

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

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RATE REGULATION REFORMS

Joint Rebuttal Comments of

**The American Chemistry Council, The Fertilizer Institute,
The National Industrial Transportation League, Arkema, Inc., The Dow Chemical
Company, Olin Corporation, and Westlake Chemical Corporation**

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The American Chemistry Council, The Fertilizer Institute, The National Industrial Transportation League, Arkema, Inc., The Dow Chemical Company, Olin Corporation, and Westlake Chemical Corporation (collectively “Joint Chemical Companies”) hereby submit these Joint Rebuttal Comments in response to the Board’s Notice of Proposed Rulemaking in this proceeding served on July 25, 2012 (“Notice”). The Joint Chemical Companies also filed opening and reply comments on October 23, 2012 and November 7, 2012, respectively (“JCC Opening Comments” and “JCC Reply Comments”). These rebuttal comments are supported by the Joint Rebuttal Verified Statement of Thomas D. Crowley and Robert D. Mulholland, President and Vice President, respectively, of L.E. Peabody & Associates, Inc. (“Crowley/Mulholland Reb. V.S.”), who also submitted an opening verified statement in support of the JCC Opening Comments.

I. THE COMMENTS IN THIS PROCEEDING FAIL TO JUSTIFY ANY CROSS-OVER TRAFFIC RESTRICTIONS.

Various railroad interests submitted reply comments on the Board’s proposed cross-over traffic restrictions notable primarily for their failure to address issues presented in the JCC Opening Comments. The JCC Opening Comments made the following four arguments:

1. The Board has not actually identified any “disconnect” that creates a shipper “bias” in the allocation of cross-over traffic revenue. (JCC Op. at 9-16)
2. The proposed cross-over traffic restrictions would violate fundamental Stand-Alone Cost (“SAC”) principles. (JCC Op. at 4-5)
3. The proposed cross-over traffic restrictions would deny shippers effective access to regulatory remedies for unreasonable rates. (JCC Op. at 6-9)
4. The proposed cross-over traffic restrictions would severely bias the SAC analysis against shippers. (JCC Op. at 16-21)

Nearly all of the railroad parties focus their reply comments on the second and third points, with barely a mention of the first and last points, if they are mentioned at all. But the first point, by itself, challenges the very predicate for justifying any cross-over traffic restrictions, and the other points reinforce the conclusion that such restrictions would be a severe detriment to both the SAC analysis and the statutory requirement that rail rates must be reasonable.

A. No Participant in this Proceeding Has Identified the “Disconnect” That Allegedly Creates the “Bias” That Warrants Cross-Over Traffic Restrictions.

After two rounds of comments, no party has yet to even attempt to demonstrate the supposed “disconnect” that creates the alleged shipper “bias” forming the basis for the Board’s proposals to restrict the use of cross-over traffic. As detailed in the JCC Opening Comments, at pages 9-16, the explanation provided by the Board in the Notice is inaccurate and contradicts the Board’s own precedent.¹ The railroad parties in this proceeding merely parrot the Notice and offer no proof whatsoever of any disconnect, even in response to the JCC Opening Comments noting the lack of any disconnect. In fact, no party to this proceeding has demonstrated (or even attempted to demonstrate) that the alleged “disconnect” exists, much less that it creates “bias” in the cross-over revenue allocation methodology. *Crowley/Muholland V.S.* at 13. The Board

¹ *See also*, WCTL Op. Comments at 14-26.

must first demonstrate and quantify a bias before it makes drastic changes to the “well-established” and “indispensable” cross-over traffic device.²

The only railroad party to address this issue in any detail is BNSF Railway Company (“BNSF”); but BNSF merely repeats the same arguments in the Notice without responding to the critique in the JCC Opening Comments:³

The most obvious problem is that both ATC and MMM require the use of URCS system-average costs but complainants assume that a SARR will operate in a manner that allows it to avoid incurring some of those system average costs. Complainants typically assume that the SARR will operate as a “hook-and-haul” railroad and therefore will not incur costs associated with gathering carload traffic for placement on trains, switching carload traffic in yards, train assembly and disassembly, and delivery of cars to their final destination, among other costs incurred by the incumbent railroad to provide carload service. While the SARR avoids these costs for carload traffic, ATC allocates revenues as if the SARR did incur these costs and MMM assigns responsibility for stand-alone costs among shippers on the SARR, including carload shippers, as if the SARR incurred these costs.

BNSF Reply at 16. The foregoing quote does little more than paraphrase the Board’s Notice, at page 16, which was quoted at page 11 of the JCC Opening Comments. As the Joint Chemical Companies noted, the Board (and now BNSF) uses the Average Total Cost (“ATC”) methodology to judge the fairness of cross-over revenue divisions relative to the Stand-Alone Railroad’s (“SARR’s”) costs, rather than the incumbent railroad’s costs, despite the fact that such comparisons are contrary to Board precedent in *Major Issues*⁴ and *Western Fuels II*.⁵ Neither the Board nor BNSF has acknowledged this departure from precedent, much less

² See *Pub. Serv. Co. of Colo. v. Burlington N. & Santa Fe Ry.*, 7 S.T.B. 589, 601 (2004); *Western Fuels Assoc., Inc. v. BNSF Ry. Co.*, Docket No. 42088, slip op. at 11 (served Sept. 10, 2007) (“*Western Fuels P*”).

³ BNSF Reply at 16-18.

⁴ *Major Issues in Rail Rate Cases*, Ex Parte No. 657 (Sub-No. 1) (served Oct. 30, 2006).

⁵ *Western Fuels Assoc., Inc. v. BNSF Ry. Co.*, Docket No. 42088 (served Feb. 27, 2009).

attempted to justify it, even, as to BNSF, when prompted to do so by the JCC Opening Comments.

In the foregoing quote, BNSF also perpetuates the same error that it made in its Opening Comments and that the Board has made in the Notice. Both erroneously assert that ATC allocates revenue to the SARR for services that the SARR does not perform.⁶ In their reply comments, at page 3, the Joint Chemical Companies refuted that contention:

When the residual incumbent (or the SARR) interchanges, originates, or terminates cross-over traffic, URCS assigns a substantial premium for the gathering, switching, assembly and delivery activities performed at the interchange or terminal location. Contrary to the Board and railroad assertions emphasized above, URCS does not spread those costs across the both the on-SARR and off-SARR segments. Specifically, URCS assigns costs associated with terminal and interchange switching (including clerical and overhead costs) to the railroad that performs those operations.

Consequently, the fact that the SARR may not provide origination or termination services does not create a pro-shipper bias because URCS, and hence ATC, does not assign the cost of those services, or any revenue for those services, to the on-SARR line segments.⁷

Crowley/Mulholland Reb. V.S. at 10. The perpetuation of this error by BNSF in its reply comments is glaring because that error was prominently featured in both the JCC and Western

⁶ See BNSF Op. at 11; Notice at 16.

⁷ The Joint Chemical Companies have noted that the issue presented by the Board, and parroted by BNSF, could arise only with inter- and intra-train (“I&I”) switching, which URCS does average across the entire movement in 200 mile blocks. But they also demonstrated that I&I switching costs comprise a very small portion of the line-haul costs, regardless of the traffic type, and that any bias would not systemically favor either the SARR or the residual incumbent. JCC Op. at 12-13; JCC Reply at 6. BNSF does not challenge these facts, but merely alleges that they are “beside the point because the costs associated with carload traffic that are avoided by the SARR are not limited to URCS system-average I&I switching costs.” BNSF Reply at 18. But as explained in the text above, BNSF’s assertions regarding those other costs are simply wrong.

Coal Traffic League (“WCTL”) Opening Comments.⁸ The failure of BNSF and of any other railroad to challenge this point is a concession to its accuracy.

Union Pacific Railroad’s (“UP’s”) only response to the JCC Opening Comments is limited to a single footnote. UP claims that the Joint Chemical Companies “mischaracterize the Board’s concern as involving the relation between the SARR’s operating costs and the allocation of the incumbent’s revenue to the SARR.”⁹ Instead, UP portrays its understanding of the Board’s concern to be that cross-over revenue allocations “are not accurately reflecting the costs of the services the incumbent is providing” on the SARR and off-SARR segments.¹⁰ It is UP, however, who has mischaracterized the Board’s concern.¹¹ In the Notice, at 16, the Board expressly stated that “[t]here is a disconnect between the hypothetical cost of providing service to these movements over the segments replicated by the SARR and the revenue allocated to those facilities.” [underline added] Contrary to UP’s understanding, the Board has focused upon the hypothetical SARR’s cost of providing service, not the incumbent’s costs.¹² UP does not offer any defense of the Board’s logic as clearly intended by the Board and critiqued by the Joint Chemical Companies.

The foregoing discussion presents the two most critical points raised in response to the proposed cross-over traffic restrictions, because those points undermine the Board’s entire predicate for restricting cross-over traffic. First, because ATC is based upon the incumbent’s cost of service, not the SARR’s, there is no “disconnect”; ATC operates as intended and the

⁸ JCC Op. at 12-13; WCTL Op. at 13, 17.

