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BEFORE THE
SURFACE TRANSPORTATION BOARD

M&G POLYMERS USA, LLC Complainant, v. CSX TRANSPORTATION, INC. Defendant.	)	Docket No. NOR 42123

UNION PACIFIC RAILROAD COMPANY'S
MOTION TO PARTICIPATE AS AMICUS CURIAE
AND COMMENTS ON QUALITATIVE MARKET DOMINANCE

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Pursuant to the Board's order served October 25, 2012, Union Pacific Railroad Company ("UP") moves to participate in this proceeding as amicus curiae to submit comments objecting to the "limit price test" for qualitative market dominance that the Board described in its decision served September 27, 2012 ("*September 27 Decision*").[1]

The Board should not use its limit price test to decide "[w]hether certain transportation alternatives are sufficiently competitive to bring market discipline to [a] carrier's pricing"—that is, whether the alternatives provide "effective competition." *September 27 Decision* at 12. The test ascribes talismanic significance to a single, deeply flawed, statistical measure, "the highest price the carrier theoretically could charge" to move the issue traffic in relation to "the average point at which the carrier could achieve revenue adequacy," *id.* at 16, despite the agency's prior acknowledgement that the presence or absence of effective competition must be assessed using

[1] UP endorses the comments filed by the Association of American Railroads.

"a variety of qualitative and quantitative evidence," and not "predetermined statistical measures," *Market Dominance Determinations*, 365 I.C.C. 118, 119 n.5 (1981).

At best, the limit price test will reveal little or nothing about the presence or absence of effective competition from transportation alternatives in any particular case; at worst, the test will produce distorted, misleading results. In Part I of these comments, UP discusses why the limit price test should not replace the market dominance guidelines the Interstate Commerce Commission ("Commission") adopted in *Market Dominance Determinations*. In Part II, UP explains why the relationship between a limit price R/VC ratio and a carrier's RSAM number cannot be used to identify the presence or absence of effective competition. In Part III, UP describes the harmful consequences of relying on the limit price test.

I. ICCTA REQUIRES AN ACCURATE DETERMINATION OF MARKET DOMINANCE, WHICH CAN BE MADE USING THE FRAMEWORK ESTABLISHED IN *MARKET DOMINANCE DETERMINATIONS*.

The *September 27 Decision*'s reliance on a single statistical measure to test for the presence or absence of effective competition seemingly disregards the critical nature of the market dominance inquiry and past experience with similar formulaic approaches. The *September 27 Decision* would treat the market dominance inquiry as a distraction that diverts resources from the main event: a rate reasonableness inquiry. However, Congress enacted the market dominance standard to limit significantly the agency's jurisdiction, so that market forces would govern most rail rates. *See* H.R. Rep. No. 96-1035, at 38 (1980), *as reprinted in* 1980 U.S.C.C.A.N. 3978, 3983; *see also* 49 U.S.C. § 10101(1) (setting forth policy "to allow, to the maximum extent possible, competition and the demand for services to establish reasonable rates for transportation by rail"). The *September 27 Decision* also overlooks the agency's previous unsuccessful experiment with the use of statistical presumptions as part of its qualitative market dominance inquiry. After Congress enacted the market dominance standard, the Commission adopted rules that incorporated statistical presumptions, but after a few years of experience, it concluded that the use of statistical measures "placed too much emphasis on quantitative evidence which did not fully reflect the circumstances of any given movement," and thus had "not facilitated proof of market dominance, to any great extent." *Market Dominance Determinations*, 365 I.C.C. at 120, 121. The agency's experience after abandoning the use of statistical presumptions demonstrates that the Board can efficiently identify the presence or absence of effective competition using case-specific, qualitative evidence.

In Section A below, we discuss the critical role the market dominance inquiry plays in allowing market forces to govern rail rates to the maximum extent possible. In Section B, we review the agency's previous, unsuccessful effort to use statistical presumptions in the market dominance test. In Section C, we describe how the agency has efficiently used case-specific, qualitative evidence to perform its market dominance inquiries.

A. Congress intended the market dominance inquiry to play a critical role in the statutory framework for rate regulation.

Congress intended the market dominance inquiry to limit significantly the circumstances in which rail rates would be subject to regulatory challenge because it recognized that regulation was forcing rates below the levels that would prevail in competitive markets. Before Congress enacted the Regulatory Reform Act of 1976 ("4R Act"), the Commission exercised general supervisory jurisdiction over all rail rates. "A 'just and reasonable' standard controlled all rates, rail users could challenge the reasonableness of rates, at any time, and the agency had authority to determine what constituted a just and reasonable rate in each case." *Ford Motor Co. v. ICC*, 714 F.2d 1157, 1159 (D.C. Cir. 1983). In the 4R Act, Congress limited the Commission's authority by providing that the agency must find, as a prerequisite to exercising its power to determine a rate's reasonableness, that the railroad has "market dominance" over the transportation to which the rate applies. Former 49 U.S.C. § 1(5)(b) (now 49 U.S.C. § 10707(b)). Congress defined "market dominance" as "an absence of effective competition from other carriers or modes of transportation for the [transportation] to which a rate applies." *Id.* § 1(5)(c)(i) (now 49 U.S.C. § 10707(a)).[2] Congress "instituted the so-called 'market dominance test' in hopes of removing most traffic from rate regulation." H.R. Rep. No. 96-1035, at 38, *as reprinted in* 1980 U.S.C.C.A.N. at 3983.

