BNSF RAILWAY

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Ms. Cynthia Brown
Chief, Section of Administration
Office of Proceedings
Surface Transportation Board
395 E Street, SW
Washington, DC 20423-0001

Re: STB Ex Parte No. 704 (Sub-No. 1), Review of Commodity, Boxcar, and TOFC/COFC Exemptions

Dear Ms. Brown:

Enclosed for electronic filing in the above-referenced proceeding are the Opening Comments of BNSF Railway Company. Thank you for your attention to this matter.

Sincerely,

Adam Weiskittel

BEFORE THE SURFACE TRANSPORTATION BOARD

STB EX PARTE NO. 704 (SUB NO. 1)

REVIEW OF COMMODITY, BOXCAR, AND TOFC/COFC EXEMPTIONS

OPENING COMMENTS OF BNSF RAILWAY COMPANY

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Dated: July 26, 2016

In response to the Surface Transportation Board's ("Board" or "STB") Notice of Proposed Rulemaking dated March 23, 2016 ("NPRM"), BNSF Railway Company ("BNSF") respectfully submits its opening comments in this proceeding.

As set forth in the NPRM, the Board is seeking public comment on its proposal to revoke the existing class exemptions under 49 C.F.R. Part 1039 for five commodity groups: (1) Crushed or Broken Stone or Rip Rap (STCC 14-2); (2) Hydraulic Cement (STCC 32-4); (3) Coke Produced from Coal (STCC 29-914); (4) Primary Iron or Steel Products (Plates, Pipes and Rods) (STCC 33-12); and (5) Iron or Steel Scrap, Wastes, or Tailings (STCC 40-211). The Association of American Railroads ("AAR") is submitting evidence and opening comments in this proceeding that address in detail the topics set forth in the Board's NPRM. BNSF joins in and supports AAR's comments. BNSF submits these additional comments in order to separately address important legal and policy principles implicated by the Board's proposal to abandon its existing case-by-case approach to exemptions for the above-referenced commodity groups, and its continued reliance upon R/VC-based metrics that do not reflect true market conditions and fail to properly recognize and incentivize capital investment.

I. R/VC-based metrics are not reliable indicators of market dynamics.

The core question under consideration by the Board in this proceeding is whether the blanket revocation of these five commodity exemptions is necessary to protect shippers of those commodities from the abuse of market power by railroads. In its NPRM, the Board determined that for each of these commodity groups, the "dynamics of the particular transportation markets appear to have changed so significantly" over the past twenty years that regulation is now necessary. NPRM at 4. In reaching that sweeping conclusion, the Board principally relies upon two R/VC-based metrics aggregated on an industry-wide basis—the change in the average R/VC for "potentially captive" (defined by the Board as any traffic with a rate producing an R/VC>180%) shippers of those commodities and the change in how much revenue railroads derive from shippers of those commodities with rates producing an R/VC higher than 180% versus shippers with rates producing an R/VC lower than 180%.

The Board focuses almost exclusively upon these R/VC-based metrics despite its own acknowledgement that "R/VC ratios in excess of the market dominance threshold of 180% do not, standing alone, establish market power or an abuse of such power,"[1] and also despite consistent input from economists with rail expertise that changes in R/VC-based metrics over time cannot be relied upon as indicators of market dynamics generally, or whether railroads are now exercising undue market power.[2] In so doing, the Board has, in essence, created a presumption that changes relative to R/VC>180 do indicate increased market power and the potential for the abuse of that power. This approach contravenes Congress's clear direction that a rate resulting in an R/VC "that is equal to or greater than 180 percent *does not establish a presumption*" that the railroad possesses market dominance or that the rate is unreasonable. 49 U.S.C. § 10707(d)(2) (emphasis added).

