackage and reduced workforces, made shippers absorb costs and

[1] That Canadian railroads complain about final offer arbitration is understandable. They are envious of the ability of US railroads to charge rates on captive traffic that are two or three times higher with little or no exposure to legal remedies.

burdens, and raised rates, with rates increasing more on captive than on non-captive traffic.

As the recent TRB Report also found, during the period 2002-2013, rail rates on grain and oilseeds went up 80% for smaller shipments (less than 50 cars), and 70% for larger shipments, more than for any other commodity except coal. The TRB also found that, by 2013, rates for smaller volumes of grain were some 35% higher than for larger volumes of 50 cars or more. It should come as no surprise that the result is increasingly frequent findings that railroads are meeting <u>and exceeding</u> revenue adequacy, even under the Board's extremely conservative standards.

In light of this long-awaited realization of one of the key goals of the Staggers Act, the time has come for a new look at the revenue adequacy constraint of CMP. The comments in this proceeding present a range of possibilities. The railroads, of course, argue that attaining or exceeding revenue adequacy, whenever it occurs, is no basis for any change in the regulatory status quo. They argue for abandoning the revenue adequacy constraint as an unlawful barrier to continued (i.e., permanent) differential pricing of captive traffic. As will be seen, this argument is untenable.

All shipper parties agree that, at a minimum, future rate <u>increases</u> imposed by long-term revenue adequate railroads on captive traffic should not be differentially higher for captive traffic than for non-captive traffic, absent exceptional circumstances. Support for this position comes from Coal Rate Guidelines, Nationwide, 1 I.C.C 2d 520, 536, footnote 36 (1985).[2]

Certain shippers call for a third approach, under which the revenue adequacy constraint could also be applied to differentially higher base rates that long-term revenue adequate railroads impose on captive traffic. This aspect of the revenue adequacy constraint is generally based on the principle that captive shippers "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." Coal Rate Guidelines, 1 I.C.C. 2d at 535-36.[3] These shippers offer various ways of implementing this aspect of a revenue adequacy constraint, which may need to be tested and developed in rate cases (if not disallowed). The rationale is that the principle just quoted cannot be achieved through a revenue adequacy constraint that applies only to future rate increases.

2 "A railroad seeking to earn revenues that would provide it, over the long term, a return on investment above the cost of capital would have to demonstrate, with particularity: (1) a need for the higher revenues; (2) the harm it would suffer if it could not collect them; and (3) why the captive shippers should provide them."

3 Though the railroads contend that this principle is an anachronism, it was quoted by the Board as recently as last year. See Docket NOR 42125, DuPont v. Norfolk Southern, decision served March 14, 2014 at pages 20-21.

Notably, ARC et al. do not seek to constrain the railroads' pricing of unregulated traffic. We regard such pricing freedom as the best means of preserving railroad revenue adequacy while constraining differential pricing by revenue adequate railroads. Both of these goals can be achieved, and the competitive disadvantages captive shippers face vis-à-vis their non-captive competitors should be subject to challenge to the extent that long-term revenue adequacy is being exceeded. Differential pricing distorts markets and injures captive shippers. As ARC Witness Whiteside observed at the July 22 hearing, you don't keep giving transfusions once the patient has been restored to health.

Despite ICC and STB rail rate regulation that has successfully served the goal of increasing major railroads' financial strength, the railroads are still not satisfied. Notwithstanding glowing reports to shareholders of their extraordinary profitability, they will not acknowledge that they have achieved or exceeded revenue adequacy, and they demand that the Board adopt replacement cost accounting. Even that would not, in their view, provide any basis for any reduction in differential pricing of any captive traffic, unless the shipper wins a SAC case.[4]

[4] Some railroads suggest that SAC could be made less expensive, but the Board should be skeptical of such suggestions. In Ex Parte 347 (Sub-No.2), Rate Guidelines – Non-Coal Proceedings, 1 STB 1004 (1996), the railroads urged adoption of an approach the Board referred to as "AAR-SSAC". After testing that approach, the Board concluded that "rates could have been raised to an r/vc level of 5,000% and still have been deemed reasonable." 1 STB at 1016.

