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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

Comments

submitted by

OLIN CORPORATION

On April 1, 2014, the Surface Transportation Board (the "Board") issued a notice publicizing its intent to receive comments in Docket No. EP 722 (the "Notice") "to explore the Board's methodology for determining railroad revenue adequacy, as well as the revenue adequacy component used in judging the reasonableness of rail freight rates." The Board also sought comments in Docket No. 664 (Sub-No. 2) relating to its methodology in calculating the railroad industry's cost of equity capital. Olin Corporation, through its Chlor Alkali Products Division ("Olin"), submits the following comments in response to the Notice.

1. INTRODUCTION TO OLIN CORPORATION

Olin is one of the leading producers of chlorine and caustic soda in North America. Olin has manufacturing sites at 10 different locations throughout North America, with its Chlor Alkali Products Division headquarters located at Cleveland, Tennessee. Olin was the first commercial supplier of chlorine in the United States and has been involved in the chlor alkali industry in the United States for over 100 years. In addition to manufacturing chlorine and caustic soda, Olin manufactures and sells many useful derivatives of the chlorine manufacturing process, such as hydrochloric acid, hydrogen, sodium hydroxide, bleach products and potassium hydroxide. Olin ships the vast majority of its chlor alkali products via rail from its various manufacturing locations in North America, which have access to only one railroad, ie “captive” sites.

2. SUPPORT FOR COMMENTS FILED BY THE CONCERNED SHIPPER ASSOCIATIONS

Simultaneous with Olin’s filing of these Comments, a collection of shipping associations, the “Concerned Shipper Associations,” is submitting comments to the Board in response to the Board’s Notice (the “CSA Comments”). Olin, as a member of the American Chemistry Council and The Chlorine Institute, supports the CSA Comments. As a captive shipper, Olin is greatly interested and optimistic about the Board’s expressed intention to provide procedural guidance regarding the revenue adequacy component used in judging the reasonableness of rail rates. Because of this strong interest, Olin has chosen to submit these comments to the Board as a supplement to the CSA Comments.

3. OLIN CORPORATION'S SUPPLEMENTAL COMMENTS

a. A Disconnect has Developed between the Actual Profitability of Railroads and the Board's Methodology in Determining the Railroads' "Revenue Adequacy."

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. By all measures, the major railroads have achieved significant profitability over the past five years. According to the Staff Report for Chairman Rockefeller, entitled, "Update on the Financial State of the Class I Freight Rail Industry," dated November 21, 2013, the financial performance of the Class I Railroads "is at its strongest since the passage of the Staggers Act."[1] As indicated in the Comments submitted by the Concerned Shipper Associations, it is therefore time for the Board to provide guidance in how it will implement the revenue adequacy constraint.

In coming to its conclusions, the Commerce Committee staff not only analyzed the financial reports of the Class I Railroads, but also reviewed the public statements of the companies' executives to investors and Wall Street analysts. Warren Buffett, described his 2010 acquisition of Burlington Northern Santa Fe as follows:

> "The highlight of 2010 was our acquisition of Burlington Northern Santa Fe, a purchase that's working out even better than I expected. It now appears that owning this railroad will increase Berkshire's 'normal' earning power by nearly 40% pre-tax and by well over 30% after tax. Making this purchase increased our share count by 6% and used $22 billion of cash. Since we've quickly replenished the cash, the economics of this transaction have turned out very well."[2]

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[1] Committee on Commerce, Science, and Transportation, *Update on the Financial State of the Class I Freight Rail Industry*, (Staff Report for Chairman John D. Rockefeller IV) (November 21, 2013) ("*Rockefeller Report*"), Executive Summary, at i.