In the Staggers Rail Act of 1980 ("Staggers Act"), Congress redoubled its efforts to allow market forces to govern most rail rates. Concerned that the rules the Commission had adopted to implement the 4R Act's market dominance test "did little to free up pricing on a movement-by-movement basis," *id.* at 115, *as reprinted in* U.S.C.C.A.N. at 4059, Congress enacted additional limits on the agency's power over rates, including a quantitative limit: a jurisdictional threshold test based on revenue to variable cost ratios, *see* former 49 U.S.C. § 10709(d)(2) (now 49 U.S.C. § 10707(d)(1)(A)). Congress also made clear that the quantitative test for market dominance was no substitute for a qualitative analysis of transportation alternatives. It provided that the existence of a rate that results in a revenue-to-variable cost percentage above the jurisdictional threshold "does not establish a presumption" that the rail carrier charging the rate "has or does not have market dominance." *Id.* § 10709(d)(4) (now 49 U.S.C. § 10707(d)(2)). In explaining its overall objective, Congress emphasized that the market dominance test was intended to further its goal of removing rates from regulation to the maximum extent possible:

> If a shipper can rely on a transportation alternative, which could include another railroad, a barge, or a truck, at a transportation cost which is not substantially greater than the rail transportation cost,

[2] The original definition referred to effective competition "for the traffic or movement" to which a rate applies, but it was amended without substantive change in the Staggers Act.

> then competition is present. Competition will serve to hold down rates ....

H.R. Rep. No. 96-1035, at 39, *as reprinted in* 1980 U.S.C.C.A.N. at 3984.

This legislative history demonstrates that any concern that the application of an accurate qualitative market dominance test might stand in the way of rate regulation is misplaced. Under the statutory framework established by Congress, even if a shipper could prove it would prevail in a challenge to a rail carrier's rate under one of the Board's tests for rate reasonableness, the shipper is not entitled to relief unless it can establish that the carrier has market dominance over the transportation to which the rate applies. Congress made this clear by directing the Board to address market dominance *before* addressing rate reasonableness. *See* 49 U.S.C. § 10707(c). Moreover, it cannot be assumed that an accurate market dominance test is unnecessary because shippers would not challenge rates for transportation that is subject to effective competition. Especially given the extent to which shippers can manipulate the Board's Stand-Alone Cost ("SAC") test through the use of cross-over traffic and the imprecise nature of the Simplified-SAC and Three-Benchmark tests, it is likely that "some shippers would consider regulators' hands to be friendlier than invisible ones." *Ass'n of Am. R.Rs. v. STB*, 306 F.3d 1108, 1111 (D.C. Cir. 2002); *see also Coal Trading Corp. v. Balt. & Ohio R.R.*, 6 I.C.C.2d 361, 372 n.11 (1990) ("The Commission developed SAC as a measure of rate reasonableness, not as an indicium of market dominance.").

Congress intended the qualitative market dominance inquiry to ensure that market forces are allowed to govern rates to the maximum extent possible. It would be contrary to Congress's intent to apply an inaccurate version of the test to encourage rate challenges for movements with effective competition.

B. The Commission rejected the use of statistical shortcuts for identifying the presence or absence of effective competition as unreliable and inefficient.

The Board's predecessor previously tried using statistical presumptions to identify the presence or absence of effective competition, but it ultimately rejected them as unreliable. The limit price test has its own distinct set of flaws, which we discuss below in Part II, but the same fundamental concern the Commission cited in abandoning the use of rebuttable presumptions applies equally to the new test: "[T]he factors determining the degree of competition faced by a rail carrier are too numerous and too varied to be gauged, with any reasonable degree of accuracy, by so few measures." *Market Dominance Determinations*, 365 I.C.C. at 120.

After Congress established the market dominance requirement in the 4R Act, the Commission adopted rules providing that a rebuttable presumption of market dominance would arise when the challenged rate exceeded the variable cost of providing the service by 60 percent or more, the carrier had handled 70 percent or more of the involved traffic during the preceding year, or the shipper had made substantial rail-related investments. *See id.* at 121-24. The Commission used those presumptions for years before replacing them with guidelines for the submission of market dominance evidence. In explaining its decision, the Commission noted some specific shortcomings associated with each presumption—several of which are similar to the flaws in the new limit price test—but its broad conclusion was that the use of presumptions "has not facilitated proof of market dominance, to any great extent." *Id.* at 121.

In other words, using presumptions neither improved the accuracy of market dominance determinations nor reduced the need to evaluate case-specific evidence "because of substantial differences among cases that preclude simple universally applicable rules." *Id.* Indeed, the use of presumptions made things worse: it "placed too much emphasis on quantitative evidence which did not fully reflect the circumstances of any given movement," and that evidence "was frequently offered at the expense of other evidence which, though less subject to quantification, is more reflective of the degree of market power possessed by a rail carrier over certain traffic." *Id.* at 120. The Commission sensibly steered away from that course in *Market Dominance Determinations*.

