

BEFORE THE
SURFACE TRANSPORTATION BOARD

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DOCKET NO. EP 715

RATE REGULATION REFORMS

OPENING COMMENTS OF
ARKANSAS ELECTRIC COOPERATIVE CORPORATION

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Arkansas Electric Cooperative Corporation (AECC) 1/ submits these opening comments in accordance with the Board's Decision served July 25, 2012.

Summary

In the July 25 Decision, the Board gave notice of its intent to implement six changes in its rate reasonableness rules. One of the proposed changes, involving the Three Benchmark method, does not have a direct impact on AECC's traffic and is not addressed in

1/ AECC is a membership-based generation and transmission cooperative that provides wholesale electric power to electric cooperatives, which in turn serve approximately 500,000 customers, or members, located in each of the 75 counties in Arkansas and in surrounding states. In order to serve its 17 member distribution cooperatives, AECC has entered into arrangements with other utilities within the state to share generation and transmission facilities. For example, AECC holds ownership interests in the White Bluff plant at Redfield, AR and the Independence plant at Newark, AR, each of which typically uses in excess of 6 million tons of Powder River Basin (PRB) coal each year. In addition, AECC holds an ownership interest in the Flint Creek plant, at Gentry, AR, which normally uses in excess of 2 million tons of PRB coal each year. Because of the large volume of coal consumed by these plants, the need for long-distance rail transportation to move this coal, AECC has a direct interest in the Board's rate regulation procedures.

these comments. With respect to two of the other proposed changes -- removing the limitation on relief for cases brought under the Simplified-SAC method and raising the interest rate on carrier overcharges -- AECC endorses the apparent intent of the changes and at this time has no suggestions for improvements to the Board's proposals. If other parties suggest changes, AECC may respond to those suggestions in its Reply.

AECC's comments focus primarily on the remaining three changes proposed by the Board: Removing the simplified computation of road property investment (RPI) currently used in Simplified-SAC; restricting the use of cross-over traffic in Full-SAC cases; and, modifying the approach used to allocate revenue from cross-over traffic in Full-SAC and Simplified-SAC cases. In these areas, AECC believes there are compelling reasons not to make the changes proposed by the Board, and that alternative approaches would better enable the Simplified-SAC and Full-SAC methods to perform as intended.

Specifically, AECC recommends:

- that the simplified RPI computation be retained as a rebuttable presumption to ensure that important benefits of Simplified-SAC are preserved;
- that the use of cross-over traffic in Full-SAC cases not be restricted in either of the ways the Board has proposed; and,
- that an alternative approach to the analysis of revenue from cross-over traffic be adopted.

AECC's detailed comments and concerns in these three areas are presented below.

Computation of Road Property Investment (RPI)

As a corollary to its proposed removal of the limitation on relief under Simplified-SAC, the Board asserts that “the approach must calculate the replacement cost of the facilities used to serve the captive shipper with as much precision as a Full-SAC presentation.

* * * Complainants would be required to submit detailed expert testimony on the replacement costs of the facilities used to serve the complainant.” July 25 Decision at 13-14.

AECC understands that the Board’s objective is to ensure that Simplified-SAC is reasonably accurate, in light of the removal of limitation on the relief available through that method. However, the RPI portion of the Simplified-SAC analysis was understood to be acceptably accurate when it was adopted, and AECC is aware of no evidence that the differences between Simplified-SAC and Full-SAC are large or systematic. Therefore, by requiring an extensive Full-SAC RPI analysis in every case, the Board’s proposal on RPI goes too far on the basis of too little evidence in a way that undermines the ability of Simplified-SAC to serve its intended purpose. It places a substantial burden on the parties to rectify a problem that may not exist.

Rather than require a Full-SAC calculation of RPI in every Simplified-SAC case, AECC recommends that the Board establish a presumption that the current Simplified-SAC method may be used, but allow either party to present evidence to rebut that presumption by showing that the Full-SAC method for calculating RPI yields a significantly different result in that case.

Typically, the defendant railroad, rather than the complainant shipper, would be best situated to rebut the presumption and identify the existence and magnitude of such a

discrepancy. By definition, Simplified-SAC analyses are based on the defendant railroad's actual facilities. Details of situation-specific factors that could influence the replacement costs of those facilities are known to the railroad in its ordinary course of business, because it is the railroad – not the shipper – that makes and maintains road property investments. If a defendant railroad believes an RPI estimate produced by Simplified-SAC is too low, it is likely to already have in hand much, most, or all of the information needed to demonstrate that.

However, in some instances, calculating RPI through the Simplified-SAC method might overstate RPI for a given movement, so the railroad would have little or no incentive to highlight or rectify such an inaccuracy. Therefore, the Board should allow the shipper an opportunity, if it wishes to do so, to remedy inaccurate RPI estimates through a Full-SAC analysis, but should not require this in every case.

