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SURFACE TRANSPORTATION BOARD**

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RAIL TRANSPORTATION OF GRAIN, RATE REGULATION REVIEW

**COMMENTS OF
NORFOLK SOUTHERN RAILWAY COMPANY**

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Dated: June 26, 2014

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Norfolk Southern Railway Company (“NS”) submits these Comments in response to the Board’s notice in Ex Parte 665 (Sub-No. 1), Rail Transportation of Grain, Rate Regulation Review. The Board has requested input from interested parties concerning “grain shippers’ ability to effectively seek relief for unreasonable rates, including proposals for modifying existing procedures, or new alternative rate relief methodologies, should they be necessary.” *Rail Transp. of Grain, Rate Regulation Review*, EP 665 (Sub-No.1), slip op. at 2 (STB served Dec. 12, 2013).

In considering comments in this proceeding, NS urges the Board to keep in mind two fundamental principles of its rate reasonableness methodology: any determination of the reasonableness of a rail rate must consider a particular rate for a movement over a particular lane, and any test for rate reasonableness must reflect sound railroad economics. These principles do not vary based on shipper or commodity. NS also briefly details the many differentiating factors that affect particular grain shipments, shippers, carriers, and markets. Accordingly, NS asks the Board to be mindful that such real world considerations defy sweeping

generalizations about grain transportation as a whole. These principles and market factors should guide the Board when considering parties' submissions in this proceeding.

I. The Board Must Adhere to the Core Principles of Its Rate Reasonableness

Methodology

The Board already has three regulatory procedures in place for shippers who believe their rail rates are unreasonable: Stand-alone Cost cases ("SAC"), Simplified-SAC, and the Three Benchmark ("3B") approach for smaller cases. SAC is the agency's rate regulation gold standard. *See McCarty Farms, et al. v. Burlington Northern Inc.*, 3 I.C.C.2d 822, 840 (1987) (The SAC constraint is the "preferred and most accurate procedure available for determining the reasonableness" of rates); *Simplified Standards for Rail Rate Cases*, EP 646 (Sub-No. 1), slip op. at 5 (STB served Sept. 5, 2007) ("*Simplified Standards*") (SAC alternatives do not offer "as much precision and degree of confidence as a Full-SAC analysis"). However, commenters have pointed to the failure of any grain shipper to bring a rate case under the simplified procedures as the central piece of evidence that those procedures are uniquely unavailing for grain transportation. *See, e.g.*, National Grain and Feed Association ("NGFA") Opening 3-4, *Rate Regulation Reforms*, EP 715. The Board's experience in formulating and applying these and other methodologies provides at least two core principles that should guide consideration of comments in this proceeding.

A. Any Determination of the Reasonableness of a Rail Rate Must Consider a Particular Rate for a Movement over a Particular Lane

Any rate reasonableness challenge must begin by specifying a particular rate for a particular movement from origin to destination. "The Board does not establish maximum rates for classes of railroad rates." *Western Coal Traffic League – Petition for Declaratory Order*,

STB Docket No. FD 35506, slip op. at 17 (STB served July 25, 2013); *see also Bessemer & Lake Erie R. Co. v. I.C.C.*, 691 F.2d 1104, 1113 (3d. Cir. 1982) (“Individual shippers who object to specific rates may file complaints against market dominant carriers challenging the reasonableness of such rates. 49 U.S.C. §§ 11701(b), 11705.”). Identification of the subject movement is fundamental to the prerequisite finding that a railroad has market dominance over the transportation. By statute, the Board must examine the competitive condition of “the transportation to which a particular rate applies.” 49 U.S.C. § 10707(d)(1); *see also id.* § 10707(a) (requiring a finding of reasonableness if “effective competition from other carriers or modes of transportation for the transportation to which a rate applies” exists); *DuPont de Nemours & Co. v. Norfolk S. Ry.*, STB Docket No. NOR 42125, slip op. at 16 (STB served Mar. 14, 2014) (holding that Board must evaluate “alternatives that directly compete with the ‘transportation to which [the challenged] rate applies.’”). The Board cannot fulfill this statutory obligation without looking at the characteristics of the move over the particular lane being challenged.