⁹ UP Reply at 6 (n. 6).

¹⁰ *Id.* [underline added].

¹¹ As discussed above, BNSF does not share UP’s misunderstanding of the Board’s concerns with cross-over traffic. *See also*, BNSF Reply at 17 (“the distortion created by the use of carload traffic does not result from the use of the incumbent’s costs.”).

¹² Indeed, nowhere in the Notice has the Board alleged that URCS fails to accurately reflect the incumbent’s average cost of service over the on-SARR and off-SARR segments.

Board has not justified any departure from its own precedent on this subject. Second, because ATC does not reward a line-haul segment (whether it is part of the SARR network or not) with revenue for terminal services not performed on that segment, then there cannot be any “bias” to justify cross-over traffic restrictions. These facts alone demonstrate that the Board lacks a rational basis for its proposed cross-over traffic restrictions.

B. The Proposed Cross-Over Traffic Restrictions Would Violate Fundamental SAC Principles.

The railroad parties contend that restrictions upon cross-over traffic would not contravene SAC principles because the concept of cross-over traffic is merely a simplification that makes the SAC analysis more manageable.¹³ In their view, because a complainant can still select from all of the defendant’s traffic if it constructs all of the facilities needed to handle that traffic to either the origin or destination (or point of interchange with a non-defendant railroad), the complainant is not deprived of the same economies of scale, scope and density that the defendant enjoys over the same route of movement. This view is not consistent with SAC principles or Board precedent.

In their opening verified statement, at pages 38-39, Messrs. Crowley and Mulholland explained precisely why and how cross-over traffic restrictions would undermine the SAC analysis. Quoting Baumol, Panzer and Willig, they noted that, because contestable market theory holds that an entrant into a market need not replace the incumbent in its entirety, the SARR may replace a subset of the incumbent’s products or services. That subset of services can take two forms. The SARR may choose to carry any subset of traffic on a particular line segment and it may choose to provide only a portion of the total service for the traffic it selects. In both cases, the SARR is choosing to serve a subset of the incumbent’s relevant market, as

¹³ AAR Reply at 5-6; BNSF Reply at 15; UP Reply at 2.

contemplated by contestable market theory. The latter form specifically includes cross-over traffic. Thus, restricting cross-over traffic to only the traffic that the SARR originates or terminates, as proposed by the Board, would violate the tenants of sustainability required for a contestable market.

Messrs. Crowley and Mulholland also explain that limits upon cross-over traffic constitute an impermissible barrier to entry and defend their position against attacks by the railroad parties. The railroad parties define “barriers to entry” too narrowly as a cost that a new entrant incurs that is not incurred by the incumbent. But a barrier to entry also can be manifested as a restriction upon a production technique. Because a new entrant could choose to serve cross-over traffic, the SARR must be able to employ the same production technique to also serve cross-over traffic. Crowley/Mulholland Reb. V.S. at 18-20.

Furthermore, as the ICC noted in *Bituminous Coal—Hiawatha, UT To Moapa, NV*, 10 I.C.C.2d 259, 265, n. 12 (1994) (“*Nevada Power*”), excluding cross-over traffic “would weaken the SAC test” by “depriv[ing] the SARR of the ability to take advantage of the same economies of scale, scope and density that the incumbents enjoy over the identical route of movement.” This statement remains true regardless whether the Board agrees that restrictions on cross-over traffic violate SAC principles. Therefore, any proposed restrictions must be reconciled with this precedent. The other arguments presented by the Joint Chemical Companies in opposition to cross-over traffic restrictions demonstrate that such reconciliation is not possible.

C. Cross-Over Traffic Restrictions Would Deprive Shippers of an Effective Regulatory Remedy for Unreasonable Rates.

The railroad parties present a variety of reasons why cross-over traffic restrictions would not deprive shippers of access to effective regulatory remedies, none of which are compelling or logical.

The Association of American Railroads (“AAR”) asserts that cross-over restrictions would not make SAC analyses impracticable because the concept of cross-over traffic was not even contemplated in *Coal Rate Guidelines—Nationwide*, 1 I.C.C.2d 520 (1985).¹⁴ The logic of this argument is elusive. The Board did not contemplate many of the SAC details in *Guidelines* that have evolved over the years. Not until the Board was presented with real SAC cases did many of these details evolve. That does not mean the absence of an explicit discussion of cross-over traffic in *Guidelines* proves that restrictions on cross-over traffic will not render SAC analyses impractical. In fact, the Board adopted the cross-over traffic construct in the very first case in which it arose precisely because the exclusion of cross-over traffic “would weaken the SAC test.” *Nevada Power* at 265 (n. 12). No one in this proceeding has demonstrated that the Board’s proposals to restrict cross-over traffic would not similarly weaken the SAC test.

The AAR also contends that the Board’s proposals do not require complainants to greatly expand their SARRs, and thus they can keep the SAC analysis manageable by simply excluding cross-over traffic.¹⁵ That overly simplistic suggestion utterly fails to address the Hobson’s choice that complainants face from the loss of cross-over traffic if they choose not to build larger and more complex SARRs. Without the cross-over traffic, a shipper may be unable to prove its case; but with the cross-over traffic, the SARR may be too complex and unmanageable to pursue the case.¹⁶

¹⁴ AAR Reply at 7.

¹⁵ AAR Reply at 7. *See also*, BNSF Reply at 15 (“A complainant would remain free to include the traffic on its SARR, but it would need to design the SARR so that the traffic would not be carried as cross-over traffic.”); UP Reply at 4-5 (“Neither proposal restricts the volume of traffic that would be available to the SARR” provided complainants construct the facilities that will originate and terminate that traffic.).

¹⁶ It is no answer to assert that a shipper can bring a case under the Simplified-SAC or Three-Benchmark standards, because as discussed in the JCC Opening and Reply Comments, and repeated in these Rebuttal Comments, the relief caps and the higher prescribed rates associated with those standards create another Hobson’s choice by forcing the shipper to leave much of its potential rate relief on the table even though the value of its case would justify using the SAC standard but for the cross-over traffic limits.

UP and BNSF argue that complainants would not be harmed by the proposed cross-over traffic restrictions because complainants have prevailed in past SAC cases without using cross-over traffic.¹⁷ The only two cases that they cite, however, are *W. Tex. Utils. Co. v. Burlington N.R.R.*, 1 S.T.B. 638 (1996), and *Ariz. Pub. Serv. Co. v. Atchison, Topeka & Santa Fe Ry.*, 2 S.T.B. 367 (1997). But, as WCTL already has noted in this proceeding, only the latter case did not contain cross-over traffic, and it had very unique facts.¹⁸ Every single SAC case decided by the Board in the 15 years since has relied upon cross-over traffic. Moreover, the ability to design a SARR that does not rely upon any cross-over traffic is peculiar to coal cases, where the complainant may be able to design a SARR that only hauls coal in unit trains. It is nearly impossible to design a SARR without cross-over traffic for non-coal commodities that do not move in unit trains, because the issue traffic must move in manifest trains with thousands of other cars that originate and terminate at thousands of locations.

Finally, UP suggests that expanded SARRs are manageable today because complainants have gained experience designing ever-larger SARRs.¹⁹ The example that UP references, however, is the SARR designed by DuPont in a currently-pending case, *E.I. du Pont de Nemours and Company v. Norfolk Southern Ry.*, NOR 42125. There are several problems with this comparison.

First, the jury is still out as to whether designing a SARR of that size is in fact feasible. The parties have submitted only opening and reply evidence, with rebuttal evidence not due until March 28, 2013, and a final decision is more than a year away. Because that case presents many

¹⁷ UP Reply at 3, *citing* BNSF Op. at 9.

¹⁸ WCTL Reply at 10-11.

¹⁹ UP Reply at 3.

issues of first impression, it is premature to point to the DuPont case as evidence that substantially expanded SARRs are practical, manageable, and economically feasible.

Second, even if DuPont successfully challenges the NS rates, the SARR that it has presented still contains 82% cross-over traffic.²⁰ The Board's proposals to restrict cross-over traffic thus would require DuPont's 8000 mile SARR to be even larger. That fact merely proves the Board's previously expressed concern that each extension of the SARR to originate and/or terminate one group of cross-over traffic will create new groups of cross-over traffic on the newly-added line segments, which quickly becomes a "cascading analysis [that] could result eventually in a complainant having to replicate almost all of [the defendant's] system." *Pub. Serv. Co. of Colo. v. Burlington N. & Santa Fe Ry.*, 7 S.T.B. 589, 602 (2004).

Third, the size of the DuPont SARR is dictated by the 138 issue movements in that case, which move all over the NS network on multiple overlapping line segments. It is the cumulative volume, and thus the cumulative value of the potential NS overcharges, that likely make such a large SARR economically feasible to develop. Many, if not most, shippers will be unable to aggregate the same volumes and potential savings into a single case to justify even attempting to design such a large and complex SARR. Therefore, the DuPont SARR does not represent a manageable SARR for most shippers.