This approach retains almost all of the RPI accuracy benefits that would accompany the Board's proposal, but does so without gutting Simplified-SAC. A shipper that elects the "low cost" approach of relying on the current Simplified-SAC analysis would bear the risk that the defendant railroad would be reply (and prevail) with a more detailed analysis, and in all instances the railroad would have a forum to challenge the shipper's RPI estimate using the full extent of the railroad's data and expertise. In many circumstances, the parties may be satisfied that the current Simplified-SAC analysis yields results that are sufficiently accurate that the detailed studies required for a Full-SAC RPI presentation and the litigation effort that accompanies them are not warranted. In some instances this may mean that a shipper that elects to rely on the Simplified-SAC analysis of RPI will obtain less relief than it would have been able to had it undertaken a detailed RPI study. In AECC's view, this outcome is preferable to the

outcome of the Board's proposal, in which the complexity of the analysis is mandated by the Board irrespective of the merits of the case or the wishes of the parties, and the simplification achieved by the current method is unavoidably sacrificed.

Restricting Cross-Over Traffic

Citing a "disconnect between the revenue allocation and the costs of providing service" for cross-over traffic, the Board proposes to restrict the use of cross-over traffic to (1) movements for which the SARR would either originate or terminate the rail portion of the movement, or (2) movements where the entire service provided by the defendant railroad in the real world is trainload service. AECC's concerns with both of these alternatives stem from the Board's proposed removal from the analysis of traffic that shares the use of facilities with the traffic for which the analysis is supposed to determine the permissible level of differential pricing. In its notice served July 25, 2012 in Docket No. EP 711, Petition for Rulemaking to Adopt Revised Competitive Switching Rules, the Board (in footnote 11 on pages 7-8) described the specific situation about which AECC is concerned as follows:

The SAC test determines the maximum amount of differential pricing a carrier needs to earn a reasonable return on the facilities used to serve the captive shipper. This becomes the limit on what the railroad can charge that shipper. But the maximum amount of differential pricing the SAC test will permit depends in part on the revenues the railroad earns from other traffic that shares those facilities. Holding everything else constant, if the carrier earns more revenue, the amount of differential pricing needed falls, and vice versa.

Here, the Board is proposing in SAC analyses to reduce to zero "the revenues the railroad earns" from entire categories of traffic that share the subject facilities. Holding everything else constant, by the Board's own description, either of its proposed changes will increase

permissible levels of differential pricing simply by ignoring a portion of the traffic that in reality uses the same facilities.

While this would be unsupportable under any circumstances, it is especially problematic in light of the Board's finding served October 16, 2012 in Docket No. EP 552 (Sub-No. 16), Railroad Revenue Adequacy—2011 Determination, that the Class I rail carriers have achieved or are very close to achieving revenue adequacy. AECC is aware of no legal, regulatory, economic, or other rationale under which it would be in the public interest for the Board to foster supracompetitive rail earnings (i.e., earnings above the revenue adequacy level). As the industry achieves revenue adequacy, it is incumbent on the Board to sharpen its pencil to ensure that differential pricing is properly and effectively limited. This would not be achieved by either of the Board's proposals, which artificially permit increased differential pricing by disregarding the contribution provided by large blocks of traffic.

In short, the Board should not be disregarding any classes or categories of traffic that use the facilities at issue in a Full-SAC analysis.

Allocation of Revenue from Cross-Over Traffic

The Board proposes to modify the "ATC method" used to allocate revenue from cross-over traffic in Full-SAC and Simplified-SAC cases as follows:

The revised ATC methodology would have two steps. First, using the URCS variable and fixed costs for the carrier, and the density and miles of each segment, parties would calculate the railroad's average total cost per segment of a move. The total revenues from each portion of the movement would then be allocated in proportion to the average total cost of the movement on- and off-SARR. . . . A second step would then be performed to ensure that the revenue allocated to both the facilities replicated by the SARR and those of the residual defendant carriers would not be driven below the defendant's URCS variable costs for the movement over those segments. If the revenue allocation to the

on-SARR (or off-SARR) segment would result in revenues falling below URCS variable costs for that segment, the revenue allocation to the on-SARR (or off-SARR) segment would then be raised to equal 100% of the defendant's URCS variable costs of providing service over that segment. If the total revenue from the cross-over movement were below our measure of total variable cost for the entire movement, revenue would be allocated between the two segments to maintain the existing total R/VC ratio on both segments.

July 25 Decision at 17-18.

AECC's fundamental concern with this proposal is that it lacks a foundation in, and indeed is contradicted by, both economic theory and railroad management practices. The entire theory of Constrained Market Pricing is applied to rail rate reasonableness assessments precisely because history demonstrated the harms that can result from the regulatory imposition of fixed relationships between rates and average costs. Notwithstanding the Board's repeated references to "allocation" in describing its proposal, AECC is aware of no theory that would support the proposition that allocating revenues "in proportion to the average total cost" has any economic significance or justification, whether or not "revenue would be allocated between the two segments to maintain the existing total R/VC ratio on both segments."