The expert statements attached to the AAR's Opening Comments thoroughly explain why using R/VC ratios as indicators of competitive forces is flawed both as a matter of economic theory and as practically applied to the data involving the five commodity groups at issue in this

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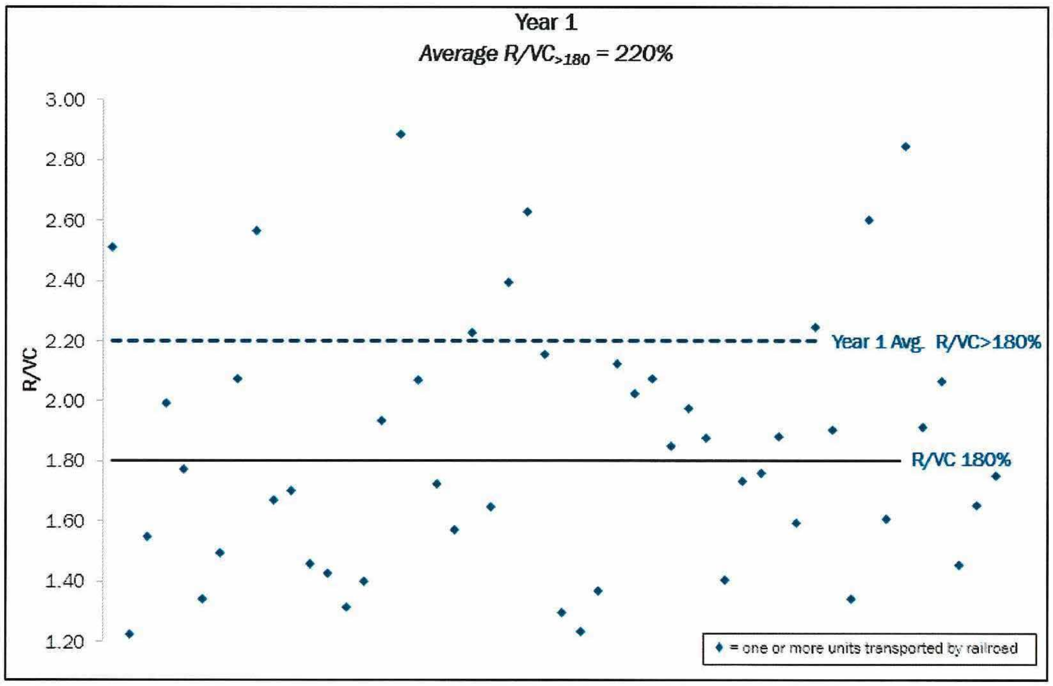
[1] NPRM at 4, n.7. *See also*, Vice Chairman Miller's concurring opinion noting that the Board's reliance upon these two metrics is "not the strongest foundation on which to propose new rules" and Commissioner Begeman's dissent concluding that "the 'record' the majority is relying on to support its proposed changes is a waybill-based hunch using limited information on these commodities." *Id.* at 14.