As the beneficiaries of 35 years of preferential treatment under CMP, the railroads cannot now claim with any legitimacy that CMP should be rewritten to make it <u>even more</u> favorable to monopoly railroads. Yet they ask the Board to eliminate the two constraints – the revenue adequacy and management efficiency constraints – that hold the most promise of helping <u>all</u> captive customers, not just those who can afford to bring a SAC case. None of the railroads' arguments for such major surgery on CMP have merit.

II. <u>THE BOARD HAS LEGAL AUTHORITY TO IMPLEMENT THE REVENUE ADEQUACY CONSTRAINT</u>

Let us consider first the argument that it would be unlawful for the Board to implement the revenue adequacy constraint, i.e., that CMP is inconsistent with the Board's governing statute. This was not the railroads' position in the original judicial review of CMP. In <u>Consolidated Rail Corp v. United States</u>, 812 F.2d 1444 (3d Cir. 1987), the court concluded "we are convinced that the ICC's basic approach on revenue adequacy is consistent with the 4R and Staggers Acts." In so holding, the court was agreeing with the position of the railroads, which had supported CMP (including revenue adequacy) but had raised questions on appeal about implementation of SAC and management efficiency that the court found premature.

More fundamentally, consider 49 USC § 10704(a)(2). Congress there provided "The Board shall make an adequate and continuing effort to assist those carriers in attaining revenue levels prescribed under this paragraph". Two points should be made in this regard. First, Congress directed the Board to help railroads to attain revenue adequacy. The Board is under no obligation to help railroads exceed revenue adequacy. (See also 49 USC §10101(6), calling for reasonable rates on captive traffic where revenue adequacy is exceeded.) Second, the revenue adequacy Congress wanted railroads to attain is revenue adequacy under the Board's revenue adequacy standards, not some other standards the railroads would prefer. [5]

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[5] In this regard, the issue of deferred taxes arose at the July 22-23 hearing, and the Board should consider the ICC's discussion of this issue in Standards for Railroad Revenue Adequacy, 3 I.C.C. 2d 261, 272-73 (1986):

> [W]hen we allowed the railroads to treat deferred taxes as an expense without a corresponding reduction in the net investment base we allowed the railroads a double benefit: they were allowed to demand rates sufficient to cover tax liabilities not yet paid and also to collect additional profits on the funds held on reserve to pay such deferred taxes. We now see this as an unfair distortion of the railroads' revenue adequacy that shippers have long argued. **** Indeed, because captive shippers are subject to the same degree of monopoly power as the customers of other regulated utilities, it seems appropriate that the railroads be evaluated in the same manner as such utilities in their dealings with captive shippers. While railroads are not guaranteed any minimum rate of return on their competitive traffic, they are in a position, in most cases, to set and maintain rates that allow for a reasonable return on their captive traffic. To the extent that they rely on differential pricing to justify higher rates from captive shippers than those charged on competitive traffic, they should be expected to incur the regulatory burdens that other regulated natural monopolies incur.

The railroads also argue that differential pricing was a goal Congress sought independent of concerns about railroad revenue adequacy. See, however, Potomac Electric Power Co. v. ICC, 744 F.2d 185 (D.C. Cir. 1984), which involved the version of CMP that was to be adopted in Coal Rate Guidelines. The court of appeals discussed the legislative history of the Staggers Act as follows: "The conference report on that Act stated that the 'over-all purpose is to provide, through financial assistance and freedom from unnecessary regulation, the opportunity for railroads to obtain adequate earnings to restore, maintain and improve their physical facilities, while achieving the financial stability of the national rail system'."[6]

