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BEFORE THE

SURFACE TRANSPORTATION BOARD

Ex Parte No. 722

RAILROAD REVENUE ADEQUACY

Ex Parte No. 664 (Sub-No. 2)

PETITION OF THE WESTERN COAL TRAFFIC LEAGUE TO INSTITUTE A RULEMAKING PROCEEDING TO ABOLISH THE USE OF THE MULTI-STAGE DISCOUNTED CASH FLOW MODEL IN DETERMINING THE RAILROAD INDUSTRY'S COST OF EQUITY CAPITAL

WRITTEN TESTIMONY
ON BEHALF OF OLIN CORPORATION
BY JOHN L. MCINTOSH, SENIOR VICE PRESIDENT OF CHEMICALS

1. INTRODUCTION TO OLIN CORPORATION

Chairman Elliott and members of the Surface Transportation Board (the "Board"), I am pleased to be here today on behalf of Olin Corporation ("Olin") as you explore the Board's methodology for determining railroad revenue adequacy and the revenue adequacy component used in judging the reasonableness of rail freight rates. I have served as a corporate officer for Olin for 16 years, and have nearly 40 years of experience in the chemical manufacturing industry.

Olin Corporation is headquartered in Clayton, Missouri and consists of three segments: Winchester Ammunition, a leader in small caliber ammunition production and a supplier to U.S.

law enforcement and military; Chlor Alkali Products, a leading producer of bulk chlorine, caustic soda, bleach and other chemicals in North America; and K.A. Steel, one of the largest distributors of chemical products manufactured by chlor alkali producers. Olin is a publicly traded company that has been listed on the NYSE since 1917. Today, I am testifying on behalf of Olin's Chlor Alkali Products business, which is headquartered in Cleveland, Tennessee and includes ten different locations throughout North America, including locations in New York, Georgia, Tennessee, Alabama, Nevada, Louisiana, California, Washington state and Quebec, Canada. Olin was the first commercial supplier of chlorine in the United States and has been involved in the chlor alkali industry for over one hundred years.

Olin ships the vast majority of its chlor alkali products via rail from its various manufacturing locations in North America, so rail transportation is absolutely essential to Olin. The ability to obtain reasonable freight rates is vital to Olin's business, so Olin appreciates the Board's effort to address revenue adequacy and rate reasonableness issues in today's hearing and hopes that meaningful changes will be made to the Board's current methodology.

2. FINANCIAL SUCCESS OF RAILROADS AND FAILURE OF STAND ALONE COST CONSTRAINT

As Olin has previously expressed in its Comments to the Board in this matter, there is a clear disconnect between the Board's current methodology in determining the railroad's revenue adequacy and the current actual financial state of the rail industry. As noted by the Senate Committee on Commerce, Science, and Transportation in November of 2013, the financial performance of the Class I Railroads "is at its strongest since the passage of the Staggers Act." A simple review of the major railroads' stock prices and corporate activity clearly supports the undeniable financial success of the rail industry. Despite their extreme profitability, the big four class I railroads have chosen to pay billions of dollars to its shareholders through stock repurchases and dividends instead of investing in the expansion of the railroad system to meet increasing demand.

In spite of the railroads' financial success, the Board's methodologies for determining the achievement of revenue adequacy and the reasonableness of rail rates have remained unchanged. In essence, while the railroads have enjoyed terrific financial success, the avenues for captive shippers like Olin to challenge the reasonableness of freight rates have remained unchanged. As noted by the Board, "Nearly all large rate reasonableness cases to date have relied upon the stand-alone cost constraint."