C. The Board can efficiently identify the presence or absence of effective competition using framework established in *Market Dominance Determinations.*

The *September 27 Decision* asserts that a new market dominance test is necessary because the approach adopted in *Market Dominance Determinations* only works in easy cases, such as those involving "large coal volumes," where "[t]ruck or truck/rail alternatives are rarely a feasible alternative to direct rail service." *September 27 Decision* at 3. However, the Board and Commission have used the traditional market dominance analysis to resolve disputes over the presence or absence of effective competition in cases involving a wide range of commodities and transportation alternatives. *See, e.g.*, *E.I. du Pont de Nemours & Co. v. CSX Transp., Inc.*, NOR 42100 (STB served June 30, 2008) (chlorine by barge); *E.I. du Pont de Nemours & Co. v. CSX Transp., Inc.*, NOR 42099 (STB served June 30, 2008) (plasticizers by transload; synthetic plastic powder by truck); *FMC Wyo. Corp. v. Union Pac. R.R.*, 4 S.T.B. 699 (2000) (coke by truck; phosphate rock by truck and pipeline; soda ash by truck and transload; sodium bicarbonate and sesquicarbonate by truck); *CF Indus., Inc. v. Koch Pipeline Co., L.P.*, 4 S.T.B. 637 (2000) (anhydrous ammonia by rail and barge); *Consol. Papers, Inc. v. Chi. & N.W. Transp. Co.*, 7 I.C.C.2d 330 (1991) (pulp and woodchips by truck); *Allied Chem. Corp. v. Ann Arbor R.R. Sys.*, 1 I.C.C.2d 492 (1985) (soda ash by truck and transload); *Platnick Bros., Inc. v. Norfolk & W.*

Ry., 367 I.C.C. 782 (1983) (scrap iron and steel by truck); *Aluminum Ass'n Inc. v. Akron, Canton & Youngstown R.R.*, 367 I.C.C. 475 (1983) (aluminum by truck).[3]

The *September 27 Decision* also suggests the traditional approach is inadequate because it cannot be used to identify whether a "feasible" transportation alternative provides "effective" competition by forcing a rail carrier to provide its service at "reasonable prices." *September 27 Decision* at 12. As the Board explains the issue, at some point, rail prices could be so high that "even patently ridiculous transportation alternatives would eventually serve to constrain rates." *Id.* But this issue is not new, and it does not require a new test to resolve. In the past, the agency often resolved the issue in one step under the rubric the *September 27 Decision* is now calling "feasibility." That is, transportation alternatives that may be possible in theory, but that would be too costly in practice to serve as an effective constraint on rail rates, such as alternatives requiring use of hundreds of trucks daily to deliver bulk products over long distances or the construction of expensive new facilities, would fail the feasibility test due to "prohibitive transport distances," "capacity/infrastructure constraints," and/or "transportation requirements imposed by the complaining shipper's customers." *September 27 Decision* at 12; *see, e.g.*, *FMC Wyo.*, 4 S.T.B. at 714-15 (concluding that trucks were not an alternative to rail shipments of phosphate rock); *Ariz. Pub. Serv. Co. v. Atchison, Topeka & Santa Fe Ry.*, 2 S.T.B. 367, 374-76 (1997) (concluding that trucks were not an alternative to rail shipments of coal); *W. Tex. Utils. Co. v. Burlington N.R.R.*, 1. S.T.B. 638, 652 (1996) (same).

The Board and the Commission have also resolved the issue in past cases by examining evidence of actual marketplace competition, such as whether rail rates respond to threats of

[3] Notably, the Commission addressed market dominance issues relating to forty lanes of traffic in *Consolidated Papers*, which is comparable to the forty-three lanes at issue here.

diversion or changes in prices of alternatives, *see, e.g.*, *FMC Wyo.*, 4 S.T.B. at 713-14 (finding that the shipper used threat of switching to trucks to discipline rail rates for coke); *Consol. Papers*, 7 I.C.C.2d at 337-38 (finding that the rail carrier had reduced its rates in response to truck competition); whether shippers are actually using the alternative, *see, e.g.*, *E.I. du Pont de Nemours & Co.*, NOR 42100, slip op. at 4-5 (finding that the shipper used barge for 90% of chlorine in the lane at issue); and comparisons of rate and cost differentials, *see, e.g.*, *CF Indus.*, 4 S.T.B. at 646-50 (comparing pipeline costs to barge costs); *Ariz. Pub. Serv.*, 2 S.T.B. at 375-76 (comparing rail costs to truck costs).

The Board has historically made timely market dominance determinations without relying on statistical presumptions. In *FMC Wyoming*, the Board took just nine months after the record closed to issue a final decision that disposed of market dominance issues for five different commodities moving in ten origin-to-destination corridors, as well as stand-alone cost issues involving sixteen rates in all.[4] As another example, the Board took less than three months from the close of the record to find that barges provided effective competition for rail movements of chlorine in *Du Pont*, NOR 42100. In short, the traditional approach to the market dominance inquiry provides a method of assessing in a timely manner the "factors that determine the degree of competition faced by a rail carrier." *Market Dominance Determinations*, 365 I.C.C. 120. The traditional approach is vastly superior to the limit price test, which is fraught with shortcomings, as we discuss next.

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[4] The Board's decision *FMC Wyoming* also resolved complex disputes over variable costing issues that have since been eliminated from modern rate cases.

II. THE LIMIT PRICE TEST IS NOT A VALID TEST OF MARKET DOMINANCE.

A comparison between the limit price R/VC ratio for the issue traffic and the defendant's RSAM number does not identify whether transportation alternatives constrain the defendant's rates. Limit price R/VC ratios will be distorted because the denominators of the ratio will be based on system-average variable costs, rather than movement-specific variable costs, and numerators will depend on calculations of hypothetical limit prices. And, even if limit price R/VC ratios could be calculated accurately, no conclusions about market dominance could be drawn by comparing them to the defendant's RSAM number. A rail carrier's RSAM number does not establish a dividing line between movements that are subject to effective competition and movements over which the carrier has market dominance.