By statute, the railroads enjoy a wide degree of latitude in setting rates. For individual traffic movements, rates are not established on the basis of a set relationship to costs, so any attempt to allocate revenues on the basis of costs is inherently arbitrary and ad hoc. In short, the type of allocation proposed by the Board has neither conceptual nor practical support.

In real life, the practices of railroad marketing and pricing personnel align closely with the behavior economic theory would predict. Railroads function largely as perfect price

discriminators, assessing the economic rent available from individual movements and pricing to capture that rent. Some traffic achieves high margins relative to variable costs and some does not; there is no fixed relationship between rates and any cost measure.

Similarly, railroads in practice enjoy a wide degree of latitude in adding to or subtracting from their networks, and their conduct in doing so corresponds closely with economic theory and not with revenue allocation. For example, a railroad might consider expending resources on a project to improve the performance of a given line segment by straightening curves and shortening the segment. In doing so, the railroad normally would make a marginal-type comparison ^{2/} of benefits and costs, and would make the change if it was found to be beneficial. In contrast, even if the project improved profitability, the Board's proposed methodology would conclude that the shortened segment, to which lower costs would be ascribed, should be credited with a proportionally lower share of revenue. As a result, the Board's proposed methodology would indicate that the railroad's investment made the segment less "profitable".

Marginal analysis reflecting mainstream economic theory is also in evidence in the assessments railroads perform when a line segment is a candidate for abandonment. Basically, the decision to remove a line segment from a carrier's network involves a marginal-type comparison of the total contribution associated with the traffic that uses the candidate

^{2/} *"One of the most important lessons of economics is that you should look at the marginal costs and marginal benefits of decisions . . ."* Samuelson, Paul A. and William D. Nordhaus, *Economics* (Eighteenth Edition), New Delhi: Tata McGraw-Hill, 2006, at p. 179 (italics in original).

segment vs. the savings that could be achieved by eliminating operations on the segment. ^{3/} Total contribution is used because it reflects the real-world loss that would occur at the margin if the segment were not operated. Allocation of gross or net revenues to different segments, while intuitively plausible, would materially understate the loss that would occur as a result of the candidate segment going out of service.

AECC believes that the economic and real-world treatment of traffic in analyses of potential abandonments provides a reasonable template for the Board to adopt for cross-over traffic in SAC analyses. ^{4/} In an abandonment case, the contribution from affected traffic is weighed against the value associated with salvaging the line, while in SAC analyses it is weighed against the value of replacing the line. In both cases the total contribution is the relevant factor because it reflects the loss that would occur at the margin absent the operation of the given trackage.

If the Board is concerned that AECC's proposal might allow large contributions from cross-over traffic to void any rationale for differential pricing on the subject traffic in a SAC analysis, it should be recalled that the Board has already introduced a method for disaggregating the analysis, so that low-density portions of the stand-alone railroad are not

^{3/} See STB Docket No. EP 575, Review of Rail Access and Competition Issues – Renewed Petition of the Western Coal Traffic League, “Reply Comments of Union Pacific Railroad Company” (March 28, 2006) Reply Statement of Warren C. Wilson, Senior Director – Rail Line Planning, footnote 1 at page 3.

^{4/} For more detailed discussion of the use of the full contribution from cross-over traffic in SAC analyses see STB Docket No. EP 657 (Sub-No.1), Major Issues in Rail Rate Cases, “Comments of Arkansas Electric Cooperative Corporation” (May 1, 2006), Written Testimony of Michael A. Nelson at pages 12-16.

cross-subsidized by higher-density portions. ^{5/} In this context, AECC's proposed reliance on total contribution would enable the analysis to focus quickly on the segments where the total contribution from cross-over traffic would not support replacement of the segment. Given that the large railroads have achieved or are very close to achieving overall revenue adequacy, it should not be viewed as a surprise that high-density segments provide little economic justification for differential pricing (i.e., because replacement of the segment would be justified economically even with zero contribution from the subject traffic), and that the rationale for differential pricing resides primarily or entirely in the lower-density segments.

AECC's proposed treatment of cross-over traffic is an economically-sound marginal analysis that would avoid the problems that have befallen the ad hoc approaches the Board has used to date. Its handling of the contribution generated by traffic moving on specific segments is consistent with industry practice, and would enable the focus of a SAC analysis to be narrowed to relevant low-density segments. On segments where large volumes of profitable traffic are carried, it should be expected that little justification for significant differential pricing will be found.

^{5/} As referenced in July 25 Decision at 13-14 (Internal Cross-Subsidy Inquiry).

Respectfully submitted,



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Dated: October 23, 2012

VERIFICATION

I, Michael A. Nelson, declare under penalty of perjury that the foregoing is true and correct. Further, I certify that I am qualified and authorized to file this statement.


Michael A. Nelson

Executed on October 18, 2012

CERTIFICATE OF SERVICE

I hereby certify that on this 23d day of October, 2012, I caused a copy of the foregoing to be served on all parties of record on the service list in this action (a) electronically in the case of parties with email addresses on the service list and (b) by first class mail on all other parties.



Eric Von Salzen