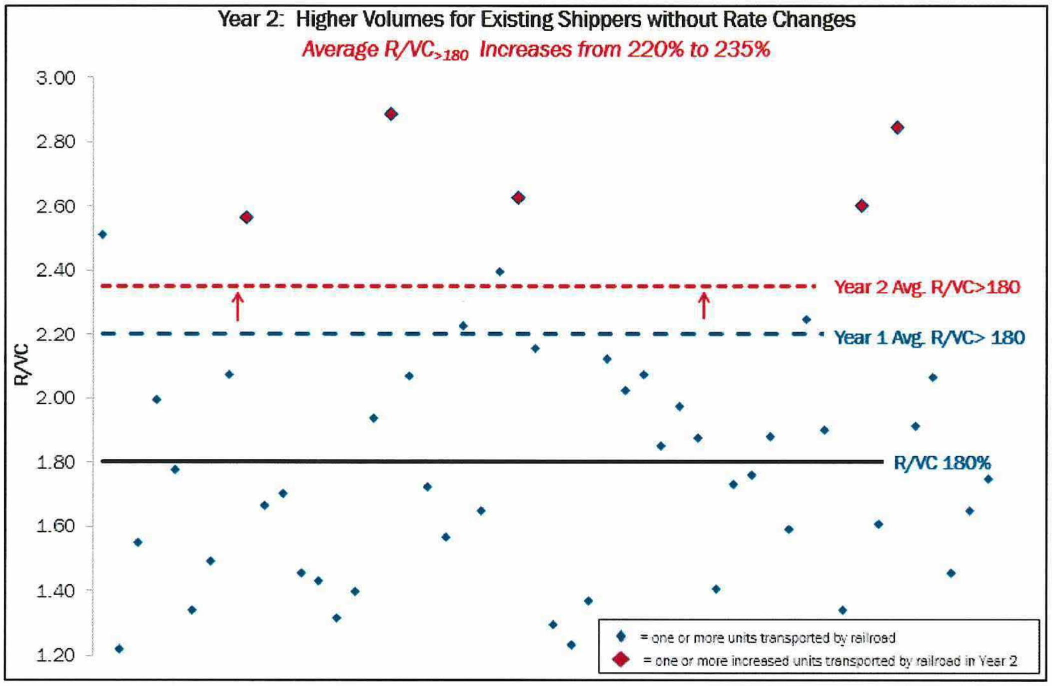
[2] *See* Lauritis R. Christensen Associates, Inc., *A Study of Competition in the U.S. Freight Railroad Industry and Analysis of Proposals That Might Enhance Competition*, at ES-5 (Nov. 2009), *available at* http://www.stb.dot.gov/stb/elibrary/CompetitionStudy.html ("The ratio of revenue to URCS variable cost (R/VC) is weakly correlated with market structure factors that affect shipper 'captivity,' and is not a reliable indicator of market dominance."); Transportation Research Board, *Special Report 318 – Modernizing Freight Rail Regulation*, at 195 (2015) *available at* www.trb.org (comparing a railroad's revenue to its URCS variable costs "is insufficient for making decisions about whether the shipment's price is unreasonable or indicative of a railroad exercising excessive market power.")

proceeding. But even considered at a much simpler level, R/VC-based metrics can be misleading because increases over time may reflect nothing more than changes in traffic mix, the impact of competitive transportation alternatives, and even efforts by railroads to *reduce* rates in response to competition. The following charts demonstrate how an average R/VC>180% can increase over time despite no additional exercise of market power by a railroad.

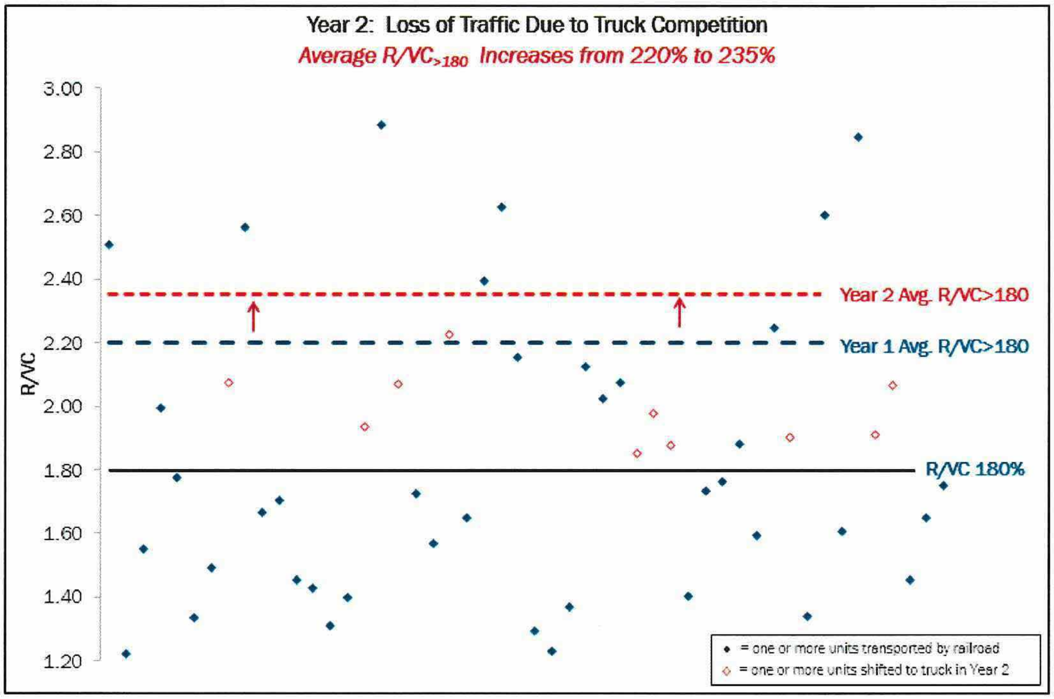
As the starting point, assume that a railroad transports 100 shipments of a particular commodity in Year 1 with the units and R/VCs associated with that traffic group dispersed as follows:



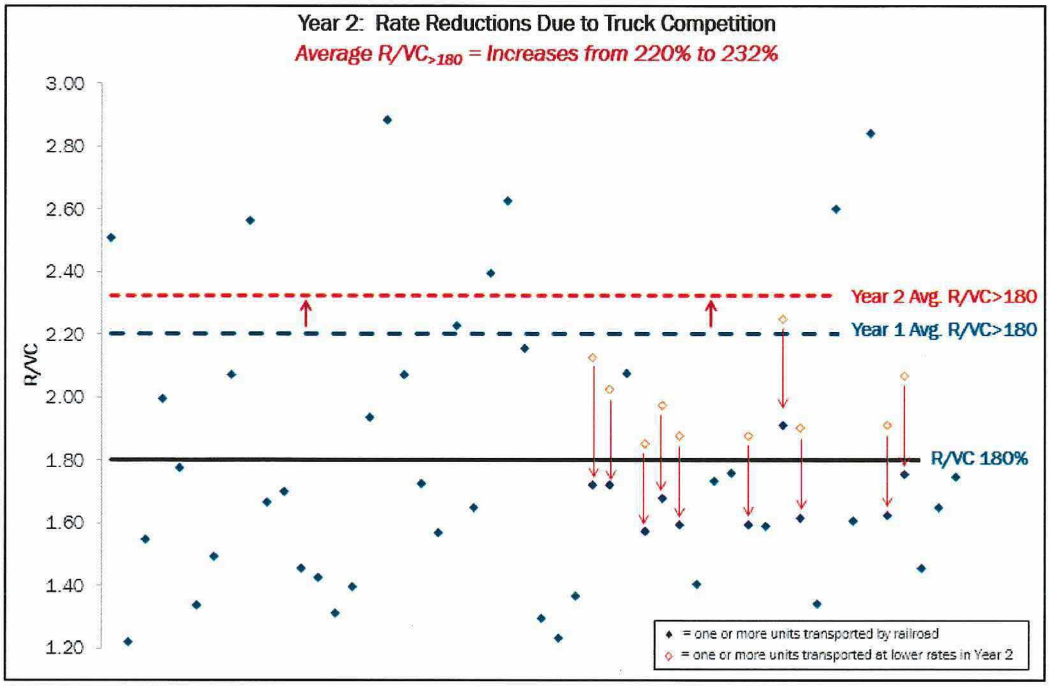
Now assume in Year 2 that one of the railroad's shippers with a rate producing an R/VC higher than the average R/VC>180% for that shipment population experiences an increase in demand for its goods. As a result, that shipper increases the number of shipments of that commodity it tenders to the railroad pursuant to that existing rate by ten units in Year 2. The following chart demonstrates how that simple change in traffic mix can cause the average R/VC>180% for that commodity group to increase from 220% to 235% even though the railroad takes no action to change its pricing or otherwise exercise increased market power:



Alternatively, assume that one of the shippers in that population with a rate producing an R/VC higher than 180%, but lower than the average R/VC>180% for that commodity group, is approached in Year 2 by a trucking company offering lower truck rates. If that shipper opts to switch ten units from the railroad to that trucking option in Year 2, that loss of volume to a competitor would actually *increase* the railroad's R/VC>180% for that commodity group from 220% to 235%. Thus, even though competition has been effective enough to cause the railroad to lose traffic, the railroad's average R/VC>180% will actually increase:



As a last example, assume that one of the railroad's shippers with a rate producing an R/VC higher than 180% receives an offer from a competing trucking option. And assume that the railroad responds to that competing offer by lowering its rate to the shipper in Year 2 down to a level that produces an R/VC lower than 180%. If the railroad lowers the rates for ten shipments in Year 2, the result of that rate reduction is that the railroad's average R/VC>180% will actually increase from 220% to 232%:



If, as it has done in this NPRM, the Board relies exclusively upon a higher average R/VC>180% to infer increased market power or the abuse of market power impacting an entire class of shippers without considering the various factors, mathematical and otherwise, possibly driving those R/VC changes, then the Board could easily be misled to conclude that those shippers are more in need of regulatory protection than before. As demonstrated by the simple examples above, the Board could draw that erroneous conclusion even when railroads are reacting to the market forces impacting one or more of those individual shippers in a pro-competitive way. Moreover, as discussed further in Section IV below, there is no need for the Board to take sweeping commodity-wide action based on possibly faulty R/VC-based metrics because every shipper of an exempt commodity with a rate producing an R/VC>180% already has the ability to individually petition for revocation of that exemption and seek rate relief, regardless of how R/VC-based metrics for the larger group of shippers might change over time. Implementing a blanket commodity wide revocation despite these obvious flaws in the Board's approach would represent precisely the type of unnecessary, artificial, and overly broad regulatory intervention into market forces that Congress has expressly prohibited.

II. BNSF's experience in the aggregates market illustrates the dangers of an R/VC-focused approach.

BNSF's experience in the aggregates market (*i.e.*, the market for Crushed or Broken Stone or Rip Rap—STCC No. 14-2) demonstrates why there is more than just a hypothetical concern that using R/VCs can lead to uninformed and incorrect decisions about whether traffic needs to be subject to Board regulation. Over the past twenty years, BNSF has developed and invested in an innovative unit train model for aggregates traffic that has enabled BNSF to effectively compete in a historically truck-dominated market.[3] Importantly, because handling full unit trains requires customers to have more physical infrastructure than if they were handling single cars or smaller block shipments, BNSF could not implement this change unilaterally. Instead, recognizing the productivity and cost-efficiency benefits offered by BNSF's unit-train product, BNSF's aggregates customers have also chosen to make capital investments of their own over the past decade to build new unit train capable facilities, upgrade existing facilities, or relocate to unit-train capable facilities.

The results of these mutual investments have been significantly pro-competitive. In 1992 less than 10% of BNSF's aggregates traffic moved in unit train service, but by 2013 more than 90% was moving in unit train service. And over that time BNSF's aggregates traffic has more than doubled from approximately 47,000 carloads in 1992 to approximately 103,000 carloads in 2013. Such mutual investment to build a more competitive service offering is precisely the sort of market-driven success story that Congress intended to foster with its deregulatory mandates.

[3] The Board's NPRM concluded that, even today, railroads still "have a relatively small modal market share" for this commodity group. NPRM at 5.

However, using a myopic R/VC-driven perspective to justify a blanket revocation of the exemption applicable to aggregates traffic would wholly fail to recognize this underlying success story. Moreover, because R/VC-based metrics only reflect variable costs (and, even then, does so on a system-average basis), the R/VCs associated with BNSF's aggregates traffic do not adequately reflect the significant capital investments made by BNSF in building its unit train service. Indeed, a blanket revocation would have the perverse effect of potentially subjecting BNSF to additional regulation for successfully competing in this market through innovation and investment over the past twenty years.