In Section A below, we discuss the hazards of relying on "high" limit price R/VC ratios as an indicator of market dominance. In Section B, we explain why there is no justification for relying on a rail carrier's RSAM number to determine whether a limit price R/VC ratio for particular traffic is "too high."

A. Limit price R/VC ratios are not reliable indicators of market dominance.

The *September 27 Decision* asserts that the use of a limit price, rather than the challenged rate, resolves the concerns that led the Commission to abandon its reliance on price-cost presumptions in *Market Dominance Determinations*. However, the use of a limit price does not resolve the Commission's fundamental concern that a "high" R/VC ratio is not reliable evidence of market dominance. As the Commission correctly observed, "even if calculated on the basis of accurate cost information," there are "any number of reasons why a high price/cost ratio may not be indicative of true market power" *Market Dominance Determinations*, 365 I.C.C. at 122. For example, the market may be signaling a need for more investment so rail carriers can better compete with trucks. Or a rail carrier may have invested substantial capital resources to provide a new service aimed at capturing high-rated traffic that historically moved by truck. Or a rail carrier may be competing with trucks to provide a high-value service to customers.

Moreover, as discussed in more detail below, the use of limit price does not address the Commission's concerns about calculating accurate R/VC ratios. To the contrary, it exacerbates those concerns. The use of a limit price fails to address the widely recognized problems with relying on R/VC ratios that are calculated using system-average costs, and the limit price test gives rise to additional problems by invoking hypothetical limit prices.

1. Reliance on limit price R/VC ratios ignores well-known problems with drawing movement-specific conclusions from data reflecting system-average costs.

The use of the limit price test does not respond to the Commission's most basic concern with relying on presumptions based on R/VC ratios: R/VC ratios are highly imperfect measures of whether a particular rate is high in relation to a particular movement's costs because of the difficulties in calculating accurate variable costs for carriers, particularly when using system-average variable costs. As the Commission explained:

> Such costs depend on numerous factors that vary considerably from one movement to another. Since the simplicity of the cost test requires that a standard costing methodology be used, there is no way of avoiding the distorting inaccuracies of such a test. Many rates falling above a designated revenue-to-variable cost ratio would, on the basis of more accurate cost estimates, in fact be below it.

Market Dominance Determinations, 365 I.C.C. at 122.

The use of the limit price, rather than the challenged rate, as the numerator of the R/VC ratio does not solve the costing problem. If the rail carrier's variable costs are understated, the limit price test will overstate the limit price R/VC ratio, and will thus produce a false finding of market dominance, just as surely as if the test used the challenged rate as the numerator. In fact, in many instances in which rail competes with truck, use of system-average variable costs will dramatically understate the rail carrier's actual cost of handling traffic, and thus overstate the limit price R/VC ratio, because the rail carriers must incur the high costs of providing truck-like service to compete. The result of such false positives is that more rates are subject to regulation, despite Congress's intent to limit regulatory intervention to only traffic that lacked effective competition. The Commission tried to address problems with using system-average costs by encouraging parties to submit evidence reflecting movement-specific adjustments. *See Market Dominance Determinations*, 365 I.C.C. at 122. By contrast, under the limit price test, parties may not submit evidence of movement-specific variable costs as rebuttal evidence: the Board will consider only "intangible" and "unquantifiable" features of the alternative transportation or the rail service that make the limit price R/VC ratio appear higher (or lower) than it actually is. *September 27 Decision* at 14.[5] Thus, the limit price test fails entirely to address the problem of basing market dominance determinations on system-average variable costs.

Indeed, the *September 27 Decision* disregards the unambiguous conclusion of independent economists that the Board recently retained to produce a comprehensive study of competition in the railroad industry that "regulatory reforms that would establish R/VC tests as the sole quantitative indicator of a railroad's market dominance are not appropriate." Laurits R. Christensen Associates, Inc., *A Study of Competition in the U.S. Freight Railroad Industry and Analysis of Proposals That Might Enhance Competition—Revised Final Report* (Nov. 2009) ("*Christensen Report*") at ES-14. The *September 27 Decision* asserts that the limit price test addresses the concern expressed in the *Christensen Report* by using the limit price, rather than

[5] The Board has proscribed the use of movement-specific adjustments in rate cases as a general matter. *See Major Issues in Rail Rate Cases*, EP 657 (Sub-No. 1), slip op. at 59 (STB served Oct. 30, 2006); *Simplified Standards for Rail Rate Cases*, EP 646 (Sub-No. 1), slip op. at 26 (STB served Sept. 5, 2007).

the challenged rate, in the numerator of the R/VC ratio. *See September 27 Decision* at 16-17. However, the *Christensen Report* is clear that the problem it was describing involves the calculation of costs in the denominator, not the revenues in the numerator:

> [C]aptivity measures based on categorizing shipment-level R/VC (or markup) data are dependent on good alignment of actual and measured costs, particularly for extreme values of R/VC, but the large shares of tons and ton-miles with R/VC below 100 percent suggest that measured and actual variable costs are not well-aligned in the tails of the R/VC distribution.

Christensen Report at ES-11.[6] As a result of these issues with measuring variable costs, the experts retained by the Board concluded that "the R/VC ratio is not very useful as an indicator of the presence of market structure factors that would increase a shipper's 'captivity' to an individual railroad." *Id.* at ES-14. The *September 27 Decision*'s failure to address the ramifications of relying on R/VC ratios calculated using system-average variable costs is a major oversight. The oversight is particularly egregious in view of the warnings provided by experts and the Board's own recognition that its regulatory costing system is due for an overhaul. *See, e.g.*, *Review of the Surface Transportation Board's General Costing System*, EP 431 (Sub-No. 3) (STB served Apr. 6, 2009); *Class I Railroad Accounting and Financial Reporting—Transportation of Hazardous Materials*, EP 681 (STB served Jan. 5, 2009).