[2] 2010 Annual Shareholders Letter of Berkshire Hathaway Inc., at 2, accessible at: http://www.berkshirehathaway.com/letters/2010ltr.pdf

Mr. Buffett is not alone in his excitement. As of 2013, 35 of the past 48 individual quarters of publicly available financial information were described by the three largest publicly traded Class I railroads as "record" or "record-breaking" quarters.[3] This is for good reason, as the railroads' operating ratios, operating income, and earnings per share have consistently improved. Incredibly, as of November of 2013, Union Pacific broke its earnings per share record for 15 of the prior 16 quarters.[4] The increased profitability of the railroads is also illustrated by the substantial increase in railroads' dividend and stock buyback programs. By way of example, between 2006 and 2010, CSX increased its dividend per share payments by 445% and the cumulative value of its share repurchase program grew from $500 million in 2006 to an incredible $5.6 billion in 2010.[5] Logically, when a railroad increases dividends and repurchases its outstanding stock without needing to borrow for the operation, it must be revenue adequate.

In spite of the railroads' clear financial success, a driving force of which is the railroads' dramatic pricing power over shippers like Olin with few alternatives, the avenues for shippers to challenge the reasonableness of freight rates have remained largely unchanged. This is true even as the Board is now routinely finding that railroads are revenue adequate. Because of this, a clear disconnect has emerged between the profitability of the railroads and the Board's methodology for determining the "revenue adequacy" of railroads.

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[3] Rockefeller Report, at 2, *supra.*

[4] *Id.*, 7.

[5] Rockefeller Report, at Executive Summary, ii, *supra*.

b. The Stand-Alone Cost Constraint on Rail Rates has Proven to be Ineffective Due to its Prohibitive Expense, Time Requirements, and Unnecessary Complexity.

As noted by the Board in the Notice, "nearly all large rate reasonableness cases to date have relied upon the stand-alone cost constraint," despite the fact that a remedy also exists utilizing the revenue adequacy methodology. Analysis of rate reasonableness under the Stand-Alone Cost ("SAC") constraint requires that the parties create a hypothetical railroad known as a "Stand-Alone Railroad" or "SARR," which is designed for optimal efficiency. The Board is then charged with determining the rates that would be charged by the SARR to meet the construction and operation costs of the railroad, plus the amount of return on capital.[6]

The SAC constraint has been ineffective in protecting carload chemical shippers from unreasonable rail rates because it is prohibitively expensive, time-consuming, and unnecessarily complex. Further, shippers are required to pay a "tariff premium" to an offered private contract rate for the duration of a rate challenge to gain access to an STB unreasonable rate challenge process. This leads to shippers going "all in" in a rate challenge with an uncertain outcome. If successful, shippers only receive a reasonable rate that they should have been entitled to originally. To further exacerbate the inequity of the process, if railroads prevail in their defense of the rate challenge, they are rewarded with incremental tariff premium revenue with no downside consequence. As far back as 2007 the Board noted that "shippers' litigation costs in recent Full-SAC cases have approached $5 million," and that does not include the tariff premium that can run several multiples more. Because of these exorbitant litigation and tariff premium

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[6] *See, e.g.,* Russell W. Pittman, *Against the Stand-Alone-Cost Test in U.S. Freight Rail Regulation*, 38 J. REG. ECON. 313 (2010).

costs, Full-SAC cases are simply not accessible to all rail shippers.[7] These observations were made seven years ago and the costs associated with rate cases under SAC analysis have only increased. In addition to the exorbitant litigation costs, SAC analysis is extremely time-consuming, as it regularly takes years to accumulate evidence and obtain a decision from the Board. In one ongoing large rate case, E.I. du Pont de Nemours and Company filed its initial complaint challenging the rates of Norfolk Southern Railway Company on October 7, 2010 under the SAC constraint. It's now been almost four years and the parties are still anxiously awaiting a final revised decision.[8] These cost and timing issues are largely driven by the overall complexity of SAC analysis. As the Director of Economic Research and International Technical Assistance, Economic Analysis Group, Antitrust Division, U.S. Department of Justice, Russell Pittman, Ph.D. observed:

> "In the case whose STB decision was just quoted, the shipper posited a SARR of 1400 route miles, traversing five states, connecting coal mines in the Powder River Basin of Wyoming with eleven coal-fired power plants in four states. The SARR was even given a name: the West Texas Railroad. Not to be outdone, another shipper created a 3000-mile SARR, dubbed the Overland Railroad, extending "from Portland, OR to Chicago, IL and Kansas City, MO, with a 375-mile extension into the Powder River Basin (PRB) coal fields." In that case the STB decision Appendix describing the SARR configuration, operating plan, and revenue analysis runs to almost 100 pages."[9]

As Dr. Pittman points out, evidence with this degree of complexity inevitably gives rise to enormous investments of time and resources, not only by shippers and railroads, but also by the Board. Further, the complexity causes the process to be "plagued with both problems of

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[7] *See Simplified Standards for Rail Rate Cases*, STB Ex Parte No. 646 (Sub-No. 1), September 4, 2007, at 5.