The court went on the provide the ICC's interpretation of the statute: "The Commission pointed out that in the Staggers Act, Congress recognized the need for this system of rates, known as 'differential' or 'demand based' pricing, if the railroads are to achieve the revenue adequacy that Congress intended them to accomplish." The court also said it had recognized the validity of differential pricing "since this method of rate-making is pertinent to the objective of an

[6] At the recent hearing, AAR Witness Hamberger cited the pending STB reauthorization bill, S. 808, as evidence that Congress supports railroad infrastructure investment. As the foregoing quotation shows, a strong rail system has been a goal of Congress since the Staggers Act became law, but it does not follow that differential pricing should continue unchanged after railroads attain or exceed revenue adequacy. Moreover, the Report of the Senate Commerce Committee accompanying S. 808 warns that Congress did not intend S. 808 to modify the Board's revenue adequacy policies.

adequate over-all level of earnings." 744 F.2d at 192-94. The statute and case law thus do not support the railroads' claim that Congress called for differential pricing as a stand-alone goal and not as a means to achieve railroad revenue adequacy.

See also Coal Rate Guidelines, 1 I.C.C 2d at 547 (emphasis added):

> The revenue adequacy constraint is a limit on the total revenues a carrier can collect. The adjustments to eliminate plant and reduce operational inefficiencies reduce the costs which may be recovered through differential pricing. The adjustments to account for revenues lost through inefficient pricing practices also reduce the allowable differential pricing. Through these steps, the total amount of permissible differential pricing is determined.

During much of the period between 1980 and the recent Board findings of revenue adequacy for several railroads for several years, railroads seldom failed to cite revenue inadequacy as an argument against more effective regulatory recourse for captive shippers. Many examples could be cited, but see the Comments filed October 24, 2006 by the AAR in EP 646 (Sub-No.1), Simplified Standards for Rail Rate Cases, at page 5: "As the AAR pointed out in its recent comments in Major Issues in Rail Rate Cases, differential pricing remains critical to achieving sustained revenue adequacy."

The railroads cannot have it both ways. Assuming for the sake of argument that being short of revenue adequacy could justify railroad differential pricing that was subject to no effective regulatory recourse (except for shippers able to afford

SAC), then attaining or exceeding revenue adequacy should be relevant to the Board's consideration of captive shipper claims of excessive differential pricing. The old "heads the railroads win, tails the shippers lose" approach to maximum reasonable rate regulation must change.

In 2001, when the DC Circuit reviewed and affirmed the STB's only application of the revenue adequacy constraint, the court rejected three arguments relevant to this proceeding. The arguments were that the Board could not apply the revenue adequacy constraint, that it should have applied the SAC test, and that it was required to use replacement cost accounting. <u>CF Industries v STB</u>, 255 F.3d 816. The fact that the carrier was a pipeline rather than a railroad does not affect the court's holding of statutory compliance.

At the recent hearing, it was suggested by the AAR that the pipeline's use of across the board price increases might have made application of the revenue adequacy constraint appropriate in the <u>CF Industries</u> proceeding. This factor has no bearing on the court's construction of the applicable statute and agency precedents from non-pipeline proceedings, including <u>Coal Rate Guidelines</u> and <u>Standards for Railroad Revenue Adequacy</u>. In any event, rail rates on grain and possibly other rail rates are subject to similar across the board increases.

The revenue adequacy constraint does not violate 49 USC 10707(d)(2), which prohibits presumptions of market dominance or rate unreasonableness when R/VC ratios are above 180. And Section 10701 does not preclude requiring revenue adequate railroads to justify continued differentially higher rate increases on captive traffic.[7] In any event, the initial burden would be on the shipper to establish captivity, invoke the revenue adequacy constraint and show that the defendant railroad was violating it. Then, in defense of a challenged differentially higher rate increase, the railroad would have to show why the increase should be permitted.