2. Reliance on hypothetical limit prices creates additional uncertainties in developing R/VC ratios.

The *September 27 Decision*'s only attempt to distinguish the use of a limit price R/VC ratio from the use of issue traffic R/VC ratios was to quote the Commission's prior observation that the challenged rates may not "'actually move traffic over an extended period of time.'"

[6] URCS allocates total variable costs over all traffic, so the existence of large amounts of traffic with overstated costs (R/VC ratios below 100%) implies that there must be a significant number of movements with understated costs (and therefore overstated R/VC ratios).

September 27 Decision at 17 (quoting *Market Dominance Determinations*, 365 I.C.C. at 122). But the Commission's observation provides a reason not to rely on *any type of R/VC ratio* to make presumptions regarding market dominance; it is not a reason to use the limit price R/VC ratio. If the challenged rate is too high to move the traffic over time, but the limit price R/VC ratio exceeds the carrier's RSAM number, the Board will end up regulating rates when market forces should have been left to do the job. The use of R/VC ratios to the exclusion of other evidence of market dominance raises the same issues no matter whether the numerator is the limit price or the challenged rate.

Indeed, far from resolving concerns associated with using R/VC ratios as an indicator of market dominance, the *September 27 Decision*'s reliance on limit price R/VC ratios introduces a new problem: how to calculate accurate limit prices. The limit price is supposed to be "the highest price a carrier could theoretically charge a shipper without causing a significant amount of the issue traffic on a particular rail movement to be diverted to a competitive alternative, assuming all other factors are held constant." *September 27 Decision* at 13. The Board has previously estimated rates that would be charged by other modes of transportation as part of a broader evaluation of whether those other modes provided effective competition. *See id.* at 16. However, in prior cases, an imperfect estimate would never have been outcome determinative—the Board was able to rely on many other forms of qualitative evidence to help it reach the correct conclusion. Now, the estimated limit price will be outcome determinative.

Unfortunately, the *September 27 Decision* sheds little light on how the Board will calculate limit prices.[7] It appears the Board chose between competing submissions from the

[7] The calculations are contained in workpapers that remain Highly Confidential. *See September 27 Decision* at 37 n.142.

parties. But those submissions were made before the parties understood how significant they would be. Now that the *September 27 Decision* has elevated the significance of limit price calculations in the Board's market dominance analysis, the Board can expect the issue to be far more contentious in future proceedings. The issue is similar to calculating a stand-alone price in a rate case, but it will be even more complicated because the Board must identify the point at which "a significant amount" of issue traffic would be "diverted to a competitive alternative." Moreover, unless there is actually a transportation alternative in the market that is capturing a "significant amount" of traffic—in which case, rail would not be market dominant—the Board will have to estimate a limit price, and an R/VC ratio that combines a hypothetical limit price with system-average variable costs is unlikely to represent anything approaching reality.

B. RSAM is not a reliable indicator of the presence or absence of effective competition.

Even if a "high" limit price R/VC ratio could provide some evidence for the existence of market power, there is no rational basis for presuming that effective competition does not exist whenever the limit price R/VC ratio falls above the carrier's RSAM number. A carrier's RSAM number is not a dividing line between traffic that is subject to effective competition and traffic that is not. A carrier's RSAM number results from a mechanical calculation of the system-wide average markup the carrier would need to charge on all of its traffic priced at or above the 180% R/VC level (which the Board has correctly identified as "*potentially* captive traffic" rather than "captive traffic") in order to achieve revenue adequacy. *See Simplified Standards for Rail Rate Cases*, EP 646 (Sub-No. 1), slip op. at 20 (STB served Sept. 5, 2007). The fact that a carrier charges a rate above or below its RSAM number for a particular movement reveals nothing about the presence or absence of effective competition for that movement.

1. The conclusion that the relationship between a limit price R/VC ratio and a rail carrier's RSAM number can be used to identify the presence or absence of effective competition for a particular movement has no support.

The *September 27 Decision*'s assertion that the relationship between a particular rate and a rail carrier's RSAM number reveals the presence or absence of effective competition for traffic moving under that rate is fallacious. The *September 27 Decision* leaps from a simple premise—that "a carrier's RSAM number represents the average level at which the carrier would achieve system-wide revenue adequacy"—to the unsupported conclusion that "the fact that a rate involving certain potentially captive traffic produces an R/VC ratio that falls below the carrier's RSAM number indicates that competitive transportation alternatives likely exist." *September 27 Decision* at 15. The *September 27 Decision* then doubles down on that error by asserting that the inverse is true—that is, the fact that a rate produces an R/VC ratio *above* the RSAM number means that competitive transport alternatives likely *do not* exist. *See id.* However, the first conclusion does not follow from the premise, and the second conclusion does not follow from the first.

The *September 27 Decision* incorrectly suggests that the *Simplified Standards* decision explains why "a rate that falls below RSAM is 'being constrained by ... market forces.'" *Id.* at 15 n.42 (quoting *Simplified Standards*, slip op. at 81). In *Simplified Standard*, the Board observed that a revenue inadequate carrier has rates that "are apparently being constrained by other market forces." *Simplified Standards*, slip op. at 81. But the Board never implied that RSAM could be used to identify which specific rates are being constrained by market forces.[8]

[8] Indeed, the Board has previously found carriers to be market dominant with regard to rates that were barely above the jurisdictional threshold. *See, e.g.*, *FMC Wyo.*, 4 S.T.B. at 744-746 (soda ash moving to Chicago).