R/VC-based metrics are also particularly unreliable tools to evaluate BNSF's experience in the aggregates market because of the distortive treatment afforded to unit-train shipments under the Uniform Rail Costing System ("URCS"). Under existing Board procedures, the Board utilizes a "make-whole adjustment" in Phase III of URCS in an attempt to "recognize the efficiency savings that a carrier obtains in its higher-volume shipments and thus render more accurate unit costs." *See* Review of the General Purpose Costing System, STB Docket No. EP 431-4 (Jan. 25, 2013 decision at 3). In practice, however, the impact of the make-whole adjustment is to create significant and unwarranted differences in the variable costs for shipments around the breakpoints between single and multiple car shipments, and between multiple car and unit train shipments. The Board itself has recognized the distorting impact of the make-whole adjustment and proposed its elimination. *Id.*

Given that more than 90% of BNSF's aggregates shipments now move in unit trains, this widely recognized flaw in how the variable costs associated with those shipments are calculated renders any R/VC-based metrics for those shipments inherently unreliable. URCS's flawed treatment of unit trains also highlights why it is inappropriate to draw any conclusions from comparisons of R/VC-based metrics in 1992, when less than 10% of BNSF's aggregates shipments moved in unit trains, to 2013, when more than 90% moved in unit trains. Looking at R/VCs from both time periods is simply not an apples-to-apples comparison.

III. Equating R/VC>180% with "potentially captive" ignores market realities.

In its NPRM, and in other proceedings, the Board considers the existence of an R/VC>180% as synonymous with an increased likelihood of the existence and possible abuse of market power. In reality, however, whether a rate charged to a shipper produces an R/VC above or below 180% says nothing about whether that shipper is subject to increased railroad market power, much less the abuse of market power, and should not be used as a basis for determining whether regulation is necessary.

The R/VC>180% metric suffers from the same defects described above in Section I, as well as in the AAR's Opening Comments, that impact all R/VC-based metrics. Drawing a line of demarcation at 180% to show relativity to the Board's jurisdictional threshold for determining quantitative market dominance does nothing to address those defects or make this particular R/VC-based metric any more reliable. Having a rate that results in an R/VC>180% does not indicate whether a shipper has physical access to one or more railroads, or other transportation modes such as barge, truck or pipeline. Even if the shipper is limited to one rail transportation option, a rate that results in an R/VC>180% in no way indicates the extent to which other market dynamics, such as product or geographic competition, may be effectively constraining that railroad's pricing power. Congress recognized and codified this reality by requiring that an R/VC>180% may not be used to establish a presumption of market dominance. 49 U.S.C. § 10707(d)(2).

The Board itself recognizes the limitations of the R/VC>180% metric in its NPRM, *see* NPRM at FN 7, but nonetheless proceeds to use two R/VC>180% metrics as the only analytical bases for determining that revoking these exemptions is necessary. While BNSF believes that this approach would be inappropriate in any proceeding, it is particularly inappropriate here because Congress has purposefully created a very high standard for an exemption to be revoked. As discussed more fully in the AAR's Opening Comments, Congress has mandated that the Board err on the side of granting or maintaining exemptions from regulation to the maximum extent possible. Given the Board's acknowledgement that changes in R/VC>180% metrics are not, standing alone, reliable proxies for changes in market conditions, and the relative dearth of supporting anecdotal evidence or shipper comments cited in the NPRM, the Board has not overcome the congressionally mandated presumption in favor of deregulation.

Not only does the Board's over-reliance upon R/VC>180% fail to meet the heightened standard Congress has created for exemptions, it effectively creates a lower standard for exemptions than it employs for market dominance. This is troubling in light of the various recent efforts by shipper interests to effectively transform various non-rate-related Board functions into rate constraints that can be deployed without having to first prove market dominance. The most prominent example of this phenomenon is the National Industrial Transportation League's competitive switching proposal which would use R/VC levels to "conclusively presume" the existence of market dominance, thus triggering the Board to order reciprocal switching with the intent that such manufactured rail competition will drive down rail rates. *See* NITL's Petition for Rulemaking to Adopt Revised Competitive Switching Rules, Ex Parte 711, at Exhibit A (filed July 7, 2011). Similarly, shipper proposals in the Board's revenue adequacy proceeding (Ex Parte 722) seek to transform the Board's annual revenue adequacy determination into a new form of rate constraint.[4] Also, BNSF is currently defending a complaint filed by the American Fuel and