It would make no sense to require a shipper to bear the burden of showing, with particularity, a defendant railroad's need for differentially higher revenues, the harm it would suffer if it could not collect them, and why the captive shipper should provide them. And if those are not the tests, how should a captive shipper challenge differentially higher rate increases? SAC, SSAC and Three Benchmark were not designed for this task.

In an analogous situation, the ICC decided in 1985, the same year it decided <u>Coal Rate Guidelines</u>, that in market dominance determinations, shippers would have the burden of proof as to inter and intra-modal competition, while the railroad

[7] Prior to enactment of the ICCTA, the Interstate Commerce Act did contain, in 49 USC § 10701a, Standards for Rates for Rail Carriers, a provision allocating the burdens of proof to shippers and railroads in rail rate cases, but that provision was deleted in ICCTA.

would have the burden of proof as to product and geographic competition. See Product and Geographic Competition, 2 I.C.C. 2d 1.

The Board clearly has legal authority to implement the revenue adequacy constraint. The real question is how the constraint should work.

III. FOUR YEARS IS ENOUGH FOR LONG-TERM REVENUE ADEQUACY

ARC, et al., agree with WCTL that revenue adequacy over a four year rolling average is enough for revenue adequacy to be adjudged long term. And, as AECC points out, the 2010 Christensen Associates report found no problems with access by major railroads to adequate capital going back many years. That said, it is unlikely that long-term revenue adequacy determinations will be made this year or even next, given the need for further proceedings and further notice and comment before the revenue adequacy constraint can be applied.

ARC, et al. are confident that further analyses in the EP 552 series, Revenue Adequacy Determinations, will continue to show multiple railroads earning revenues not just at, but well above, revenue adequacy. It should not take much longer for the Board to have enough years of revenue adequacy to satisfy any reasonable definition of "long-term".

A more serious concern will be whether railroads might anticipate implementation of a revenue adequacy constraint and respond by (1) attempting to "game" the Board's revenue adequacy calculations, or (2) attempting to raise as many captive customers' rates as high as possible prior to the time when differentially higher rate increases for captive customers might be constrained. The Board should be vigilant in addressing any such actions.

The question of how to implement the revenue adequacy constraint needs to be considered in two parts.

IV. THE REVENUE ADEQUACY CONSTRAINT SHOULD APPLY TO RATE INCREASES

The first part involves constraining future rate increases by revenue adequate railroads, by disallowing differentially higher rate increases on captive traffic than on non-captive traffic, absent exceptional circumstances. ARC, et al. and other shipper parties strongly support such a constraint, consistent with the discussion in Coal Rate Guidelines, 1 I.C.C. 2d 520, 534-36, and footnote 36.

The revenue adequate railroad whose differentially higher rate increase is challenged by a captive shipper as violating this constraint should bear a heavy burden in attempting to justify any exception. The railroads cannot seriously contend that this aspect of the revenue adequacy constraint, so long anticipated, will significantly affect their revenues or their ability to invest in necessary infrastructure improvements.

As for suggestions of service problems if the revenue adequacy constraint finally becomes applicable, there could be no justification if a railroad were required to impose non-differential rate increases on captive and non-captive shippers, and then attempted to retaliate against the captive shipper with service cutbacks. Such conduct should invite an unreasonable practice complaint or other vigorous regulatory responses.

Revenue adequate railroads should be more likely, not less likely, to provide good service, even if revenue adequacy does not guarantee honest, economical and efficient management. Unregulated monopolies can be guilty of service failures regardless of their revenue levels, and may be more likely to fall short of meeting customer needs, given the absence of disincentives.

It is not clear how the management efficiency constraint would apply to revenue adequate railroads. That constraint has been interpreted to serve only to offset the amount by which a railroad falls short of revenue adequacy. However, if it is not applicable, the Board has other tools available to address poor service, and increased differential pricing of captive traffic should rarely, if ever, be seen as an appropriate remedy.