The bottom line is that cross-over traffic restrictions would present shippers with a Hobson's choice. Either they undertake the Herculean task of designing a SARR that replicates nearly the incumbent's entire rail network, or they have no other choice, and must forego the use of cross-over traffic, which will deprive their SARR of the economies of scale, scope, and density needed to demonstrate the incumbent's unreasonable rates. The Board should be mindful

²⁰ See Docket No. NOR 42125, "Reply of E.I. du Pont de Nemours and Company to Norfolk Southern Railway Company's Motion to Hold Case in Abeyance Pending Completion of Rulemaking, at 15 (filed Aug. 27, 2012).

of the complexity and cost of SAC cases even with the benefit of cross-over traffic. If it further complicates SAC cases through restrictions upon cross-over traffic, the Board truly will have created the kind of “inhospitable rules and procedures” that Judge Becker, in his concurring opinion affirming the *Coal Rate Guidelines*, cautioned “would violate the shipper’s statutory rights to challenge rates....” *Consolidated Rail Corp. v. U.S.*, 812 F.2d 1444, 1457-58 (3rd Cir. 1987) (Becker, J. concurring in part and dissenting in part).

D. The Proposed Cross-Over Traffic Restrictions Would Severely Bias the SAC Analysis Against Shippers.

Although the JCC Opening Comments, at pages 16-21, demonstrated that the Board’s proposed cross-over traffic restrictions would create a significant pro-railroad bias, the railroad comments largely ignore this issue.

The first bias is due to the overbroad nature of the proposed restrictions.²¹ Although the concern expressed by the Board is with carload traffic that moves in “hook-and-haul” service, its first proposed restriction would eliminate even carload traffic that does not move in hook-and-haul service, and would eliminate hook-and-haul traffic even when the incumbent itself only provides hook-and-haul service. Similarly, the second proposed restriction would exclude all cross-over traffic except real-world trainload movements, depriving the SARR of any carload cross-over traffic even if the SARR actually originated or terminated that traffic. The railroad parties completely ignore these points.

The second bias is caused by the disconnect that the restriction would create between the average fixed cost component of the ATC methodology and the average fixed cost contribution required of traffic actually available to the SARR.²² Although ATC allocates cross-over revenue

²¹ JCC Op. Comments at 17-19.

²² *Id.* at 19-21.

to the on-SARR and off-SARR line segments based upon real-world traffic density, the proposed cross-over traffic restrictions will deny the SARR the ability to actually achieve those densities. Because the SARR will have much lower traffic density than the incumbent over the same line segment due to the cross-over traffic restrictions, it will require more revenue per unit to cover its higher average total cost per ton than the real-world incumbent. But ATC will allocate revenue to the SARR as if it had the higher density of the incumbent, thereby denying it the revenue it needs to cover its average total cost per ton. In essence, the Board intends to justify cross-over traffic restrictions based upon a perceived “disconnect” between SARR variable costs and incumbent variable costs, but in doing so would create an even larger disconnect between SARR average fixed costs and incumbent average fixed costs. Therefore, the Board would also need to use the SARR’s traffic density to recalibrate the average fixed cost component for the on-SARR movement segment in the ATC calculation so as to avoid the creation of an even larger “disconnect” between the SARR’s fixed cost recovery requirements and the revenue allocated to the SARR. The only railroad reply to this second bias is that a complainant can avoid this “disconnect” by building the SARR to originate and/or terminate the cross-over traffic.²³ But that response merely exacerbates the Hobson’s choice discussed in Part I.C., above.

II. THE COMMENTS IN THIS PROCEEDING DEMONSTRATE THAT MODIFIED-ATC IS SUPERIOR TO BOTH ORIGINAL AND ALTERNATE-ATC.

At pages 21-24 of the JCC Opening Comments, the Joint Chemical Companies opposed the adoption of Alternate-ATC and supported the continued use of Modified-ATC. AAR, UP, Norfolk Southern (“NS”), and CSX Transportation, Inc. (“CSXT”) urge the Board to resurrect

²³ AAR Reply at 7; BNSF Reply at 15; UP Reply at 4-5.

Original-ATC, but if the Board refuses to do that, then they support Alternate-ATC.²⁴ BNSF supports Alternate-ATC without urging a return to Original-ATC.²⁵ All of the railroad parties criticize the Joint Chemical Companies' defense of Modified-ATC.

AAR's claim that Modified-ATC is systemically biased in favor of high-density segments is a classic red herring.²⁶ While Modified-ATC may allocate more revenue to high-density segments relative to similar allocations made by Original-ATC or Alternate-ATC, all three ATC formulae accomplish the Board's intended objective to allocate more cross-over revenue to low-density than high-density segments. The key difference is that, while Original-ATC and Alternate-ATC slavishly adhere to that single principle, Modified-ATC appropriately balances it with other important economic principles, such as the importance of covering a segment's variable costs before allocating revenues to defray joint and common costs. Crowley/Mulholland Reb. V.S. at 3-4.

Because Modified-ATC takes a more balanced approach, it is the only ATC formula that is not biased. Through the testimony of Messrs. Crowley and Mulholland, the JCC Opening Comments demonstrated that Alternate-ATC produces the same sort of absurd and illogical results as Original-ATC that were the impetus for the Board's adoption of Modified-ATC. Both Original and Alternate-ATC display a clear bias when applied to different populations of rail movements. Original-ATC is biased in favor of low-density segments when applied to low-rated movements, and Alternate-ATC is biased in favor of low-density segments when applied to certain low-rated and all high-rated movements. Crowley/Mulholland Reb. V.S. at 4-5. While Original-ATC and Alternate-ATC represent different ways to bias revenue allocation in favor of

²⁴ AAR Reply at 8; NS/CSXT Reply at 23; UP Reply at 7-8.

²⁵ BNSF Reply at 18.

²⁶ AAR Reply at 8. *See also*, NS/CSXT Reply at 24.

low-density segments when applied to different populations of rail movements, Modified-ATC produces reasonable and predictable results when applied to the entire population.

The railroad parties attempt to undermine the Crowley/Mulholland analyses by misrepresenting their use of the term “profit.”²⁷ They attempt to confuse the issue by referring to “profit” as revenue that exceeds “total variable and total fixed costs, including...cost of capital,” to challenge the logic of examining the profitability of high and low-density segments that are part of a single through movement.²⁸ Crowley/Mulholland, however, referred only to “revenue in excess of total variable plus total fixed costs;” cost of capital was never part of their equation.²⁹ Their definitions of variable cost, fixed cost, total cost, revenue, and contribution are consistent with the definitions that the Board itself has used to frame the issues, beginning with the very first discussion of the ATC methodology. Thus, the Crowley/Mulholland analyses of how all three ATC formulae impact profitability on high and low density segments is consistent with the framework for the Board’s own discussion of ATC issues in terms of high and low density segments.

Furthermore, while BNSF argues that “it makes no sense to think about the relative profitability of two segments of an integrated through movement,”³⁰ its argument is ironic because it could apply equally to the railroads’ argument that Modified-ATC “under weights” the impact of fixed costs on low density segments. If it makes no sense to evaluate the relative profitability of the segments of a through movement, it also makes no sense to think in terms of the relative fixed cost components of those same segments because railroads do not price by

²⁷ AAR Reply at 9, and Baranowski V.S. at 9; BNSF Reply at 19-22; UP Reply at 8-9.

²⁸ AAR Reply, Baranowski V.S. at 9 (n. 7) [underline added].

²⁹ Crowley/Mulholland Reb. V.S. at 6-7.

³⁰ BNSF Reply at 21.

segment. But, the ATC model itself demonstrates that the Board does evaluate the relative fixed costs components of two segments of an integrated through movement. If segment-specific cost requirements are to be teased out of through rates, then it is appropriate to tease out segment-specific profitability. Crowley/Mulholland Reb. V.S. at 7.

Finally, NS/CSXT suggest that the Board should reverse course entirely by adopting a cross-over revenue allocation methodology that “would use the SARR’s variable costs rather than the carrier’s system average URCS costs.”³¹ To do this, the Board would have to resurrect the concept of movement-specific adjustments to the URCS Phase III variable cost model to account for operational and investment differences between the incumbent’s and the SARR’s system. Crowley/Mulholland Reb. V.S. at 8. The Board forbade such adjustments in *Major Issues* because those adjustments had not produced results demonstrably more reliable than the URCS program. Furthermore, the URCS program results were unbiased, easy to apply, and worked for their intended purpose.³² If the Board were to implement movement-specific adjustments for the purpose of revenue allocation, it also would need to make similar fixed cost adjustments to reflect SARR densities for the same purpose. *Id.*

III. THE COMMENTS IN THIS PROCEEDING WARRANT ELIMINATION OF THE SIMPLIFIED-SAC RELIEF CAP.

The railroad parties’ reply comments largely echo their opening comments on the Board’s two Simplified-SAC proposals. The Joint Chemical Companies previously responded to those points at pages 7-8 of the JCC Reply Comments. Rather than repeat those arguments here, the Joint Chemical Companies refer the Board to the JCC Reply Comments. In one area,

³¹ NS/CSXT Reply at 21.