[4] *See* Opening Comments of Arkansas Electric Power Cooperative Corp., at 22, STB Docket No. Ex Parte 722 (filed Sept. 5, 2014) (proposing to annually identify and refund to shippers supposed "supracompetitive earnings" from traffic with rates producing R/VC ratios higher than 180% with no determination of market dominance); Opening Comments of the Alliance for Rail Competition, at 21, STB Docket No. Ex Parte 722 (filed Sept. 5, 2014) (proposing

Petrochemical Manufacturers' association that seeks to circumvent the market dominance requirement by mislabeling a challenge to the level of BNSF's rates as an unreasonable practice and a violation of the common carrier obligation.[5] If these or other similar efforts are successful, then obtaining the revocation of an exemption would be tantamount to providing access to rate relief without having to prove the existence of market dominance, thus circumventing the statutory safeguard erected by Congress to ensure that market forces, not regulatory intervention, govern rail rates to the maximum extent possible. For this reason, the Board should apply at least the same analytical rigor in considering revocations as it does in adjudicating market dominance.

IV. Revocation of exemptions can and should be determined on a case-by-case basis for individual shippers.

In light of Congress's directive that the Board exempt rail traffic to the maximum extent possible and the potentially misleading nature of R/VC-based indicators, exemptions should only be revoked after a determination of an individual shipper's competitive situation and potential need for protection from market abuse. A case-by-case analysis not only ensures that exemptions are maintained "to the maximum extent," as required by 49 U.S.C. §10502, but also that Board regulation is reserved only for those specific instances when market forces have not adequately protected shippers from an abuse of market power, as required by Rail Transportation Policy. *See* 49 U.S.C. § 10101(1) ("to allow, to the maximum extent possible, competition and the demand for services to established reasonable rates for transportation by rail") and § 10101(2) ("to minimize the need for Federal regulatory control over the rail transportation system"). The Board's existing

establishment of presumption that rates charged to "captive shippers" by a railroad found to be revenue adequate cannot be increased unless the railroad proves justification for the increase to the Board).

[5] *See Am. Fuel & Petrochemical Mfrs. v. BNSF Railway Co.*, STB Docket No. NOR 42146 (commenced April 25, 2016). AFPM only filed its complaint at the STB after a federal district court dismissed virtually identical allegations on the grounds that AFPM's claims were manifested exclusively in the level of rates being charged and thus were subject to the Board's exclusive jurisdiction over rail rates. *AFPM v. BNSF Railway Co.*, Docket No. H-15-682, slip op. at 7 (S.D. Tex. Mar. 11, 2016).

processes allow a shipper of an exempt commodity to petition for revocation on a case-by-case basis, regardless of whether R/VC-based metrics for all shippers of that exempt commodity change in ways that could theoretically be attributed to an increase or decrease in rail market power. There has been no evidence provided by any party in this proceeding, or cited by the Board in its NPRM, to suggest that this existing process has thus far proven inaccessible or otherwise inadequate.

Indeed, the evidence relied upon by the Board in proposing to revoke the exemptions for the iron and steel commodity groups (i.e., STCC Nos. 29-914, Coke Produced from Coal; 33-12, Primary Iron or Steel Products (Plates, Pipes, and Rods); and 40-211, Iron or Steel Scrap, Wastes, or Tailings) is a good example of why a case-by-case approach is more appropriate. In its NPRM, the Board cited (in a footnote) comments from only *one* shipper, AK Steel, requesting revocation of certain exemptions. NPRM at 7, n. 13. Notably, while AK Steel requested blanket revocation of the exemptions associated with Coke Produced from Coal (STCC 29-914) and Iron and Steel Scrap, Wastes or Tailings (STCC 40-211), it only requested revocation of a particular sub-set of seven-digit STCCs associated with Steel Slabs (STCC 33-121-40) and Steel Sheets (STCC 33-123-32),[6] which are just two of the more than 150 specific commodity types falling under the Primary Iron or Steel Products umbrella associated with STCC 33-12. In proposing a blanket revocation for all of the commodities falling under STCC 33-12, the Board is proposing something much broader than what AK Steel actually requested and would encapsulate a number of different commodity types used in unique and often unrelated markets.