It must also be remembered that a revenue adequacy-based constraint on future differential price increases would affect relatively little traffic. It would not apply to rate increases on captive traffic that match rate increases on non-captive traffic. Many railroads claim that they engage in such pricing. Only long-term revenue adequate railroads would be subject to the constraint, and most of their customers could not invoke it. According to the most recent STB data, relatively few shippers pay rates exceeding 180% of variable cost.

Many of those shippers with R/VCs above 180% ship under contracts or ship exempt goods. Others pay rates at or only slightly above 180% of variable cost or ship low volumes, making rate litigation uneconomical, especially since rates cannot be ordered reduced below 180% of variable cost. Other shippers would be unable to show qualitative market dominance, or would not want to shoulder the necessary litigation burdens, despite having grounds for relief. Accordingly, railroad claims of being driven below revenue adequacy due to rate cases seeking to limit future differential rate increases are not credible.

This is especially true in light of evidence by railroads of their increasing ability (which comes as no surprise to captive shippers) to raise rail rates on nonregulated traffic. AAR Witness Kalt says revenues from regulated shipments have been flat, while "revenues from competitive traffic have generated an additional $2.5 billion in contribution above variable costs – half of the overall increase from 2008-2012." Kalt Opening V.S. at 37.

Remarkably, some railroads argue that this is a bad thing, as if captive customers should make disproportionately high contributions to railroad revenues forever. But in its October 30, 2006 decision in EP 657 (Sub-No. 1), Major Issues in Rail Rate Cases, aff'd. 556 F.3d 770 (DC Cir. 2008), the Board cited the "important principle that a railroad should recover as much of its costs as possible from each shipper before charging differentially higher rates to its captive customers." STB decision at 12.

V. APPLYING THE REVENUE ADEQUACY CONSTRAINT TO BASE RATES SHOULD ALSO BE AN OPTION

At a minimum, then, the Board should implement a revenue adequacy constraint that protects captive shippers against unjustifiable differentially higher rate increases by long-term revenue adequate railroads. There is, however, more to the issue. Specifically, the revenue adequacy constraint should also provide for challenges seeking to constrain continued differential pricing of captive traffic that occurs through means other than future differentially higher rate increases. In Coal

Rate Guidelines, 5 I.C.C. 2d at 535-36, the revenue adequacy constraint was characterized as follows: "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."

A constraint like that described above, which would prevent only future differentially higher rate increases on captive traffic by revenue adequate railroads, would help prevent further differential pricing of captive traffic from exacerbating the current competitive disadvantages borne by captive customers vis-a-vis non-captive customers. However, it would not remedy those current competitive disadvantages. Put another way, those disadvantages might not increase, but they also would never decrease, no matter how high the level of railroad revenues.

As a result, captive customers would continue to pay differentially higher base rates than other shippers even after the attainment of long-term revenue adequacy made some or all of that differential unnecessary for the railroad. To this extent, a limited revenue adequacy constraint allowed only as to future rate increases would fall short of constraining rail rates as called for in Coal Rate Guidelines.

The railroads argue that the Board should not risk driving railroads below revenue adequacy. Many shippers would agree, but too many rate cases and too many prescriptions of reductions of rail rates on captive traffic are hardly a pressing concern today. Over-regulation of rail rates has not been a problem since the 1970s. [8]

Why should the Board refuse to allow challenges to differentially higher base rates on captive traffic if the railroad could eliminate the differentials, charge similar rates to similarly situated captive and non-captive shippers, and still earn revenues well above levels found adequate by the Board? Such a situation better serves the public interest than does a permanent disadvantage for businesses whose only "deficiency" is being captive to a single railroad.