³² *Major Issues in Rail Rate Cases*, EP 657 (Sub-No. 1), slip. op. at 50-61 (served Oct. 30, 2006).

however, the AAR did substantively reply to the JCC Opening Comments, and that reply is addressed below.

In the JCC Opening Comments at pages 24-26, the Joint Chemical Companies demonstrated that, because the simplifying factors in Simplified-SAC ensure that the resulting prescribed rate will be greater than the rate resulting from Full-SAC, the Board would be justified in removing the relief cap for Simplified-SAC even if it does not adopt the proposed change to calculating road property investment (“RPI”). In its reply comments, the AAR provided three reasons to reject this conclusion.

First, the AAR asserts that a relief cap is necessary to comply with the statute at 49 U.S.C. 10701(d)(3).³³ But even without a relief cap, the Simplified-SAC process would be consistent with the statute because the simplifying factors act as a natural relief cap and incentivize shippers to use the most robust and least crude rate standard given the value of their case.

Second, the AAR implies that the Board already rejected this argument because it adopted the relief cap with full knowledge that Simplified-SAC is a less precise application of constrained market pricing.³⁴ But it is not the lack of precision alone that justifies elimination of the relief cap; it is the consistently higher prescribed rate that results from this lack of precision. The AAR has not seriously challenged this fact in its comments.

Third, the AAR illogically contends that, “if any shipper believes that the level of relief in Simplified SAC is already ‘naturally constrained’ so as to make the Board’s limit on relief unnecessary, then it should have no problem with the limit’s existence, as it would never come

³³ AAR Reply at 14. *See also*, NS/CSXT Reply at 16.

³⁴ AAR Reply at 14-15.

into play.”³⁵ The AAR’s argument leads to the absurd conclusion that even a \$1 relief cap should not concern shippers. That is ridiculous because relief from the higher prescribed rate produced by Simplified-SAC still could be unjustifiably capped.

Because no party to this proceeding has contested the fact that Simplified-SAC produces higher prescribed rates than Full-SAC, there is sufficient evidence and reason for the Board to eliminate the relief cap, even without also adopting the proposed RPI changes, which the Joint Chemical Companies oppose. The Board also should extend the relief period from five to ten years for the same reasons it should eliminate the relief caps.

IV. THE COMMENTS IN THIS PROCEEDING WARRANT ELIMINATION OF THE THREE BENCHMARK RELIEF CAP.

At pages 27-29 of the JCC Opening Comments, the Joint Chemical Companies advocated for the elimination of relief caps in Three-Benchmark cases. Their rationale was based on the same logic as noted above for Simplified-SAC cases: the cruder Three-Benchmark standard necessarily leads to higher prescribed rates than result from Simplified or Full-SAC, and this discrepancy provides ample incentive for shippers to choose the standard that best fits the value of their case.

BNSF’s response to this argument either distorts or ignores the various reasons why the Three-Benchmark standard necessarily produces higher prescribed rates. First, BNSF claims that this argument ignores the purpose of the cap, which is a trade-off for the inaccuracies that result from the Three-Benchmark methodology.³⁶ The Joint Chemical Companies have not ignored this fact at all. Their point is that the cap serves no purpose when the inaccuracies nearly always favor the railroad. Thus, the shipper should have the option to select between a higher

³⁵ AAR Reply at 15.

³⁶ BNSF Reply at 5-6.

prescribed rate with shorter and lower-cost litigation, or a lower prescribed rate requiring more litigation time and cost, but without an artificial relief cap. The natural cap inherent in the Three-Benchmark standard is more than sufficient.

Second, BNSF contends that the premise that the Three-Benchmark approach produces higher prescribed rates is unsupported,³⁷ but in doing so ignores three strong explanations provided on page 29 of the JCC Opening Comments. First, the rate comparisons are limited solely to potentially captive traffic (*i.e.* R/VC ratios >180%), which eliminates any downward influence from comparable rates with lower R/VC ratios; and while BNSF contends that all rates above 180% are not necessarily “monopoly” rates, it does not challenge the broader mathematical effect on the prescribed rate of only considering rates with an R/VC above 180%. Additionally, the JCC Opening Comments also point out both the upward influence on the comparative R/VC ratios resulting from the Board’s preference for comparison groups excluding contract traffic, and the upward adjustment to the comparative R/VC ratios for revenue inadequacy; BNSF has not addressed either explanation in its comments.

Finally, BNSF, along with the AAR, repeats the ratcheting arguments made in various railroad opening comments.³⁸ But the ratcheting argument is not plausible because the Three-Benchmark standard produces higher rate prescriptions than Full-SAC cases. If there is any ratcheting, it is far more likely to be in an upward rather than a downward direction.

V. THE COMMENTS IN THIS PROCEEDING JUSTIFY THE PROPOSED CHANGE IN THE INTEREST RATE ON REPARATIONS.

At pages 30-32 of the JCC Opening Comments, the Joint Chemical Companies expressed support for the Board’s proposal to change the interest rate on reparations from the T-Bill to the

³⁷ BNSF Reply at 6.

³⁸ BNSF Reply at 7-8; AAR Reply at 16.

Prime Rate and proposed an increase in the rate prescription period in the SAC analysis if cases take longer than three years, to mitigate the impact of procedural delays on shippers and reduce railroads' incentives to delay cases. The railroad parties continue to oppose any change in the interest rate and dismiss the new proposal as beyond the scope of this proceeding. With slight variations, they mostly echo the common theme from their opening comments that the T-Bill rate is the most appropriate for "risk-free" investments.³⁹ As the JCC Reply Comments, at page 9, observed, a rate case is not "risk-free."

UP responds to the arguments of the Joint Chemical Companies most directly. UP contends that "[a] complainant is not making a risky investment when it pays freight rates, even if they are later determined to be excessive, so it is not entitled to a level of return that reflects the risks railroads undertake when they make investments."⁴⁰ This contention misses the mark. Because the railroad has an enormous interest-free loan from the shipper across three to five years of litigation, the railroad earns a windfall even if its rates are later deemed unreasonable, which naturally incentivizes the railroad to delay a case as long as possible. As discussed below, that windfall is enhanced by the tariff premium that complainants frequently must pay for the opportunity to challenge a rate as unreasonable.

UP also argues that:

The Chemical Companies appear to suggest that complainants *do* face risk when they bring a rate case—the risk that they will lose and the railroad “keeps all of the tariff premium.” (Chemical Companies Op. at 31.) But if the railroad prevails, that means its rates were not unreasonable—there was no “tariff premium.” Moreover, complainants are not required to reimburse railroads when railroads defeat meritless claims. In other words, when a railroad prevails in a rate case, it retains only what it was entitled to in the first place, and it is out the costs of its defense.

³⁹ AAR Op. at 24-25; BNSF Op. at 18; KCS Op. at 11-13; UP Op. at 18-19.

⁴⁰ UP Reply at 15-16.

Accordingly, the fact that railroads prevail in some rate cases is no justification for awarding complainants extra higher payments when they prevail.⁴¹

There are several errors and logical disconnects in the foregoing statements.

First, while it is true that if the railroad prevails, its rates were not unreasonable, it does not follow that there was no tariff premium. Shippers typically do not request a tariff rate unless and until contract negotiations have failed to produce an agreement at rates the shipper believes to be reasonable. Nearly always, the tariff rate published by the railroad exceeds the rates of the rejected contract offer by a substantial margin. That rate differential is the “tariff premium;” the shipper still pays higher rail rates during the case than it otherwise would have if it had quietly acquiesced and accepted the contract offer.⁴² The potential inability to recover this tariff premium is a risk that the shipper incurs merely by filing the case, and, as noted in the JCC Opening Comments, the risk grows significantly each week that the rate case is pending. A railroad has the incentive to delay cases to increase both the amount and duration of the premium.

Second, although complainants are not required to reimburse railroads for their litigation costs if the rates are upheld as reasonable, the railroads in turn are not required to reimburse the complainants’ litigation costs if the rates are unreasonable. This is a reciprocal risk, whereas the opportunity cost associated with reparations falls entirely upon the shipper. The reciprocal risk of litigation costs and the risk of tariff premiums are unrelated.

⁴¹ UP Reply at 16 [*italics in original*].

⁴² The railroad justification for this differential typically is that contracts contain volume commitments that are not found in tariffs. While that might be a reasonable explanation for competitive traffic, it makes absolutely no sense when the traffic is captive to rail anyway, thus ensuring that the railroad still retains the same volume of business. Since reparations are awarded only when there have been findings of both market dominance and rate unreasonableness, the market dominance finding means that there should not be any volume difference when shipping by contract or tariff, which means that the tariff premium cannot be justified on the basis of a volume commitment. Thus, the tariff premium equates to a penalty for pursuing a rate case.