Congress's mandate dictates the opposite result. In 2015 alone, BNSF transported commodities falling into the broad iron and steel grouping defined by the Board for more than 470 shippers, including AK Steel, but AK Steel is the only one of those shippers who has sought relief

[6] Comments of AK Steel Corporation, at 1-2, STB Docket No. Ex Parte 704-1 (filed January 31, 2011).

in this proceeding. In past exemption decisions, the ICC has held that in "determining whether regulation is necessary to protect shippers from an abuse of market power, a significant consideration is whether the participating shippers actually seeking transportation are concerned about an abuse of market power." *Pet. of Ass'n of Am. Railroads*, 9 ICC 2nd 969, 973 (1993). Facing a lack of shipper outcry for revocation, the Board should maintain the existing exemption while continuing to reserve the power to apply revocations on a case-by-case basis as needed upon shipper request. This would permit the Board to revoke exemptions when truly necessary without unduly interfering in market forces in situations where there is no evidence that the particular railroad has significant market power and has abused that power.

V. R/VC-based regulation is not only unreliable and potentially misleading, but also counter to the public interest.

Regulatory policy that imposes adverse regulatory consequences on railroads based on R/VC ratios which may reflect only improved efficiencies clearly could have the perverse consequence of discouraging innovation and productivity improvements, as well as the investments needed to achieve those improvements. BNSF has long advocated that incentivizing high-costs and inefficiency is bad public policy that ultimately harms railroads, shippers and the public.[7]

This proceeding demonstrates the possible policy dangers associated with such an approach. Here the Board is exercising its critical gatekeeping function to determine whether or not regulation is necessary to remedy or avoid possible market power abuse. By injecting R/VC-based metrics into that gatekeeping function, the Board is not only utilizing unreliable indicators but may also be inadvertently incentivizing railroads to be less efficient and refrain from making

[7] *See, e.g.,* Opening Comments of BNSF Railway Co., at 5, *Railroad Revenue Adequacy,* STB Docket No. Ex Parte 722 (filed Sept. 5, 2014); Opening Comments of BNSF Railway Co., at 5, *Pet. for Rulemaking to Adopt Revised Competitive Switching Rules,* STB Docket No. Ex Parte 711 (filed Mar. 1, 2013).

capital investments. For example, it would be harder to justify capital investment in innovative service offerings, such as BNSF's development of its unit train network for aggregates shipments, if the result of that investment is increased regulation of the shipments meant to benefit from that investment. Also, as demonstrated by the examples in Section I above, railroads might think twice before responding to competitive pressures with lower prices if the mathematical result of dropping those prices would be to subject to the railroad to increased regulatory scrutiny due to an R/VC-focused exemptions standard. Shippers served by higher cost, less efficient railroads would conceivably thus suffer the double disadvantage of receiving less efficient rail service while also having less access to regulatory relief. Board policy should never, whether purposefully or inadvertently, encourage this sort of result.

VI. Conclusion

The R/VC-driven approach taken by the Board in its NPRM is fatally flawed for the theoretical and legal reasons described above. That approach also represents yet another inappropriate step towards regulatory policies that are ultimately bad for railroads and shippers alike. BNSF encourages the Board to continue its sound policy of examining requests to revoke exemptions on a case-by-case basis, and to maintain those exemptions to the maximum extent possible as Congress intended.

Respectfully submitted,

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Dated: July 26, 2016

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