The railroads have argued that the goal of STB rail rate regulation should be rates on captive traffic that mimic rates charged in the competitive marketplace. As AAR Witness Kalt explained at the recent hearing, the goal should be to push prices to levels they would have if there were competition. This also appears to be the ideal espoused in the TRB report (See pages 91-92 and Appendix B).[9]

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[8] In its 1996 decision in Rate Guidelines – Non-Coal Proceedings, the Board noted and rejected the AAR's prediction "that the multiple R/VC Benchmarks approach would lead to a flood of successful rate complaints that would jeopardize the health of the Railroad industry." 1 STB at 1051. Since then, the railroads' financial health has improved dramatically.

[9] For all their talk of "sound economic principles", it is not clear that the railroads really want rates on captive traffic to match rates on non-captive traffic. Rather, their equivocation on the comparability of captive and non-captive shippers suggests that what they really want is differential pricing of captive traffic limited only by SAC. Only a railroad lawyer or economist could regard rate cases that cost $5 million per party and take 3-5 years as the best way of establishing pricing that mimics competition.

A revenue adequacy constraint that only applies to reduce most differentially higher future increases in rates on captive traffic cannot mimic truly competitive outcomes. To achieve this goal, we need revenue adequacy constraint that goes further, and also enables captive shippers bringing rate challenges to seek reductions in differentially higher base rates where some or all of the differential is no longer needed because a railroad's revenues significantly exceed long-term revenue adequacy.

There would still be a bias in the railroad's favor. As noted above, relatively few captive shippers are able to seek such relief, and many who could file rate cases with some hope of success will never take that step. In addition, the jurisdictional threshold of 180% of variable cost means that significant differential pricing for railroads is built-in, and will always be beyond the reach of regulatory remedies. However, this fact is not a reason to avoid fuller implementation of the revenue adequacy constraint. On the contrary, it is a reason to discount the railroads' alarmist claims of financial disaster if there is any change in the status quo.

Various shipper groups have put forward various ways of implementing the revenue adequacy constraint. In EP 665 (Sub-No. 1), Rail Transportation of Grain, Rate Regulation Review, ARC, et al. made proposals to deal with these issues, which we reiterated in our comments in this proceeding. Basically, we recommend a Two Benchmark approach that eliminates the problematic R/VCcomp benchmark, for three reasons. First, the R/VCcomp benchmark is by far the most contentious benchmark, and the most costly to develop and defend. Second, it is designed to reflect differential pricing, a questionable goal for revenue adequate railroads. And third, it is subject to manipulation by railroads like BNSF and UP, which have market dominance over entire states and regions, and are therefore able to control comparables.

The Board can and should pursue a revenue adequacy constraint that reins in differentially higher future rate increases on captive traffic, and also offers the possibility of challenges to excessive differential pricing in base rates by railroads whose rates are now, and will continue to be, above revenue adequacy over the long term. As the record in this proceeding shows, SAC, SSAC and Three Benchmark, in their current form, will do too little to restrict differential pricing by revenue adequate railroads for the vast majority of captive shippers.

The Board has asked whether this problem might be alleviated through expanded competitive access remedies. The answer is yes, but only where expanded access, through switching or otherwise, actually produces effective competition, as opposed to the appearance of competition. And if that happened, no rate case would be filed.

The railroads would have the Board believe that a shipper with access to two railroads should never be able to show qualitative market dominance, no matter how high its rail rates. The statute and the case law show why such claims are false. In its CF Industries decision upholding the Board's application of the revenue adequacy constraint, the DC Circuit cited a number of agency and court decision holding that, for rates above 180% of variable cost, the statutory test of captivity is the absence of effective competition. Effective competition does not mean having access to a second railroad. Effective competition is competition that keeps rail rates reasonable.

ARC, et al. support action in EP 711 to improve access remedies that have long been provided for in the statute. However, such remedies, even if made available, will not obviate the need for other regulatory remedies including rate remedies under CMP. Many captive shippers are simply too far from any second railroad, especially in Montana and other large western states, for access remedies to produce effective competition. And even if a second railroad were able to provide alternative service subject to a reasonable access fee, the result would not be effective competition if the two railroads elected not to compete on price, or if they both charged excessive rates.