[8] E.I. du Pont de Nemours and Company v. Norfolk Southern Ry. Co., Docket No. 42125 (served March 24, 2014).

[9] Pittman, "Against the Stand-Alone-Cost Test in U.S. Freight Rail Regulation," *supra*.

asymmetric information and the resulting incentives and ability to pick and choose among such information in order to further one's own agenda."[10] Vice Chairman Miller expressed a similar sentiment in her concurrence to the Board's decision in *SunBelt Chlor Alkali Partnership v. Norfolk Southern Ry. Co*., in which she stated that she was "struck by the level of detail that must be considered to design a SARR and the high burden this places on both parties – but especially for the shipper, which lacks familiarity with constructing and running a railroad."[11] Due to the time, expense, and uncertainty involved in pursuing a large rate case, the SAC constraint is an ineffective remedy for shippers, particularly in an environment where railroads are not only "revenue adequate," but extremely profitable. Additionally, it has failed to provide shippers with an effective counterbalance against the railroads' strong pricing power, as it is neither certain nor clear in determining whether rates are reasonable. Class I Railroad consolidation has effectively removed the competition counterbalance contemplated by the Staggers Act. And it is time that shippers receive a reasonable tool to ensure they are treated fairly.

c. As an Alternative to the SAC Analysis, the Board should Implement a Ceiling to the Revenue-to-Variable Cost Ratio that may be Charged by Railroads to Captive Shippers.

In the Notice, the Board indicated a desire to "address how the revenue adequacy constraint would work in practice in large rail rate cases." In addressing this issue, the Board should avoid the same pitfalls that render the SAC constraint ineffective. Instead of creating another "full employment bill for economists" as analysis under the SAC constraint has been dubbed, the Board should focus its efforts on creating a simpler and more efficient procedure for

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[10] *Id.*

[11] SunBelt Chlor Alkali Partnership v. Norfolk Southern Ry. Co., Docket No. 42130 (served June 20, 2014) (Miller, concurring).

reviewing rate cases.[12] To accomplish this, the Board should adopt a ceiling on the revenue-to-variable cost ratio ("R/VC Ceiling") that a railroad may charge captive shippers. The revenue-to-variable cost ratio is already imposed by Congress as a jurisdictional floor on the Board's ability to intervene in rate cases, so the R/VC Ceiling would act as a counterweight to this floor by providing a rate ceiling.[13] Olin, as well as the Department of Agriculture and others, including Westlake Chemicals and the Western Coal Traffic League, have already supported this approach in its comments under Docket No. EP 705. Additionally, Olin adopts the position of the U.S. Department of Agriculture in EP 705, which supported the R/VC Ceiling, stating that,

> "A corresponding R/VC ratio adopted as a rate ceiling (or a rebuttable presumption of a maximum reasonable rate) would seem to be just as straightforward to calculate and not require the devotion of significant resources by all parties that has been characteristic of rate cases under the SAC tests."[14]

The Department of Agriculture effectively argued in favor of the R/VC Ceiling by asserting that,

> "Moreover, an R/VC ceiling has at least one advantage…a relatively high level of certainty about its effects. It is relatively easy to estimate what the effect of such a ceiling would be on the revenues of the railroad industry, and the level of the ceiling can be calibrated to achieve whatever balance between rate relief and revenue adequacy is considered desirable from a railroad competition policy standpoint…an R/VC ceiling has the additional benefit of focusing a remedy on the most egregious cases of high rates caused by lack of competition, and does not depend on the competitive response of a second carrier (which, as already noted, some parties have alleged to be less than might be expected)."[15]

Dr. Pittman also advocated for the implementation of the R/VC Ceiling, stating,

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[12] *Consolidated Rail Corp. v. U.S.*, 812 F.2d 1444 (3d Cir. 1987), at 1463 (Becker, J., concurring in part).