Unfortunately for captive shippers like Olin, the stand-alone cost constraint on rail rates has proven to be almost completely ineffective due to its prohibitive expense, lengthy time requirements, and unnecessary complexity. In fact, the inefficiencies of the stand alone cost constraint process have made rate cases almost completely inaccessible to shippers. The result of this is that shippers lack a meaningful counterbalance to the railroads' strong pricing power over captive shippers. As a result, captive shippers are faced with two bad alternatives: they can simply accept the "tariff premium" forced upon them by railroads, or they can challenge freight rates under the stand alone cost constraint. Recognizing that these rate challenges cost many millions of dollars and take years to resolve, Olin and similarly situated captive shippers are required to go "all in" with extremely uncertain outcomes. Despite the inherent and costly risks associated with rate cases, shippers have very limited upside. If a shipper manages to win a rate case, its only reward is that it can pay reasonable freight rates to railroads. Railroads, on the other hand, have no downside consequences in losing a rate case, as they are simply returning shipper money to which they were never actually entitled. And, considering that shippers must continue to pay tariff premium prices throughout a rate case, the railroads are actually incentivized to prolong rate cases as long as possible. Given this, it is not surprising that railroads and railroad groups adamantly oppose any suggested changes to the stand alone cost system.

In addition to the obvious inefficiencies of the stand alone cost constraint, there is no economic justification for this approach either, especially for railroads enjoying such extreme profitability. For a detailed analysis of the failures of the stand alone cost constraint on the basis of economic theory, I would like to draw the Board's attention to the Verified Statement of Dr. Gerald R. Faulhaber, which was attached to the initial comments of the Concerned Shipper Associations on September 5, 2014. Dr. Faulhaber is one of the original developers of the stand alone cost constraint, yet he clearly argues that in today's economic environment, there is no economic justification for the use of the stand alone cost constraint.

3. REVENUE-TO-VARIABLE COST RATIO CEILING

In addressing the various shortcomings of the Board's application of the stand alone cost constraint in rate reasonableness cases, Olin stresses that the Board should avoid the same pitfalls that have rendered the stand alone cost constraint so ineffective for captive shippers. The Board should avoid creating another "full employment bill for economists" as the stand alone cost constraint has been called and should focus on creating a simple and efficient alternative for reviewing rate cases.

Following the works of Dr. Russell Pittman of the U.S. Department of Justice, Olin has consistently supported the implementation of a ceiling on the railroads' revenue-to-variable cost ratio that may be charged by railroads to captive shippers. In its Comments, Olin cited to a number of past filings and sources that have advocated for this approach, so this is not a new concept. Nonetheless, due to the relative simplicity of the revenue-to-variable cost ceiling, it would provide a much more practical means of protection for captive shippers against the railroads' pricing power in lieu of the unworkable stand alone cost constraint. As a result, captive shippers like Olin would finally obtain a meaningful counterbalance to the railroads' pricing power. The increased efficiency of the revenue-to-variable cost ceiling and relative predictability due to the inherent simplicity of this approach would cause rail rates for captive shippers to be self-policing because a shipper's threat to implement a rate case would almost immediately become viable (as opposed to the empty threat of commencing a long and arduous rate case under the Board's current framework). This, in turn, would incentivize railroads to enter into private contracts with captive shippers or otherwise provide for reasonable rates under tariff. As a result, not only will a captive shipper's rate case become much more efficient for the Board, but fewer rate cases will be necessary because railroads will have additional incentive to enter into private contracts with captive shippers.

The Board has wisely undertaken this proceeding to examine the revenue adequacy constraint on Ramsey pricing in rate cases, which was adopted by the Interstate Commerce Commission in 1985. Because the revenue-to-variable cost ceiling may be implemented as a result of this 722 proceeding, Olin respectfully submits that it is not necessary for the Board to implement a formal rulemaking proceeding. Olin's understanding of the Board's mission in implementing this 722 proceeding is simply to provide some clarity to the process of enforcing the revenue adequacy constraint. Therefore, Olin strongly advises the board against implementing a burdensome rulemaking process.

4. CONCLUSION

The recent extreme profits of the major railroads show that they have far exceeded revenue adequacy, yet the Board's methodology in judging the reasonableness of rail freight rates and in determining whether railroads have achieved revenue adequacy has remained unchanged and ineffective for shippers like Olin. Olin, therefore, agrees with the Board that it is necessary to implement new methodologies for enforcing the revenue adequacy constraint on rail rates. Olin respectfully urges the Board to implement a clear, simple and efficient procedure for reviewing rate cases under this revenue adequacy constraint so that shippers may gain a meaningful counterbalance to the railroads' strong pricing power over captive shippers.

Respectfully submitted for and on behalf of Olin Corporation by:

/s/ John L. McIntosh
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