Third, the Board's proposal is not for "extra higher payments" when shippers prevail. Instead the Board seeks to reasonably compensate shippers for their inability to access and earn a return upon money retained by the railroad during litigation, where the money is found to have been unlawfully retained.⁴³ This interest is also intended to prevent the railroad from receiving a windfall for charging unreasonable rates. The T-Bill rate is inadequate for either purpose.

NS/CSXT miss the point when they assert that "[t]here is also no evidence that complainants in rate cases before the Board typically use borrowed funds to pay rail rates, or that they would pay interest rates approximating the WSJ Prime Rate if they did borrow such funds."⁴⁴ No one is contending that a shipper must borrow money to pay tariff rates. The relevant consideration is the opportunity cost to the shipper from not being able to invest these funds, including the cost of borrowing funds for those investments instead of using funds paid to the tariff premium.

BNSF attempts to argue that the railroad has a greater risk than the shipper:

As BNSF pointed out in its opening comments, adopting a higher interest rate would be particularly inappropriate given the length of time it takes to resolve many cases and would exacerbate the adverse impact on railroads caused by extended rate reasonableness proceedings. There are many reasons why rate cases take years to resolve, including unsettled or changing precedent that sometimes leads to extra rounds of evidentiary submissions. Railroads should not be expected to bear higher costs due to delayed proceedings in the form of higher interest rates.⁴⁵

⁴³ If a railroad's rates are found to be unreasonable, it should not be able to retain the punitive tariff premium for the 3-5 years of litigation without paying an interest rate that compensates the shipper for its opportunity cost. As recent rate complainants, M&G Polymers USA, LLC and Total Petrochemicals & Refining USA, Inc., have told the Board, their tariff premiums are \$60,000 and \$110,000 per week, respectively. *See* Docket NOR 42123, M&G Letter to Chairman Elliott (dated March 22, 2011); Docket NOR 42121, Total Letter to Chairman Elliott (dated March 22, 2011). Over the course of a 3-5 year litigation, this adds up to tens of millions of dollars that otherwise could have been reinvested in the business at its cost of capital.

⁴⁴ NS/CSXT Reply at 34.

⁴⁵ BNSF Reply at 24 [footnote omitted].

The interest rate on reparations is not a “cost” to BNSF. As noted many times in these Rebuttal Comments, the interest rate makes the shipper whole and prevents the railroad from enjoying a windfall, and from expecting a windfall when it sets an unreasonable rate subsequently challenged. The interest rate would not be a cost to the railroad unless it earned a lesser return on freight overpayments than it would pay the shipper on reparations. No railroad party to this proceeding has made any such allegation, or offered any such proof. Furthermore, as the Joint Chemical Companies have demonstrated, the extremely low T-Bill rate actually rewards railroads for case delays.

As WCTL pointed out at page 77 of its opening comments, the Federal Energy Regulatory Commission (“FERC”) has adopted the Prime Rate for reparations. The AAR attempts to undermine this point by contending that FERC administers a different regulatory regime and has not applied the same reasoned approach as the Board.⁴⁶ But the AAR does not explain why the different regulatory regimes warrant different interest rates, nor does it effectively demonstrate that there is no reasonable basis for the Board to adopt the Prime Rate. Indeed, the AAR’s argument that the Fifth Circuit affirmed FERC’s adoption of the Prime Rate while criticizing FERC’s reasoning illustrates the substantial deference afforded to the Board’s exercise of discretion on this subject. The comments in this proceeding provide ample justification for the Board to follow FERC’s lead by adopting the Prime Rate for rate case reparations.

⁴⁶ AAR Reply at 19.

Respectfully submitted,

A handwritten signature in cursive script, appearing to read "Jeffrey O. Moreno".

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January 7, 2013

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I hereby certify that this 7th day of January 2013, I served a copy of the foregoing to the following parties by first class mail:

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I. INTRODUCTION

We are Thomas D. Crowley and Robert D. Mulholland. We are the same Thomas D. Crowley and Robert D. Mulholland that submitted an Opening Verified Statement in this proceeding on October 23, 2012. Copies of our credentials are included as Exhibit No. 1 and Exhibit No. 2 to our Opening Verified Statement, respectively. Our Opening Verified Statement addressed the Surface Transportation Board's ("STB" or "Board") proposal to modify its rules related to various aspects of its three maximum rate procedures as identified in *EP 715*.¹

We have been requested by counsel for the American Chemistry Council ("ACC"), The National Industrial Transportation League ("NITL"), The Fertilizer Institute ("TFI"), Arkema, Inc. ("Arkema"), The Dow Chemical Company ("Dow"), Olin Corporation ("Olin"), and Westlake Chemical Company ("Westlake") (collectively "Joint Chemical Companies") to address the railroads' reply comments dated December 7, 2012.²

The results of our review are summarized in the remainder of this Rebuttal Verified Statement and accompanying exhibits and are organized under the following topical headings:

- II. Modified ATC Is Superior To Both Original ATC And Alternate ATC
- III. A Sound And Reasonable Revenue Division Methodology Obviates The Need For Cross-Over Traffic Restrictions
- IV. The Disconnect Perceived By The Board Does Not Exist
- V. Crude And Overly Broad Cross-Over Traffic Restrictions Are Unnecessary
- VI. A SAC Test Based On Restricted Access To Cross-Over Traffic Is Meaningless
- VII. Conclusions

¹ STB Docket No. *EP 715, Rate Regulation Reforms*, decided July 25, 2012 ("*EP 715*").

² Specifically, we address the December 7, 2012 Reply Comments of the Association of American Railroads and the Reply Verified Statement of Michael Baranowski ("Baranowski VS") included with the AAR's Reply Comments, the Reply Comments of the Union Pacific Railroad Company ("UP"), the Reply Comments of the BNSF Railway Company ("BNSF"), and the Joint Reply Comments of CSX Transportation, Inc. and Norfolk Southern Railway Company ("CSXT/NS").

II. MODIFIED ATC IS SUPERIOR TO BOTH ORIGINAL ATC AND ALTERNATE ATC

In our Opening Verified Statement, we demonstrated that the STB's initial concerns that the application of the Original average total cost ("ATC") formula resulted in over allocation of revenues to low-density lines were valid. Specifically, we showed that Original ATC transforms movements for which real-world revenues do not exceed their end-to-end URCS variable costs (i.e., movements that make no contribution to defray the incumbents' joint and common costs) into movements that do make a contribution to defray the low-density segment's joint and common costs while failing to cover the high-density segment's variable costs. Stated differently, Original ATC unfairly benefits the low-density segment to the disadvantage of the high-density segment. The application of Modified ATC eliminated this glaring shortcoming inherent in Original ATC.

While we acknowledged in our Opening Verified Statement that the proposed Alternate ATC formula would partially correct this particular problem, we also demonstrated that, when the Alternate ATC formula is applied to a group of moves with a broad spectrum of R/VC ratios (i.e., a group of moves representative of the universe of shipments that move over Class I railroad systems in the real world), the Alternate ATC formula also produces nonsensical results in many of these circumstances. Specifically, application of Alternate ATC on some low-rated movements, where revenues are just above variable costs, can produce the illogical result that all of the movement's end-to-end contribution is allocated to a single line segment, and application of the formula on high-rated movements produces the counterintuitive result that the low-density segment earns more per-mile profit than the high-density segment after both segments have recovered their full (variable plus fixed) costs.

The railroads, led by the Association of American Railroads (“AAR”), replied to our Opening Verified Statement with several unfounded and unsupported criticisms, and mischaracterizations of our argument. Our responses to the railroads’ critique are summarized below under the following topical headings:

- A. Modified ATC *Does* Allocate Relatively More Revenue To Light Density Lines Than To High Density Lines
- B. Original And Alternate ATC Bias The Revenue Division Results In Favor Of Light Density Segments
- C. The Railroads’ Characterization Of Our Profitability Analysis Is Erroneous
- D. The Revenue Division Methodology Should Continue To Be Based On The Incumbent’s Relative Costs

A. MODIFIED ATC *DOES* ALLOCATE RELATIVELY MORE REVENUE TO LIGHT DENSITY LINES THAN TO HIGH DENSITY LINES

In its Reply Comments, AAR cites *Major Issues*³ in support of the use of Original ATC or Alternate ATC over Modified ATC. Specifically, AAR argues that:

By allocating revenues based on average total cost, the Board’s intent was to ensure that low density segments, with their higher average total costs, are allocated relatively more revenue from each individual movement than the high density segments, because low density segments have fewer movements to help cover fixed costs.⁴

We agree with the AAR’s statement. What the AAR failed to mention, however, is that all three ATC formulae meet this requirement. Low-density segments are allocated relatively more revenue than the corresponding high-density segments under Modified ATC just as they are under Original and Alternate ATC. The key difference is that Modified ATC makes this

³ STB Ex Parte No. 657 (Sub-No. 1), *Major Issues In Rail Rate Cases*, served October 30, 2006 (“*Major Issues*”).