Evaluation of a particular rate based on the characteristics of the movement of the issue traffic from origin to destination also forms the core of the SAC analysis. *See, e.g., Rate Regulation Reforms*, EP 715, slip op. at 2 (STB served July 25, 2012) (“In other words, we judge the challenged rate against a simulated competitive rate a captive shipper would enjoy if a competitive transportation market existed.”). Simplified-SAC takes the same approach, albeit with a less robust analysis. Even the 3B test, which the Board itself described as a “rough and imprecise” comparison methodology, allows for “whatever additional information is available that bears on the reasonableness of the pricing of the traffic at issue.” *Rate Guidelines – Non-Coal Proceedings*, 1 S.T.B. 1004, 1021-22 (1996). The Board must evaluate any comments in

this proceeding with the understanding that a valid rate reasonableness determination cannot be made without consideration of the characteristics of the particular rate and of the movement over a particular lane.

B. Any Test for Rate Reasonableness Must Reflect Sound Railroad Economics

The Board has long recognized that *any* methodology used to evaluate the reasonableness of rates must rest on sound economics.¹ Previous agency efforts to develop and apply novel rate reasonableness tests have failed or been overturned on appeal because they lacked economic support. Several such examples may provide guidance to the Board in this proceeding:

- **Seven Percent Additive:** The Interstate Commerce Commission (“ICC”) created a rule that a seven percent additive above a carrier's fully allocated costs could be included in a rail rate in order to support a carrier's effort to attain revenue adequacy. In *City Pub. Serv. Bd. ex rel. San Antonio v. United States*, 631 F.2d 831, 850 (D.C. Cir. 1980), the D.C. Circuit rejected the methodology, explaining that the ICC “provide[d] no defensible rationale for the inclusion of the seven percent increment.” *Id.* at 851. The Court admonished that the agency was obliged to “provide adequate justification for its choice of a particular increment above fully allocated costs.” *Id.* at 852.
- **Ton Mile Method:** The ICC’s subsequent maximum rate reasonableness methodology, the “ton-mile method,” assigned a carrier's constant costs “to particular traffic based upon the tonnage and ton-miles involved.” *Coal Rate Guidelines - Nationwide*, 1 I.C.C.2d 520, 523 (1985). A carrier would then be able to attribute the “fully allocated cost” to that traffic and charge it to the shipper. *Id.* at 522. While a challenge was pending at the Third Circuit, the ICC belatedly determined that the methodology would yield maximum rates that would not adequately reflect demand or contribute adequate revenues. *Id.* at 523, n.7. Given these economic failings, the ICC requested a remand, withdrew the methodology, and began its rulemaking anew. *See id.*

¹ *See, e.g., Simplified Standards* at 13 (“The SAC test, which judges the reasonableness of a challenged rate by comparison to the rate that would prevail in a competitive market, rests on a sound economic foundation and has been affirmed by the courts Any simplified methodology for assessing the reasonableness of rail rates should be designed to achieve the same objective, albeit in a less precise manner.”); *Rate Guidelines – Non-Coal Proceedings*, 1 S.T.B. at 1010 (“Even though the impact of simplified procedures would be limited, the ICC acknowledged that it did not have free rein in devising simplified reasonableness procedures. Rather, the simplified procedures must be equitable, must comport with the underlying statutory directives and guiding economic principles, and must produce realistic measurements.”).

- **Revenue over Variable Cost Methodology:** The ICC’s R/VC method deemed a rate reasonable if “its mark-up over variable cost is no greater than the mark-up on ‘benchmark’ traffic selected as suitable for comparison.” *Burlington Northern R.R. Co. v. Interstate Commerce Comm’n*, 985 F.2d 589, 595 (D.C. Cir. Feb. 9, 1993). The D.C. Circuit found that the ICC’s approach and explanation lacked “supporting principle or intellectual coherence” and the agency “had not intelligibly explained why the trade-off chosen was reasonable.” *Id.* at 597. Concluding that “the jettisoning of CMP/SAC cannot pass for reasoned decision making,” the Court remanded the case to the ICC. *Id.* at 599.