The Board was explaining that its Three-Benchmark test would include an upward adjustment to all comparison group rates whenever the defendant was revenue inadequate because using an unadjusted average would move the carrier further away from revenue adequacy—a relevant consideration in determining the reasonableness of a rate. The Board did not say anything about RSAM's ability to identify whether individual rates were being constrained by market forces. *See Simplified Standards*, slip op. at 81-82. Moreover, even if all traffic with rates that produce R/VC ratios below a carrier's RSAM number has competitive alternatives, that would not imply the inverse—*i.e.*, that all other traffic lacks competitive alternatives. The *September 27 Decision* cannot rely on the Board's decision in *Simplified Standards* to justify its current decision to use a rail carrier's RSAM number in its limit price test.

2. A rail carrier's RSAM number is determined by factors that have no bearing on the presence or absence of effective competition for a particular movement.

The *September 27 Decision*'s assertion that "a finding that the limit price R/VC ratio … falls above RSAM … provides an objective indication of monopoly pricing" is unsupported and unsupportable. *September 27 Decision* at 17. There is no connection between a rail carrier's RSAM number and the presence or absence of effective competition for a particular movement. A carrier's RSAM number can and will change without any change in competitive circumstances for any particular movement. All else remaining equal, a carrier's RSAM number will:

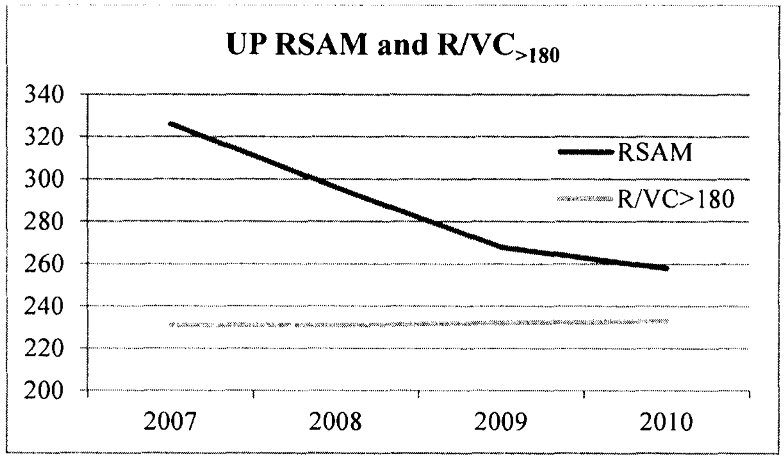
- fall (or rise) if the rail industry cost of capital falls (or rises);
- fall (or rise) if the amount of traffic the carrier transports with R/VC ratios below 180% increases (or decreases); or
- fall (or rise) if the carrier's operating costs are reduced (or increased).

In short, the drivers of RSAM values are system-wide changes in costs, revenue, and traffic mix, and not the competitive circumstances of millions of individual movements.[9]

The chart below further illustrates the point that RSAM cannot be used as an indicator of market power. As shown in the chart below, UP's RSAM number dropped from 326% in 2007 to 258% in 2010.[10] According to the theory espoused in the *September 27 Decision*, the falling RSAM number would mean that UP's market power supposedly increased—as RSAM falls, UP would be presumed to have market dominance over movements at lower R/VC ratios. Yet, over the same period, UP's $R/VC_{>180}$—that is, UP's average markup over variable cost on the same set of "potentially captive traffic"— remained essentially the same. In other words, during this period of supposedly increasing market power, UP's average markups on "potentially captive traffic" did not increase. That makes no sense, if RSAM is an indicator of market power.

[9] Moreover, in most cases, the Board will not even have a RSAM figure that reflects the current market environment. The Board cannot publish RSAM numbers for a particular year until well after the year has ended. For example, the Board did not publish the 2010 RSAM numbers until February 24, 2012. Thus, if a shipper were to file a complaint in January 2013 challenging rates for 2013, the Board would have to use a RSAM number from 2010 (which would itself be based on an average of RSAM data from 2007 through 2010) to assess the market environment in 2013, or wait until some later point to use more recent RSAM data.

[10] *See Simplified Standards for Rail Rate Cases—2007 RSAM and $R/VC_{>180}$ Calculations*, EP 689 (STB served May 12, 2009); *Simplified Standards for Rail Rate Cases—2008 RSAM and $R/VC_{>180}$ Calculations*, EP 689 (Sub-No. 1) (STB served July 23, 2010); *Simplified Standards for Rail Rate Cases—2009 RSAM and $R/VC_{>180}$ Calculations*, EP 689 (Sub-No. 2) (STB served July 13, 2011); *Simplified Standards for Rail Rate Cases—2010 RSAM and $R/VC_{>180}$ Calculations*, EP 689 (Sub-No. 3) (STB served Feb. 24, 2012).