⁴ AAR Reply Comments, p. 10.

allocation while also adhering to other important economic axioms, whereas Original and Alternate ATC adhere only to this single principle.

AAR further claims that, “Modified ATC... fails to achieve the Board’s goals in allocating cross-over traffic revenue in relation to the defendant carrier’s relative costs of providing service.”⁵

As discussed above, what distinguishes Modified ATC as the superior alternative to both Original and Alternate ATC is that Modified ATC allocates greater revenues to lower density line segments while also adhering to other important axioms, whereas Original and Alternate ATC adhere only to this single purpose regardless of the resulting violations of other equally relevant economic principles. Modified ATC ensures that all segments’ variable costs are covered before allocating revenues to defray joint and common costs to any segment. Original ATC does not. Modified ATC ensures that revenues in excess of variable plus fixed costs (i.e., profits) are allocated in a reasonable, equitable, and rational manner. Alternate ATC does not.

**B. ORIGINAL AND ALTERNATE
ATC BIAS THE REVENUE
DIVISION RESULTS IN FAVOR
OF LIGHT DENSITY SEGMENTS**

The AAR claims that Modified ATC “systematically biases revenue allocation in favor of high-density segments, apportioning them a larger share of revenues than is warranted.”⁶

This statement is self-serving and patently false. Modified ATC does not bias revenue allocation because it produces reasonable and predictable results when applied to the entire population (i.e., universe) of railroad movements. In contrast, both Original and Alternate ATC display clear bias when applied to different portions of the universe of railroad movements. Original ATC is demonstrably biased in favor of low-density segments when applied to low-

⁵ AAR Reply Comments, p. 9.

⁶ AAR Reply Comments, p. 8.

rated movements, and Alternate ATC is demonstrably biased in favor of low-density segments when applied to some low-rated, and all high-rated movements.

Indeed, the fact that Alternate ATC is being considered as a viable replacement for Original ATC is a classic example of detection bias. Detection bias arises when a narrow segment of the population is observed. The classic example involves diabetes and obesity. Doctors are more likely to screen for diabetes in patients who are overweight than in patients who are not. The skewed detection efforts lead to inflated diabetes rates among obese patients and deflated diabetes rates among patients who are not obese. Similarly, when Alternate ATC is applied to the low-rated movements for which Original ATC is known to be a problem, it appears to be a viable solution to the problem.

However, when Alternate ATC is applied to the full population of railroad moves, it becomes apparent that, while Alternate ATC effectively masks the bias inherent in the Original ATC on a narrow band of movements, yet another mask would be required to hide the bias inherent in Alternate ATC when applied to movements on the opposite end of the spectrum.

In our Opening Verified Statement, we clearly demonstrated that Alternate ATC, which closely resembles a formula developed by BNSF for litigation purposes, does not fully address the Original ATC formula shortcomings (bias), but rather hides them when applied to a narrow segment of the overall railroad movement population.

When the STB first discovered the bias inherent in the Original ATC formula, it developed a sound remedy for the unforeseen problem – the Modified ATC formula. There is no need or justification for abandoning Modified ATC for an obviously flawed Alternate ATC. The AAR simply wishes for low-density segments to be allocated as much revenue as possible. It

has not, nor can it demonstrate that any specific amount of revenue is “warranted” on any move or set of moves.

**C. THE RAILROADS’
CHARACTERIZATION OF
OUR PROFITABILITY
ANALYSIS IS ERRONEOUS**

In an attempt to discredit shippers’ opening statements and supporting analyses, the railroads repeatedly mischaracterize shippers’ statements. Specifically, the AAR’s Witness Baranowski states that, after a movement’s calculated fixed cost allocation has been covered, “The remaining contribution above variable cost – which Crowley/Fapp refer to as ‘profit’ (but is really contribution to fixed costs) – is allocated again based on variable cost.”⁷ Mr. Baranowski goes on:

The revenues that a railroad earns on a movement in excess of the movement’s variable costs are not a railroad’s economic “profits.” They are the movement’s contribution towards the railroad’s fixed costs. If and only if a railroads’ revenue exceeds its total variable and total fixed costs, including its cost of capital, does a railroad earn an economic profit. Thus, “profit” cannot be measured by comparing revenue to variable costs for individual movements.⁸

Mr. Baranowski apparently misunderstood the term “profit” as included in our Opening Verified Statement. However, it is clear that we were in fact treating revenue in excess of total variable plus total fixed costs as profits in our discussion and analyses. We never stated or implied that revenue in excess of variable costs is or should be considered profit, nor did we measure profit by “comparing revenue to variable costs for individual movements.”⁹

We refer to revenue above variable costs as contribution, costs above variable costs as fixed costs, and variable plus fixed costs as total costs. Our definitions of variable cost, fixed

⁷ Baranowski VS, pp. 9-10. See also related statements at AAR Reply Comments, p. 9; BNSF Reply Comments, pp. 19-22; UP Reply Comments, pp. 8-9.

⁸ Baranowski VS, p. 9, fn 7.

⁹ *Id.*

cost, total cost, revenue, and contribution are therefore consistent with the definitions the STB has used to frame the issue from its first discussions of the ATC methodology. If revenue exceeds variable costs, there is contribution. If contribution exceeds fixed costs, there is profit.

Mr. Baranowski's injection of cost of capital into the equation implies that he is dissatisfied with the STB's definition of total costs. We accept the STB's definition and reference it in our discussion of the ATC model.

BNSF puts forward an equally weak objection to our profitability analyses. Specifically, BNSF states:

[I]t makes no sense to think about the relative profitability of two segments of an integrated through movement. BNSF does not set segment-specific prices. It sets a single through rate for service from origin to destination.¹⁰

The very same statements could be made with respect to the fixed cost weighting argument put forward by the railroads, where they argue that Modified ATC "under weights" the impact of fixed costs on light-density segments. One could argue that it makes no sense to think about the relative fixed cost components of two segments of an integrated through movement, because the railroads do not set segment-specific prices. They set a single through rate for service from origin to destination. But the Board's implementation of the ATC model demonstrates that the Board does believe it makes sense to think about the relative fixed cost components of two segments of an integrated through movement. Therefore, it makes perfect sense to think about the relative profitability of two segments of an integrated through movement. If segment-specific cost requirements can and should be teased out of through rates, then it is completely appropriate to tease out segment-specific profitability, as the two items represent both sides of the same coin.

¹⁰ BNSF Reply Comments, p. 21.

**D. THE REVENUE DIVISION
METHODOLOGY SHOULD
CONTINUE TO BE BASED ON
THE INCUMBENT'S RELATIVE COSTS**

CSXT/NS state that:

[A] proper cost-based cross-over revenue allocation methodology would use the SARR's variable costs rather than the carrier's system average URCS costs. This would require additional effort by the parties and the Board, but done properly could form the basis for a more reasonable and coherent allocation of cross-over traffic revenues.¹¹

What CSX/NS appear to advocate is the return of movement-specific adjustments to the URCS Phase III variable cost model results to account for operational and investment differences between the incumbent's and the SARR's systems.¹² For reasons clearly articulated by the Board in its decision in *Major Issues*, based on its experience and observations over the preceding decades, manual movement-specific adjustments to URCS variable costs simply had not proven to produce results that were demonstrably more reliable than those produced by the URCS Phase III costing program. More importantly, the Board found that, while the model results were not perfect, they were unbiased, easy to apply, and worked in practice for their intended purpose. Furthermore, if the Board were to implement movement-specific URCS adjustments to reflect SARR operating costs for revenue division purposes, it would also need to make similar fixed cost adjustments to reflect SARR densities for the same purpose.

¹¹ CSXT/NS Reply Comments, p. 21.

¹² It is possible that CSXT/NS advocate for the development of SARR URCS from the ground-up, which would be an even more laborious and contentious approach than adjusting the incumbent's URCS.

III. A SOUND AND REASONABLE REVENUE DIVISION METHODOLOGY OBVIATES THE NEED FOR CROSS-OVER TRAFFIC RESTRICTIONS

Although we disagree with the railroads on many of the subjects at issue in this proceeding, we agree with CSXT/NS on one critical item as it relates to the Board's proposed restrictions on cross-over traffic in Full SAC cases. Specifically, we agree with the following CSXT/NS statement.

Several shipper commenters and CSXT/NS appear to be in general agreement that cross-over traffic could be allowed without additional limits, *if* revenue allocations between the SARR and the residual incumbent were done properly.¹³

As we demonstrated in our Opening Verified Statement, the goal of cross-over traffic revenue allocation should be to ensure that, for any given incumbent movement, both the SARR and the residual incumbent will receive a fair and reasonable allocation regardless of which segment of the movement is included in the SARR footprint. Modified ATC is clearly the only option under consideration that possesses no inherent bias when applied to the full spectrum of railroad movements (low-rated, high-rated, and everywhere in between).