The railroads like to cite contestable market theory, under which the possibility of a new entrant might keep an incumbent from charging too much. Like access remedies, contestable market principles can work, but they can also be used in an attempt to shield abuses of market power from regulatory remedies. In EP 705, Competition in the Railroad Industry, we learned of situations in which a shipper captive to one railroad built out to another, at great expense, only to find that the second railroad was unwilling to compete with the first.

The balance between STB promotion of railroad revenue adequacy and protection against excessive rates for captive shippers needs to be adjusted to meet changing realities. While new access remedies are a step in the right direction, they are not a substitute for implementation of an effective revenue adequacy constraint.

Finally, ARC Witness Whiteside was asked at the July 22 hearing about the vulnerability to excessive differential pricing of shippers of agricultural commodities. As indicated in our comments in EP 665 (Sub-No.1), all captive shippers are entitled by law to reasonable rail rates, even if many arguably captive shippers are not currently subject to excessive rates. And, as noted above, the TRB report shows significant increases in grain rates in recent years, especially for grain shipments moving in shipments of under 50 cars.

One of the questions asked by the Board at the hearing centered on the magnitude of claims that wheat producers might mount in wheat rate cases from the Northern Plains. Data tying farm size and wheat production together with rail rate levels have not been gathered in any recent authoritative analysis we know of. However, estimates can be made utilizing current data. Taking Montana as an example, the sizes of wheat producers are estimated in studies by NASS, the National Agricultural Statistics Service of the USDA [10]. For Montana wheat the report lists 5,608 farms as the total number of farms, some of which are small "hobby farm/part time" operations. About 3,043 farming operations covering over 500 acres are listed, along with 1,874 farms exceeding 1,000 acres (33%). The majority of wheat production is grown on the largest farms. This 33% of farms ships the majority of wheat from Montana.

Other internal studies have shown that estimated rail wheat freight costs average about $150 million per year from Montana. This total freight cost number will vary year to year based upon variations in production, destinations, and origination patterns. If the 33% representing the largest farms move about 80% of the wheat, they are bearing about $120MM of the freight charges from Montana. Of course, there are some mega farms among the 33% that have over 10,000 acres, and their annual rail freight costs would be the highest in the state.

[10] The most recent relevant break down from NASS would be 2012 Census info, http://www.agcensus.usda.gov/Publications/2012/Full_Report/Volume_1,_Chapter_1_State_Level/Montana/st30_1_037_037.pdf,

Estimating claim amounts is extremely difficult, for several reasons discussed more fully in the Comments filed by ARC, et al. in EP 665 (Sub-No.1), Rail Transportation of Grain, Rate Regulation Review. These include standing issues, variations among the relief available depending on whether a rate case involves the SAC, SSAC or Three Benchmark approach, and URCS issues that affect R/VC percentages, with different impacts on larger and smaller volume shipments. See the Opening Comments filed by ARC et al. on June 26, 2014, and the Verified Statement of ARC Witness Fauth. Mr. Fauth also identifies wheat and corn movements with R/VC percentages above 300% in his Appendices GWF-3 and GWF-4 (Highly Confidential versions), though many shipments are lower-rated, at least under current costing.

These problems are another basis for the support of ARC, et al. for an effective revenue adequacy constraint, which would benefit captive shippers of agricultural commodities as well as other commodities moving at high rail rates.

VI. CONCLUSION

For the foregoing reasons and for reasons set forth in the comments previously filed by ARC, et al. in this proceeding, the Board should, in the near future, initiate further proceedings to allow the public to be heard on rules or policies proposed by the Board for implementation of the revenue adequacy constraint of Constrained Market Pricing.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that I have this 6th day of August, 2015, caused copies of the foregoing document to be served on all parties of record by mail or by electronic means.

Terry Whiteside