[13] 49 U.S.C. 10707(d)(1)(A)

[14] Reply Comments of the U.S. Department of Agriculture to EP Docket No. 705, 15.

[15] Reply Comments of the U.S. Department of Agriculture to EP Docket No. 705, 16.

> "Surely a simpler, more straightforward, and above all cheaper way could be chosen to protect "captive" shippers...one possibility would be a ceiling on the price-to-variable cost ratio – corresponding to the floor on this ratio below which the STB lacks jurisdiction to challenge rates – that would, like the stand-alone-cost test, act as a constraint on the degree to which Ramsey pricing is permitted."[16]

The relative simplicity of the R/VC Ceiling would provide captive shippers with a practical means of protection against the railroads' pricing power in lieu of the unworkable SAC constraint. This would create increased efficiency and streamline the regulatory process, thereby creating certainty for both shippers and railroads. This, in turn, would cause rail rates for captive shippers to be self-policing because a shipper's threat to implement a rate case would be viable. Because enforcement of the revenue adequacy constraint under the R/VC Ceiling would be more likely, the R/VC Ceiling will serve as a more meaningful counterbalance to the railroad's strong pricing power. As a result, the railroads would be incentivized to enter into private contracts with shippers. These increased efficiencies would not only reduce the economic burdens associated with analysis under the SAC constraint, but would also reduce the burden on the Board because fewer rate cases will linger on the Board's docket.

d. In Order to Implement the R/VC Ceiling to Apply the Revenue Adequacy Constraint, a New Rulemaking Proceeding is Not Necessary.

In implementing new rate case procedures at this time which could have previously been implemented under current law, it is wholly unnecessary for the Board to undertake an entirely new rulemaking proceeding. The revenue adequacy constraint on Ramsey pricing in rate cases was adopted by the Interstate Commerce Commission in 1985.[17] Because the Board is now

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[16] Pittman, "Against the Stand-Alone-Cost Test in U.S. Freight Rail Regulation," *supra*.

[17] *See Ex Parte No. 347 (Sub-No.1) Coal Rate Guidelines Nationwide*, 1 I.C.C.C. 2d 520 (1985), aff'd *sub. Nom. Conrail v. United States*, 812 F.2d 1444 (3rd Cir. 1987).

merely striving to provide clarity to the procedure for enforcing this constraint, a burdensome rulemaking process is unnecessary.

e. Olin Supports the abolishment of the Board's Use of the Multi-Stage Discounted Cash Flow Model in its Determination of the Railroad Cost of Equity Capital.

While not the focus of these Comments, Olin would like to formally express its support of the Petition of the Western Coal Traffic League in Ex Parte No. 664 (Sub-No. 2). The calculation of the railroads' cost of capital by the Board is very important to the rail industry as it impacts a number of meaningful analyses, including the determination of whether a railroad is revenue adequate. It has become clear to Olin that in light of the railroads' vast profits, the Board's current methodology for determining revenue adequacy creates too high of a threshold. Olin concurs with the Western Coal Traffic League that the Capital Asset Pricing Model will provide a more accurate calculation of the cost of equity capital than the current Multi-Stage Discounted Cash Flow.

4. CONCLUSION

As demonstrated in these comments, the major railroads have not only achieved revenue adequacy over the past five years, but have actually realized extremely high profits. In spite of this profitability, the Board's methodology in determining whether railroads have achieved revenue adequacy as well as judging the reasonableness of rail freight rates has remained unchanged and largely ineffective for shippers. It is, therefore, highly appropriate for the Board to clarify the methodology for enforcing the revenue adequacy constraint on rail rates. In doing so, Olin urges the Board to implement a clear, simple and efficient procedure for reviewing rate cases under the revenue adequacy constraint that will create a more powerful counterbalance to the railroad's strong pricing power over captive shippers. As previously advocated by Olin and other commentators, the implementation of the R/VC Ceiling would be an effective approach that would be greatly more efficient than the SAC test.

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