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

Re: STB Ex Parte No. 705, *Competition in the Railroad Industry*

Dear Ms. Brown:

Enclosed for filing in the above-referenced proceeding, please find substitute, corrected Written Testimony of Frederick R. Warren-Boulton and Kenneth C. Baseman, filed on behalf of the Western Coal Traffic League. The reason for the filing of this substitute version is to correct a few inadvertent typographical errors on page 2-3 of their testimony. The substitute testimony reflects the following changes:

p. 2, two lines from bottom, change "UP's CEO" to "BNSF's CEO";
p. 2, last line, change "UP displaced BNSF" with "BNSF displaced UP"; and
p. 3, line 2, change "from UP, and had won the bid without UP's prior knowledge," with "from BNSF, and had won the bid without BNSF's prior knowledge."

Thank you for your attention to this matter.

Respectfully submitted,

Peter A. Pfohl
An Attorney for
Western Coal Traffic League

Enclosure

WRITTEN TESTIMONY

Frederick R. Warren-Boulton

Kenneth C. Baseman

We are Frederick R. Warren-Boulton and Kenneth C. Baseman. We appear here on behalf of the Western Coal Traffic League (WCTL). We previously filed a statement in this docket on behalf of WCTL on the current state of railroad competition and possible policy alternatives to facilitate more competition. In that statement, we concluded that the rapid increases in prices for the transportation of Western coal after 2004 were likely due to collusion, either tacit or explicit, between BNSF and UP, the railroad duopolists serving the Powder River Basin. We also found that the pricing pattern was not explainable by normal market factors such as growing demand, increasing marginal costs, or capacity constraints. We concluded by endorsing WCTL's proposal to clarify that the STB's "market dominance" protections extend to non-captive shippers. In this written testimony, we summarize our findings and provide additional analysis of the state of the market/competition for Western coal transportation based on the railroad replies made in response to our initial statement.

We have now reviewed the reply comments filed by BNSF Railway Company (BNSF), Union Pacific Railroad Company (UP) and the Association of American Railroads (AAR). In particular, we have reviewed the statements of Dr. Robert Willig (for AAR), Mr. John Lanigan (for BNSF), and Mr. John Koraleski (for UP). Nothing in these statements causes us to modify our opinion. As a general matter, these statements were almost completely devoid of useful evidence. Dr. Willig proposes an empirical test for whether abusive conduct has occurred that makes no economic sense. Mr. Lanigan offers assertions, but no evidence. Mr. Koraleski attempts to provide evidence, but his evidence actually reinforces the case that normal competitive market factors cannot explain the magnitude of the price increases for transporting Western coal.

We have also reviewed the written testimony to be filed by Duane Richards. This testimony contains additional evidence on the absence of significant customer switching between BNSF and UP. He also provides additional evidence that modest increases in variable costs are not remotely plausible as explanations for the massive price increases for transporting Western coal over the period.

In our previous statement, we concluded that collusion provides the best explanation for the magnitude of the price increases for transportation of Western coal, and that changes in variable costs, capacity constraints, and demand were not remotely plausible explanations. In particular, we noted that:

- Prices for new contracts trebled between 2004 and 2011.
- In 2004, BNSF and UP announced "public pricing" for new coal contracts, with large price increases under the new tariffs. The railroads also implemented new policies under which the contract length to which they would agree was sharply reduced. These policies allowed a reset of pricing at much higher levels.
- Before 2004, BNSF and UP routinely won Western coal shipping business at the expense of the other. After 2004, this pattern stopped, and the incumbent almost always retained the business. When an analyst asked BNSF's CEO in 2009 whether a recent case where BNSF displaced UP at a customer indicated that pricing discipline might be

breaking down, he indicated that this was a special case, where a third party had rights to service from BNSF, and had won the bid without BNSF's prior knowledge.