Sound economics must be the agency’s lodestar.

Moreover, nothing in the Board’s governing statutes or prior considerations of rate regulation by the agency suggests that the economic basis or soundness of a methodology for evaluating rate reasonableness should vary based on the shipper or commodity at issue. The Board’s current procedures are available to all shippers and shipments alike. *See, e.g., Rate Guidelines – Non-Coal Proceedings*, 1 S.T.B. at 1008, n.7 (“Notwithstanding its title, the Coal Rate Guidelines procedures are not limited to coal cases. Because of the prevalence of coal rate challenges, and because coal cases typify captive, high-volume, repetitive rail traffic, they served as the springboard for the ICC’s analysis of all such cases.”). By comparison, limiting an economically unsupported methodology to some subset of shippers or commodities could not cure such an unreasoned approach, but instead would only inject further arbitrariness.

NS recognizes with concern that the Board made a conscious turn away from utilizing precise methodologies by adopting Simplified-SAC and especially the 3B test. *See Simplified Standards* at 5 (SAC alternatives do not offer “as much precision and degree of confidence as a Full-SAC analysis.”). The Board has continued down that path in creating the economically-unsupported limit price approach to assess qualitative market dominance in recent SAC cases.²

NS once again urges the Board to adopt only methodologies that have reasoned economic bases

² *See, e.g.,* NS Comments of Amicus Curiae, *M&G Polymers USA, LLC v. CSX Transp., Inc.*, STB Docket No. NOR 42123 (Nov. 28, 2012) (detailing economic failings).

and account for accepted economic principles applicable to the railroad industry, including economies of scope, density, and scale.³

Still, until recently the Board had conditioned the availability of imprecise methodologies with respect to the amount of relief available, recognizing that less precise methodologies should not be used to decide high value cases. *See Simplified Standards* at 5 (“This approach follows the small claims court model used in civil litigation, a long-accepted alternative dispute resolution process whereby procedures and discovery are expedited, but with limits placed on the relief available.”). The Board’s decision to remove the relief limit from Simplified-SAC in EP 715 took with it the Board’s prior justification for allowing a less accurate showing of unreasonableness.⁴ The Board should not take any further steps away from grounding its regulatory policy and authority in sound economic theory here.

Nonetheless, many shippers have called for the Board to untether its rate reasonableness examination from economic principles and its statutory requirements if those principles stand in the way of lower rates.⁵ As NS has stated in many forums, the fact that a shipper is dissatisfied

³ *See Rate Guidelines – Non-Coal Proceedings*, 1 S.T.B. at 1018, n.39.

⁴ The United States Court of Appeals for the D.C. Circuit recently denied NS’s and CSX Transportation, Inc.’s appeal of the removal of the relief limit from Simplified-SAC. *See CSX Transp., Inc. v. Surface Transp. Board*, 2014 U.S. App. LEXIS 11617 (D.C. Cir. June 20, 2014).

⁵ *See, e.g.*, NGFA Opening at 5, *Rate Regulation Reforms*, EP 715 (“But Congress neither suggested nor required the Board to include in its simplified rate-rule regime the ‘constrained market pricing’ (‘CMP’) that provides the theoretical underpinning of the Full-SAC rail rate rules.”); Alliance for Rail Competition (“ARC”) Opening at 14, *Rate Regulation Reforms*, EP 715 (“It appears that the Board sees the need to deter rate cases by small shippers which theoretically might have sound transportation alternatives as more important than the need to remedy monopoly pricing by railroads (which it cannot deter.)”); ARC Rebuttal at 6, *Rate Regulation Reforms*, EP 715 (“It is rather that STB rate regulation as it exists today provides no effective relief, which is the same thing as providing no relief, for thousands of captive shippers. For captive shippers paying rates well above 180% of variable cost, who nevertheless cannot afford to bring Full-SAC or SSAC rate cases, the fact that courts have approved these methodologies as economically respectable and as reasonable under the statute provides no consolation.”); Consumers United for Rail Equity (“CURE”) Reply at 6, *Rate Regulation*

with its rate or considers a rate too “high” constitutes no evidence that any rate is unreasonable. The Board’s job is to establish economically sound regulating rules, and apply those rules in an unbiased fashion in individual proceedings. NS urges the Board to abide by its charge to adhere to economic principles when considering comments from other participants in this proceeding. The Board must review all comments offered in this proceeding against the backdrop provided by sound economic theory and by the United States Court of Appeals.