Additional evidence that RSAM is not suited for the role the *September 27 Decision* assigns it in the limit price test can be found by considering the range of rail carrier RSAM numbers. The *September 27 Decision*'s use of RSAM implies that, all else remaining equal, trucks must have lower rates to provide effective competition for traffic moving on some carriers than for traffic moving on other rail carriers. For example, UP's rates would be subject to regulation if truck alternatives produce a limit price R/VC ratio of at least 258%, while rates charged by other carriers could not be regulated unless truck alternatives produce a limit price R/VC ratio of at least 265% (for Norfolk Southern), or 293% (for CSX Transportation), or 309% (for Illinois Central), or 327% (for Kansas City Southern). *See Simplified Standards for Rail Rate Cases—2010 RSAM and R/VC$_{>180}$ Calculations*, EP 689 (Sub-No. 3), at Table 1. That is an absurd outcome, and it undermines any reliance on RSAM: there is no reason why the ability of a transportation alternative to provide effective competition would turn on the system-wide average markup a particular carrier would need to charge on all its traffic priced at or above the 180% R/VC level in order to achieve revenue adequacy.

The fact that RSAM does not provide the information the Board needs to make market dominance determinations is even more apparent when two railroads operate between the same origin and destination. Because each carrier has a different RSAM number, market dominance results can differ even when two rail carriers would charge the same rate for the same traffic as the alternative transportation. For example, if UP, Kansas City Southern, and a truck/transload company each offered to move plastics from New Orleans to Fort Worth at a 2010 rate of $4,000 per car, UP would be found market dominant (with a limit price R/VC ratio of 268%, compared to an 258% RSAM), while Kansas City Southern would not be found market dominant (with a limit price R/VC ratio of 320%, compared to a 327% RSAM).[11] The outcome is inconsistent and incoherent because comparisons of limit price R/VC ratios with RSAM numbers reveal nothing about the competitive circumstances of particular movements. The Board created the RSAM number as a tool for its Three-Benchmark rate reasonableness test. It needs a different set of tools to perform market dominance inquiries.

III. THE LIMIT PRICE TEST REPRESENTS A HARMFUL CHANGE TO THE MARKET DOMINANCE ANALYSIS.

UP understands the Board's interest in creating a simple, objective test for identifying the presence or absence of effective competition. But the limit price test is not a valid test, and it represents a decidedly harmful change to the Board's rules. The limit price test appears to place greater reliance on the use of cost-based presumptions than the approach that the Commission rejected in *Market Dominance Determinations*, it will likely have the perverse effect of discouraging rail carriers from improving their service to compete more effectively with other transportation modes, especially with trucks, and its reliance on R/VC ratios to the exclusion of more relevant evidence is contrary to Congress's intent that the Board conduct accurate market

[11] In this example, the variable costs are calculated based on receiving and terminating one car of plastics (STCC 282) moving in a single-car shipment in a private covered hopper car, at 96 tons per car, for 540 miles, after a 500-mile movement that originated on Norfolk Southern. UP's variable costs would be $1,492.54; Kansas City Southern's variable costs would be $1,250.57.

dominance inquiries to ensure that market forces are allowed to govern rates to the maximum extent possible.

A. The evidentiary impact of limit price test is not entirely clear from the *September 27 Decision*, but the test might actually increase the burdens on parties and the Board, and it will certainly produce less accurate results.

The *September 27 Decision* does not state expressly that application of the limit price test will create a rebuttable presumption, but the analysis in the Appendix makes clear that is how the test is being used. Moreover, the *September 27 Decision* appears to make the presumption even more difficult to rebut than the cost-based presumption that the Commission rejected in *Market Dominance Determinations*. Even when it was using cost-based presumptions, the Commission never precluded parties from submitting relevant qualitative evidence to rebut the presumptions. By contrast, under the limit price test, evidence submitted to rebut the presumption must focus on the presumption itself: the *September 27 Decision* says the Board can consider only "intangible" or "unquantifiable" features of the alternative transportation or rail service that make the limit price R/VC ratio appear higher (or lower) than it actually is. *See September 27 Decision* at 14. In other words, the limit price test would require the Board to disregard the types of direct evidence of marketplace competition that it has used in the past to identify the presence or absence of effective competition, such as: whether rail rates respond to threats of diversion or changes in price of the alternative, actual use of the alternative by shippers, and comparisons of rates and costs of rail service and alternative transportation. *See* pp. 8-9, *supra*.[12] Ironically, the *September 27 Decision* might not end up reducing the amount of evidence that the parties

[12] Notably, the limit price test would not help the Board improve on the traditional methods of identifying when effective competition exists, albeit at rates that may seem high in relation to variable costs. *See September 27 Decision* at 3. The limit price test simply presumes that there is no effective competition in those circumstances.

submit, but it will require the Board to sort through evidence aimed at rebutting the presumption, rather than evidence that more directly addresses the presence or absence of effective competition. In short, the Board could end up doing a similar amount of work to produce a less accurate result.

Moreover, if the Board were willing to accept *any* evidence of effective competition to rebut the results of the limit price test, the test would speed up the market dominance inquiry only when neither party seeks to rebut the presumption. In every other case, the test would *increase* the amount of evidence the Board would have to address.

B. Reliance on the limit price test will produce perverse and anticompetitive, results.

The Commission correctly recognized that any market dominance test that relies solely on a single statistical measure will fail more often than it succeeds. "[F]lexibility is necessary because of substantial differences among cases that preclude simple universally applicable rules." *Market Dominance Determinations*, 365 I.C.C. at 121. Inflexible rules often generate unintended consequences, and this holds true for the limit price test. Application of the limit price test will likely have the perverse effect of discouraging rail carriers from improving their service to compete more effectively with other transportation modes, especially with trucks. Limit prices may be high because an alternative mode of transportation has not faced pricing pressures as a result of competition from rail carriers. Rail carriers might be able to compete, but only after making investments to enter the market. However, rail carriers will be reluctant to make the necessary investments if their efforts to compete will expose them to rate regulation that threatens their ability to earn a market return on that investment.