If the Board continues to rely on Modified ATC for revenue division purposes, there is no reason to limit SARR access to cross-over traffic. If the Board reverts to either the clearly flawed Original or Alternate ATC formula, it will bias the formula in favor of light density lines. This distortion could be further compounded if the Board were to also decide to limit SARR access to the full complement of traffic densities.

¹³ CSXT/NS Reply Comments, p. 21.

IV. THE DISCONNECT PERCEIVED BY THE BOARD DOES NOT EXIST

BNSF contends that the inclusion of carload cross-over traffic together with the use of incumbent's URCS variable costs in the ATC revenue division formula necessarily leads to distortions that result in over allocation of revenues to the SARR. BNSF opines that:

Complainants typically assume that the SARR will operate as a "hook-and-haul" railroad and therefore will not incur costs associated with gathering carload traffic for placement on trains, switching carload traffic in yards, train assembly and disassembly, and delivery of cars to their final destination, among others costs incurred by the incumbent railroad to provide carload service. While the SARR avoids these costs for carload traffic, ATC allocates revenues as if the SARR did incur these costs and MMM assigns responsibility for stand-alone costs among shippers on the SARR, including carload shippers, as if the SARR incurred these costs.¹⁴

BNSF's observation is that, in circumstances where the SARR (or the residual incumbent) operates trains in "hook-and-haul" overhead service, it does not incur costs associated with gathering carload traffic for placement on trains, train assembly and disassembly, and delivery of cars to their final destination (i.e., origin and termination switching activities). BNSF's statement that ATC allocates revenues as if the SARR did incur these costs is flatly incorrect. ATC allocates revenues based on URCS costs. URCS allocates origin and destination terminal costs to the carrier that performs the terminal switching operations. As shown in our Exhibit No. 3 to our Opening Verified Statement, the terminal switching costs assigned to carload traffic are more than four-and-a-half times greater than the terminal switching costs assigned to unit train traffic.¹⁵

BNSF's observation that costs associated with switching carload traffic in yards may be allocated to rail segments where no such switching occurs is, in certain instances, correct. As we discussed in detail in our Opening Verified Statement, URCS allocates inter/intra train ("I&I")

¹⁴ BNSF Reply Comments, p. 16.

¹⁵ East Line 11, Column (3) $\$0.83 \div \text{Column (9)} \$0.18 = 4.61$ and West Line 32, Column (3) $\$0.97 \div \text{Column (9)} \$0.21 = 4.62$.

switching costs on a per-mile basis. As a result, some segments are over allocated I&I costs and other segments are under allocated I&I costs. However, as we clearly demonstrated in Exhibit No. 3 and Table 4 to our Opening Verified Statement, the impact of those costs on the variable cost allocation among segments is minimal.

Furthermore, BNSF's statement that "the incumbent's costs for the portion of the through movement replicated by the SARR will necessarily be overstated when average costs associated with the through movement are used"¹⁶ is also incorrect. Whether the incumbent's costs are overstated or understated depends entirely on the SARR configuration and operations replicated by the SARR. In our Opening Verified Statement, we posited several different scenarios where the SARR may be under compensated for performing yard switching activities on moves where the residual incumbent performs none. In fact, depending on the issue movements' requirements, this is just as likely as the opposite scenario that BNSF claims (with no proof or attempt at demonstration) will necessarily be present in a SAC analysis.

¹⁶ BNSF Reply Comments, p. 17.

V. CRUDE AND OVERLY BROAD CROSS-OVER TRAFFIC RESTRICTIONS ARE UNNECESSARY

As we discussed in our Opening Verified Statement, if the Board perceives a problem with the way its revenue allocation methodology allocates revenues to incumbent segments, it should address the perceived methodological shortcomings rather than avoiding the problem through the implementation of broad cross-over traffic restrictions in an effort to render the issue moot. In fact, we also demonstrated that the Board's proposed cross-over traffic restrictions are likely to result in the unintended creation of even larger disconnects between the incumbents' densities included in the fixed cost calculation in the ATC formula and the density restrictions its rules would impose on SARRs.

A. THE BOARD'S PROPOSED "SOLUTION" IS DISPROPORTIONATE TO THE "PROBLEM" IT PERCEIVES

Based on the supposed distortions BNSF perceives are caused by the use of system-average URCS variable costs to allocate revenues to the SARR and residual incumbent, BNSF concludes that "[E]liminating cross-over traffic in Full-SAC cases is also the simplest and most straight-forward way of dealing with the particular distortions created by the use of carload traffic as cross-over traffic."¹⁷ Similarly, UP asserts that "the Board should prohibit the use of cross-over traffic entirely because any method of allocating cross-over revenue is necessarily arbitrary."¹⁸ The railroads' proposed self-serving solutions may be clean and easy to implement, but they are an overreaction to a relatively minor "problem" and are wildly disproportionate to any small disconnect they are intended to avoid. Eliminating cross-over traffic altogether because, in certain limited situations, the revenue allocation may not perfectly

¹⁷ BNSF Reply Comments, p. 14.

¹⁸ UP Reply Comments, p 6.

reflect the incumbent's real-world operations "would be like using a cannon to stop a feeding mosquito."¹⁹

**B. THE BOARD'S PROPOSAL
DEPARTS FROM PRECEDENT**

In our Opening Verified Statement, we showed that the Board has never demonstrated that the disconnect it perceives actually exists. The perceived disconnect is merely a recognition that the Board's URCS Phase III costing model develops individual movement costs based on unit costs that reflect the incumbent's system-average operations. We further demonstrated that if any disconnects between URCS phase III costs and costs actually incurred to move traffic actually do exist, they are just as likely to be present on the off-SARR segments as on the on-SARR segments, and thus do not inherently bias the allocation of cross-over revenue in favor of either the complainant or the defendant.

Review of the filed Reply comments reveals that none of the commenting parties have demonstrated (or even attempted to demonstrate) that the perceived disconnect exists. The railroads simply assert that it does and further that the alleged disconnect creates distortions. The railroads offer no proof of these distortions or make any attempt to quantify them. Just because the railroads claim a distortion exists does not make it so. The Board should first demonstrate and quantify any supposed distortion before it makes drastic changes regarding SARR access to cross-over traffic in Full-SAC cases.

¹⁹ BNSF Petition for Review of a Final Order of the Surface Transportation Board in the US Court of Appeals for the DC Circuit, Filed 12/05/2012, page 27.

**C. CROSS-OVER TRAFFIC
SHOULD NOT BE RESTRICTED**

The Board concluded in *Major Issues* that results based on system-average URCS costs, while imperfect, were not discernibly less reliable than results based on movement-specific adjustment to URCS costs. The STB further concluded that the costs and time associated with the complex movement-specific adjustments served to unnecessarily complicate the analysis without producing materially different results.²⁰ Finally, the STB concluded that:

And in proposing to include additional inputs in URCS Phase III, or more generally, that we reexamine the entire URCS system, the carriers request a change to the URCS program. That should only be considered in a separate rulemaking proceeding, where the specific proposal(s) would be subjected to public comment and, if adopted, uniform application.²¹

The Board's sentiments and statements in its *Major Issues* decision are no less valid today than they were then. If the Board or the parties believe the URCS program inadequately reflects the costs for certain movements or movement segments, the solution to the problem is clear: the URCS program should be updated and adjusted to reflect more accurate cost allocation algorithms.

The Board's proposal to eschew the pursuit of the clear and obvious solution to its perceived problem (adjusting the URCS formula) in favor of taking actions designed to avoid the problem (limiting SARR access to cross-over traffic) is troubling.

Furthermore, the proposed cross-over traffic restrictions would introduce far more uncertainty and imprecision than it would solve. UP states that:

The Board remains free to prohibit the use of cross-over traffic when it lacks confidence that the benefits from that device outweigh the costs of

²⁰ *Major Issues*, pp. 51-60.

²¹ *Major Issues*, p. 59.

uncertainty and imprecision. By restricting the use of cross-over traffic, the Board can be confident that it will obtain more accurate, reliable results than if it tried to address its concerns through a less direct, more expensive effort to modify URCS.²²

UP's self-serving statements are clearly intended to obfuscate the issue in hopes that the Board cannot see the forest for the trees. UP's statement improperly couches the issue of obtaining accurate, reliable results in the narrow context of revenue divisions on cross-over traffic. The Board's objective should be to achieve accurate, reliable results *at the end of the SAC analysis*. The revenue division formula produces results that feed only a small part of the overall development of revenues and costs that ultimately determine the reasonable rate level applicable to the issue movement.

There are many individual revenue and cost components that are calculated independently and that feed into the larger SAC model. Any one of them could be scrutinized to the point where some input on some level could be called into question. If the Board were to simply discard any cost or revenue input that could potentially be construed as less than absolutely precise, there would be no components left in the SAC analysis framework. As we discussed in our Opening Verified Statement, all models inherently incorporate some level of imprecision. If the Board cannot accept some level of imprecision in its modeling exercise, the exercise is doomed from the start.