II. Grain Transportation Is Not Homogenous

Grain transportation needs, options, and experiences can and do vary widely. Such crucial distinctions shape the real markets in which producers, consumers, and transportation providers compete, and defy any easy or sweeping generalizations. Accordingly, the Board may find helpful the following high-level summary of just some of the important market and transportation differences among the various shipments moved under the general umbrella of grain.

A. Defining Grain

Even starting a conversation on grain shipments first requires a decision on what commodities are (and are not) being discussed. Standard Transportation Commodity Code (STCC) 0113 lists barley, corn, oats, rice, rye, sorghum, and wheat, along with a catchall code for grains not elsewhere classified (“NEC”), as grain movements.⁶ The Association of American Railroads (“AAR”) reports regularly on grain shipments and includes those same commodities

Reforms, EP 715 (“As for SAC, in the only grain case ever brought since the Staggers Rail Act of 1980 was enacted- the infamous *McCarty Farms* litigation, in which the ICC granted relief- was reversed by the D.C. Circuit on the ground that the ICC, having determined that SAC provided the only economically rational approach to ratemaking, had to be followed. So, grain shippers essentially have no recourse to challenge rail rates at the STB.”).

⁶ See, e.g., 49 C.F.R. § 1039.10 (exempting agricultural commodities including “farm products, with the exception of grain (STCC No. 0113) . . .”).

along with soybeans.⁷ Title 49 of the U.S. Code defines grain by reference to the United States Grain Standards Act, which itself defines grain as “corn, wheat, rye, oats, barley, flaxseed, sorghum, soybeans, mixed grain, and any other food grains, feed grains, and oilseeds for which standards are established under section 4 of this Act.” 7 U.S.C. § 75 (referenced by 49 U.S.C. § 10709(d)(1)). Perhaps the most expansive scope for grain shipments would include all of the “grain, feedstuffs, and/or grain products” eligible for NGFA’s rail arbitration process.⁸

B. Different Traffic Flows

Whatever definition is chosen, traffic flows vary widely among different grains and grain products and even within single commodities. The major factor driving transportation flows are the locations of agricultural storage facilities, such as elevators, and the locations of the destination processing facilities. Processing facilities are often located near the source of the commodity⁹ but are increasingly found near consuming markets,¹⁰ creating different considerations due to the distance between many crop locations and population centers.

Looking at wheat transportation in the East, soft wheat¹¹ shipments typically originate from producing locations and move to mills in deficit states¹² that are located near a consuming

⁷ See AAR, *Railroads and Grain*, at 1 (Aug. 2013), <https://www.aar.org/keyissues/Documents/Background-Papers/Railroads-and-Grain.pdf>.

⁸ See NGFA Rail Arbitration Rules, at 56-57 (Mar. 2014), http://www.ngfa.org/wp-content/uploads/trade_rules/2013_Rail_Arbitration_Rules.pdf (listing STCC codes).

⁹ See USDA and DOT, *A Study of Rural Transportation Issues*, at 33 (Apr. 2010) (“*USDA Rural Transportation Study*”) (“Agricultural processing facilities are usually located in close proximity to the raw agricultural products they use, in part due to the economic advantages that include lower transportation costs. This is also the case with the grain and oilseed milling facilities.”).

¹⁰ See, e.g., C.S. Kim et al., *Economic Analysis of the Changing Structure of the U.S. Flour Milling Industry*, *Agribusiness*, Vol. 17, at 161 (2001) (discussing increased construction of flour mills near metropolitan areas since 1980).

¹¹ Soft wheat is typically milled into flour for cakes, cookies, and coatings. “Wheat – Background,” *USDA Economic Research Service*, <http://www.ers.usda.gov/topics/crops/wheat/background.aspx>.

market. In contrast, hard wheat grows in the Plains States,¹³ requiring a long-haul move to reach eastern destination mills.