Similarly, limit prices may be high because a shipper is willing to pay a premium for a high-value service. Rail carriers may be able to offer shippers a superior alternative to the mode that is setting the limit price, but only if rail carriers invest in developing new services to match the service levels offered by the incumbent. As a final example, limit prices may be high because demand is rising or because of an increase in volume to a particular part of a rail network. High rates are often a signal of a demand for additional investment in capacity, and the rates help pay for that investment. Again, rail carriers will be reluctant to make such investments if their efforts to compete or to increase capacity make it more likely they will end up with regulated rates that deprive the rail carriers of the opportunity to earn a reasonable return on the capital they put at risk.[13] Rate regulation that interferes with market signals will result in less service and less ability to respond to customers' constantly changing transportation needs.

In each of the situations described above, the limit price test is particularly problematic because the denominator of the limit price R/VC ratio reflects the rail carrier's system-average variable cost, and the system-average cost will understate the actual cost of providing service (especially if incremental investment or premium service is required). The rail carrier's actual cost will be understated for two reasons. First, in the situations described above, the service at issue are generally truck-competitive services, which involve a higher level of costs to meet the service requirements of customers than system-average traffic. Second, many of the situations above will require incremental capital investment by the carrier, but the Board's costing system will treat a portion of those costs as fixed and distribute the remainder across all of the carrier's

[13] UP has previously explained how the increased prospect of rate regulation puts pressures on railroads to return more of their earnings directly to investors rather than spending on growth opportunities. *See* Comments of Union Pacific Railroad Company, Verified Statement of James R. Young at 13-15, *Competition in the Railroad Industry*, EP 705 (Apr. 12, 2011). Such a result would be contrary to the public interest in increased investment in the U.S. freight rail network. *See generally*, U.S. Dep't of Transportation, Federal Railroad Administration, National Rail Plan: Moving Forward (Sept. 2010), http://www.fra.dot.gov/downloads/NRP_Sept2010_WEB.pdf.

traffic, rather than assign it to the traffic that is giving rise to those costs. The immediate result will be overstated limit price R/VC ratios and findings of market dominance when rail carriers are actually engaged in vigorous competition with other modes of transportation. The predictable, longer-term result is that rail carriers will be less likely to try to engage in such competition and shippers will lose a transportation alternative.

Ironically, the situations described above are ones in which evidence regarding the actual conduct of shippers and carriers in the marketplace would readily demonstrate the presence or absence of effective competition.

C. The limit price test is contrary to Congress's intent.

Ultimately, the *September 27 Decision* justifies the use of the limit price test by asserting that Congress would have wanted the Board to investigate the reasonableness of rates when the limit price R/VC ratio is "too high." The *September 27 Decision* states:

> [I]f a feasible alternative prevents the railroad from charging rates above 190% of variable costs, it would appear that the marketplace is capable of disciplining the carrier's behavior. In contrast, if that same alternative serves only to prevent the railroad from charging rates above 500% of variable costs, then it is equally clear to us that the marketplace is not placing sufficient discipline on the carrier's behavior and that Congress would have intended for the Board to investigate the reasonableness of those rates.

September 27 Decision at 17. There are two substantial problems with that statement.

First, even assuming that the existence of limit price R/VC ratios of 190% and 500% for some traffic provides reliable information about the presence or absence of effective competition for that traffic, it still does not explain why the limit price test uses RSAM. The current RSAM number for every carrier with a Board-calculated RSAM number is much closer to 190% than 500%—the range is from 253% to 327%. *See Simplified Standards for Rail Rate Cases—2010 RSAM and $R/VC_{>180}$ Calculations*, EP 689 (Sub-No. 3), at Table 1. The *September 27 Decision* suggests that use of RSAM "balances the revenue needs of the carrier with the need to protect captive shippers from the abuse of market power," *September 27 Decision* at 17, but if the Board incorrectly decides to regulate a movement subject to effective competition on the basis of a limit price R/VC ratio above RSAM, the rail carrier is not protected from a possible outcome in which the regulated rate is pushed well below RSAM. The *September 27 Decision*'s "balancing" act thus ignores the primary policy interest that Congress sought to advance by enacting the 4R Act and the Staggers Act—the interest in allowing rates to be determined by market forces to the maximum extent possible.

Second, Congress did *not* want the Board to regulate rates simply because an R/VC ratio appears "too high." Congress specifically told the Board *not* to draw presumptions about market dominance based on a finding "that a rate charged by a rail carrier results in a revenue-variable cost percentage for the transportation to which the rate applies that is equal to or greater than 180 percent." 49 U.S.C. § 10707(d)(2). While the limit price test reflects a hypothetical rate, it is nonetheless supposed to reflect the highest rate that a rail carrier could charge without causing the diversion of a significant amount of the issue traffic. *See September 27 Decision* at 16. Again, Congress intended the Board to engage in a case-by-case, qualitative analysis to help ensure that rates would be governed by market forces to the maximum extent possible.

IV. CONCLUSION

UP asks the Board to accept these comments into the record in this docket pursuant to its October 25, 2012, order. UP also urges the Board to reject the limit price test. The comparison of a limit price R/VC ratio to a rail carrier's RSAM number does not provide a meaningful indicator of the presence or absence of effective competition for the traffic at issue.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that on this 28th day of November, 2012, I caused a copy of the foregoing document to be served by electronic mail and first-class mail, postage prepaid, on the parties of record in STB Docket No. NOR 42123.

Michael L. Rosenthal