If one option is to include cross-over traffic whose revenue divisions may not be absolutely precise in every instance, and the other option is to exclude the cross-over traffic entirely, it is clear that retaining the traffic, even with imperfect revenue divisions, will produce far more accurate, reliable *SAC results* than eliminating the traffic.

²² UP Reply Comments, p. 7.

VI. A SAC TEST BASED ON RESTRICTED ACCESS TO CROSS-OVER TRAFFIC IS MEANINGLESS

As discussed in our Opening VS, the STB's proposed limitations on cross-over traffic would directly impact the SARR's ability to group traffic, and thus undermine the foundation of the SAC test. Cross-over traffic limitations would undermine the SARRs ability to group traffic, would severely and unfairly restrict the SARR from access to the same scale economies the incumbent enjoys, and would render the SAC test incomplete.²³

The Railroads assert that limiting the use of cross-over traffic in SAC presentations is consistent with the theory of contestable markets and CMP because cross-over traffic is just a simplifying device. Therefore, the railroads conclude, its limitation does not create a barrier to entry upon the SARR. The Railroads' positions contradict both the theory of contestable markets and Board precedent. The concept of entry barriers is not limited just to costs incurred by the SARR and not by the incumbent. Restricting the SARR from access to the same production techniques available to the incumbent also acts as a barrier to entry. The STB has previously articulated this point in *Coal Rate Guidelines* where it stated that the SAC constraint would be useless if a shipper could not employ the same production techniques used by the incumbent in grouping traffic to maximize economies of density.

²³ Opening VS, pp. 38-39.

**A. THE RAILROADS' ASSERTIONS THAT
RESTRICTIONS ON CROSS-OVER TRAFFIC
ARE CONSISTENT WITH CONTESTABLE
MARKET THEORY ARE INCORRECT**

The railroads response to our argument was based on a misrepresentation of statements made by the Board regarding the use of cross-over traffic as it relates to contestable market theory. Specifically, BNSF opines that:

The Board's proposed restrictions do not affect whether traffic may be included but only how traffic that is included may be used. The restrictions would only prohibit the complainant from using specified traffic as *cross-over traffic*. A complainant would remain free to include the traffic on its SARR, but it would need to design the SARR so that the traffic would not be carried as cross-over traffic. Rather than limiting traffic selection, the Board is limiting the use of a simplification mechanism to those situation [sic] where it may actually provide simplification instead of exacerbating the complexities and distortions already created by the presence of cross-over traffic in the analysis.²⁴

This interpretation is exactly at odds with the Board's statements on the issue in *Major Issues* as cited by UP: "Cross-over traffic is merely a simplifying device that the Board has allowed complainants to use to reduce their litigation costs. In theory, a SAC analysis should produce the same result whether or not the complainant uses that device."²⁵

The Board's proposed restrictions would make it impossible to achieve the same result "whether or not the complainant uses that device." This is because a SARR that is configured to serve all of its traffic end-to-end will have access to traffic that is not available to a SARR that is configured, for example, to serve only the issue traffic end-to-end. Therefore, in the scenario where the SARR is configured to provide end-to-end service to the issue traffic, that traffic will be forced to bear more of the SARR cost burden over that segment than the same traffic would in the scenario where the SARR is configured to serve all of its traffic end-to-end. In other words,

²⁴ BNSF Reply Comments, p. 15.

²⁵ UP Reply Comments, p. 2, citing *Major Issues*.

the cross-over traffic restrictions will result in dramatically different SAC results depending on the SARR configuration (which will determine the volume of traffic available to the SARR if the restrictions are implemented). This is precisely the opposite of the Board's stated intent that a SAC analysis should produce the same result whether or not the SARR is configured to carry traffic as cross-over traffic or as local traffic.

Contestable markets are defined by the ability of new entrants to access the market. In contestable markets, new entrants can serve the same markets and use the same productive techniques as employed by the incumbent firms without restriction. Therefore, restricting cross-over traffic is inconsistent with the concept of contestable markets because it would restrict the new entrant's access to the same production techniques available to the market incumbent.

The Railroads disagree with this premise and instead state that restricting cross-over traffic is not a barrier to entry, and therefore not inconsistent with contestable market theory, based on their interpretation of a statement in *Major Issues* in which the STB provided a partial definition of the barriers to entry, while ignoring other instances where the Board, or its predecessor ICC, provided a full definition of entry barriers.

The statement cited by the railroads focuses on only one aspect of the definition of a barrier to entry – a cost that a new entrant incurs that is not incurred by the incumbent. However, the originators of contestable market theory defined entry barriers much more broadly. As explained by Baumol, Panzar and Willig, an entry barrier can be manifested as a cost or as restriction to a production technique.

We define a perfectly contestable market as one that is accessible to potential entrants and has the following two properties: First, the potential entrants can, without restriction, serve the same market demands and use

the same productive techniques as those available to the incumbent firms.²⁶

Other economists also define barriers to entry as including limited access to the production techniques used by the incumbent that would lead to efficiency disadvantages available to the SARR.

Very importantly for the theory of contestable markets, potential entrants are able to impose this strong discipline on the incumbent only if they are able to compete on equal terms with no cost or efficiency disadvantages that would impose barriers to entry.²⁷

When the ICC developed the SAC test in *Coal Rate Guidelines*, it recognized that barriers to entry could take many forms, including any limitation that would place the stand-alone entity in a subordinate position relative to the incumbent carrier:

The costs and other limitations associated with these entry and exit barriers must be omitted from the SAC analysis in order to approximate the cost structure of a contestable market.²⁸

The ability to group traffic of different shippers is essential to theory of contestability... Without [traffic] grouping, SAC would not be a very useful test, since the captive shipper would be deprived of the benefits of any inherent production economies.²⁹

The ICC recognized that restricting a stand-alone entrant from access to the same production techniques available to the incumbent carrier would effectively create a barrier and make the SAC test useless. The concept of a barrier to entry is clearly and simply not so narrowly defined as the railroads' imply in their Reply statements.

²⁶ Baumol, William J., John C. Panzar, and Robert D. Willig, "*Contestable Markets and the Theory of Industry Structure*," New York, Harcourt Brace Jovanovich (1982) ("Baumol, Panzar and Willig") at page 5. Stigler defined a barrier to entry as a cost of producing (at some or every level of output) that must be borne by firms seeking to enter an industry but not borne by the firms already in the industry. See Stigler, George, "The Organization of Industry," Chicago, IL: University of Chicago Press (1968) at page 67.

²⁷ Tye, William B., "The Applicability of the Theory of Contestable Markets to Rail/Water Carrier Mergers," *Logistics and Transportation Review*, Volume 21, Number 1, March 1985, 57-76, at page 58.

²⁸ *Coal Rate Guidelines*, p. 529.

²⁹ *Coal Rate Guidelines*, p. 544.

VII. CONCLUSIONS

Above, and in our Opening verified statement, we have shown that Modified ATC is superior to both Original and Alternate ATC because, while all three models take into account the impact of economies of density on the railroads' cost structure, only Modified ATC can be applied to all movements across the entire R/VC spectrum without ever producing biased or counterintuitive results. We showed (and CSXT/NS agreed) that if a logical and unbiased revenue allocation methodology is used, then both the SARR and the residual incumbent will receive "fair" revenue allocations regardless which segments are replicated by the SARR and there is no reason to restrict the use of cross-over traffic in SAC cases. We demonstrated that neither the Board nor any of the commenting railroads has ever demonstrated that the alleged disconnect exists or attempted to quantify it, although many parties claim it to be significant and "distorting" absent any such proof.

Further, we showed that, even if the perceived disconnect is real, it is as likely to exist on the off-SARR segments as the on-SARR segments, that its impact is minimal, and that it could be easily addressed through modifications to the revenue division formula rather than through crude cross-over traffic restrictions. We showed that restrictions to cross-over traffic would create a disconnect between the incumbent's fixed cost requirements (reflected in the ATC formulae) and the SARR fixed cost requirements caused by the reduced SARR densities imposed by the proposed cross-over traffic restrictions. This disconnect would be of similar nature to the alleged disconnect between the incumbent's variable costs (reflected in the ATC formulae) and the SARR operating costs that are used as justification to restrict SARR access to cross-over traffic in the first place. Finally, we showed that a SAC test based on restricted access to cross-

over traffic is inconsistent with contestable market theory, is not a true measure of stand-alone costs, and would bias the SAC results in favor of the incumbent.

For these reasons it is clear that the only justifiable action for the Board to take is to decide on the revenue allocation methodology that most fairly and reasonably allocates revenues to incumbent segments based on incumbent costs, and allows the SARR to replicate any segment and access all traffic, including all cross-over traffic, that moves over the replicated segment for inclusion in its SAC presentation.