Eastern corn shipments vary more by customer than crop location or type. Corn may be short-hauled distances of less than 100 miles from elevators to Midwest processing plants, but at the same time surplus corn is long-hauled to deficit corn states such as Georgia, South Carolina, North Carolina, and Virginia for processing.¹⁴ Likewise, soybean movements are split between short-haul moves to local processors and long-haul moves to deficit destination markets.¹⁵

More broadly, transportation of grain-related products often differs significantly from transportation of the commodity itself. For example, ethanol facilities and other Midwest processing plants typically receive corn via truck,¹⁶ but a majority then use long-haul rail transportation to access markets after processing.¹⁷ All of these supply chain differences demonstrate different transportation needs and constraints, and certainly no singular movement is exemplary of a universal or typical grain experience.

C. Different Transportation Competition

With these varied traffic flows come different competitive conditions. As the United States Department of Agriculture (USDA) has recognized, “the level of rail-to-rail competition is

¹² Deficit states consume more wheat than they produce, requiring wheat to be pulled from other states. Surplus states mostly consume wheat grown locally and trucked to nearby mills. *See generally* Adam Sparger & Nick Marathon, *Transportation of U.S. Grains: A Modal Share Analysis*, USDA Agricultural Marketing Service, at 3 (May 2013), <http://dx.doi.org/10.9752/TS049.05-2013>.

¹³ Hard wheat is milled into flour for breads and pastas. “Wheat – Background,” *USDA Economic Research Service*, <http://www.ers.usda.gov/topics/crops/wheat/background.aspx>.

¹⁴ *See USDA Rural Transportation Study*, *supra* note 9, at 36 (discussing demand for corn in deficit areas including the Southeast).

¹⁵ *See id.* at 41 (showing soybean deficits in the southeast).

¹⁶ *Id.* at 36 (“More than 90 percent of ethanol production capacity is located within a 50-mile radius of the corn producing areas, so trucks have been the primary mode of transportation for inbound corn.”).

¹⁷ *Id.* at 142.

not a function of the market concentration of railroads in the Nation as a whole. Instead, it is a function of the quality and effectiveness of competitive options in particular markets.”¹⁸ Further, rail competition is only one piece of the larger transportation market. “Between origin and final destination, most grain shipments have traveled by two or more modes of transportation.”¹⁹ As discussed above, many grain movements in the East, such as soft wheat or corn shipments to Midwest processors, are shorter distances and thus particularly vulnerable to truck competition.²⁰ Barges provide yet another alternative for mills or plants located near navigable waterways. Differences in competitive options show up in national market share statistics; for example, in 2011 trucking captured 69% of corn shipments, but only 23% of wheat shipments.²¹

D. Geographic and Product Competition

The bigger story for a number of grain shipments in the East, however, is indirect competition.²² Grains such as corn and wheat, as well as products such as flour, are commodities. Price, not sourcing or quality differences (within accepted standards), drives purchasing decisions.²³ As a result, the cost for transportation may be constrained by a variety of factors. A flour mill can purchase and receive local wheat by truck or utilize another rail carrier to access a different supply. Moreover, that mill will only stay in business if its flour remains competitively priced to its downstream customers, who can also purchase trucked flour from

¹⁸ *Id.* at 213.

¹⁹ John Frittelli, *Grain Transport: Modal Trends and Infrastructure Implications*, Congressional Research Service, at 4 (Jan. 5, 2005).

²⁰ *See, e.g., USDA Rural Transportation Study*, *supra* note 9, at 499-500 (discussing trucking’s relative cost advantage for shorter hauls).

²¹ *See Adam Sparger & Nick Marathon, Transportation of U.S. Grains: A Modal Share Analysis*, *supra* note 12, at 7.

²² Of course, determining whether and to what extent indirect competition affects a particular movement requires an individual market analysis.

²³ *USDA Rural Transportation Study*, *supra* note 9, at 204 (observing that “farmers are generally price-takers”).

nearby mills located on other rail lines or waterways, or buy flour from a mill in another market entirely and receive it via truck, rail, or barge.²⁴ Similarly, increased production of corn or soybeans in destination markets can displace long-haul moves, while ethanol consumers can receive unit trains from various Midwest processors as well as any local plants. Product substitution can occur as well. Some animal producers switch from corn to local feed wheat when prices are advantageous.²⁵

E. Import v. Export

Most of NS's grain business involves domestic production and consumption.²⁶ As a result, its grain traffic is more predictable, and the variation between the peaks and troughs of NS's grain traffic is comparatively small.²⁷ Grain destined for export, however, is affected by many more variables in the world marketplace.²⁸ Exports headed for port facilities also face different markets for transportation than domestic production.²⁹ For example, 49 percent of export soybeans moved by barge in 2011, versus just 2 percent of domestic shipments; trucks in turn moved 80 percent of domestic corn, versus only 12 percent of export shipments.³⁰

²⁴ Cf. Kyle Stiegert & Olivier Carton, *Increasing Concentration in the U.S. Hard Wheat Milling Industry: Efficiency Gains or Market Power?* Dept. Agricultural Economics, Kan. St. Univ., at 10 (1998) (observing that "wheat mills compete for wheat inputs and flour outputs on a national scale").

²⁵ See, e.g., Whitney McFerron, "Livestock Eat More Wheat as Cheapest Corn Alternative Since 1996," *Bloomberg* (June 14, 2011), <http://www.bloomberg.com/news/2011-06-14/livestock-eat-more-wheat-as-cheapest-corn-alternative-since-1996.html>.

²⁶ See generally NS Comments, *Rail Transp. of Grain*, EP 665 (Oct. 30, 2006).

²⁷ See *USDA Rural Transportation Study*, *supra* note 9, at 28 ("Transportation is impacted most by changes in crop production and export demand; domestic demand for the major crops tends to be relatively stable.").

²⁸ See AAR, *Railroads and Grain*, *supra* note 7, at 6-7.

²⁹ See *USDA Rural Transportation Study*, *supra* note 9, at 30 (describing "two distinct patterns" for transportation depending on domestic or foreign destination).

³⁰ See Adam Sparger & Nick Marathon, *Transportation of U.S. Grains: A Modal Share Analysis*, *supra* note 12, at 7.

F. How These Considerations Impact NS

While the foregoing is a simplistic and incomplete overview, grain transportation on NS is varied in its forms and markets. Although NS hauls considerably less grain than other railroads, NS moved approximately 130,000 carloads of grain³¹ in 2012. Of those, 92,000 were carloads of corn, and 32,000 were carloads of wheat. Due to the many factors discussed above, including both direct and indirect competition, most of NS’s rates for grain traffic were far below 180 percent of revenue-to-variable cost - the statutory threshold for the Board potentially to have jurisdiction over a rate complaint. {{

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}}³³ In short, NS’s traffic does not support many of the assertions made in EP 715, including complaints that grain rates are uniformly high.³⁴

III. Conclusion

NS submits that the Board should examine the comments in this proceeding in light of two of the core principles that underlie its judicially-approved rate reasonableness methodology: any determination of the reasonableness of a rail rate must consider a particular rate for a movement over a particular lane, and any test for rate reasonableness must be based on sound

³¹ Limited to STCC No. 0133. Looking at all commodities eligible for NGFA’s Arbitration Rules, NS moved 455,000 carloads.

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³⁴ For example, CURE asserted that the 3B methodology will provide no relief “[i]f grain rates tend to be fairly uniform, as is apparently the situation.” CURE Reply at 5, *Rate Regulation Reforms*, EP 715; see also NGFA Opening at 11, *Rate Regulation Reforms*, EP 715 (expressing concern that 3B may not provide relief because a railroad might have imposed a 500 percent increase for all traffic of a certain commodity).

railroad economics. Importantly, these principles are not commodity-specific. Further, the Board should keep in mind that grain transportation is an umbrella covering numerous different markets and competing interests, and generalizations about a typical or universal experience do not accurately reflect the real world considerations of NS or its customers. NS looks forward to reviewing and commenting on the submissions in this proceeding using this framework.

Respectfully submitted,



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