- Variable costs increases over the 2004-2011 period are not remotely plausible as an explanation for the observed price increases.
- Between the mid 1990s and 2004, prices for new Western coal transportation contracts remained roughly constant, but volumes increased by 80%. The margins the railroads earned over this period were thus clearly sufficient to support investments necessary to expand output. A financial requirement to cover the costs of new investments cannot explain the observed post-2003 price increases.
- Continued price increases after traffic fell during the current recession directly contradict the theory that the price increases are the result of increased demand during a period of temporarily tight capacity.

Faced with this collection of evidence in support of tacit or explicit collusion, and despite the clear lack of any evidence in support of normal market explanations for the massive price increases, the railroad witnesses in their reply statements adopt a mantra that prices increased because demand increased, capacity was tight, higher prices were necessary to cover the costs of investments in new capacity, productivity improvements were declining, and variable costs were increasing. Importantly, none of the railroad witnesses makes any attempt to provide a quantitative link between these factors and the enormous price increases observed over the period. The reason is clear. These explanations, alone or in combination, do not pass the laugh test as explanations for the observed price increases.

We will organize our discussion around Mr. Koraleski's statement, since he at least attempts to offer an empirical assessment of the issues. We will then turn to Dr. Willig's proposed test for collusion. To start with, however, we first want to make a couple of conceptual points.

First, the mere fact that a seller incurs costs for new capacity does not imply that prices must increase. If capacity is scalable (i.e. constant returns to scale), then per unit capacity costs do not change when capacity is expanded, and prices do not have to rise to elicit the necessary investment. Producers will require higher expected future prices in order to justify investment to serve additional volumes only if incremental capacity is more expensive than infra-marginal capacity (i.e. decreasing returns to scale). If, as appears to be the case for Western coal transportation, incremental capacity was less expensive than infra-marginal capacity after 2003 (i.e. economies of scale), then competing sellers will make the incremental investments even if, all else equal, they expect prices to be lower in the future. A numerical example may help illustrate this point. Suppose that the first 100 units of capacity required an investment of $1000. Using standard financial tools, one can calculate the required annual contribution (revenues less variable costs) necessary to recover this investment. The required annual contribution will be higher for higher costs of capital, and lower for longer lived assets. Suppose we solve the financial arithmetic, and the answer is that an annual contribution of $200 is required to justify the investment. If customers buy 100 units of output, and variable costs are $1 per unit, the required price is $3 per unit. Suppose that an additional 100 units of capacity can be acquired for $500 (perhaps by debottlenecking choke points in the system), and this capacity has the same useful life as the initial capacity. Since the cost of this capacity is only one half that of the initial capacity, and everything else is held constant, the required annual contribution will also be cut in half, to $1 per unit. The required price falls to $2 per unit. It is simply not the case that prices must go up in order to elicit investment. None of the railroads' witnesses has made a cursory attempt to explain why incremental investment undertaken after 2003 was more expensive per unit of capacity than the investments made earlier.

Second, there is conceptual double counting in the discussions by the railroads' witnesses of declining rates of productivity improvements. When productivity improvements decline, this implies, all else equal, that costs will be higher than they otherwise would be. But if one is measuring cost changes there is no reason to separately analyze productivity. Productivity affects costs, but once you measure costs, there is no reason to go back and tack on a separate "adder" for productivity.

UP's Koraleski paints a gloomy picture of his company's coal business in 2003, stating that "[b]y 2003, rates were at rock-bottom levels," and that while "life was good for coal shippers in 2003 . . . the pattern of growing volumes and declining rates was not sustainable."[1] Koraleski asserts that "[o]ur SPRB coal traffic was generating returns significantly below other commodities and well below the level needed to maintain existing capacity, let alone add capacity."[2] Koraleski also states that "[w]e were faced with the need to make substantial investments in new capacity to accommodate growth in traffic." He concludes, "[i]n the old environment, shippers got what they wanted: low rates. The railroad got volume. However, when demand for rail services increased and capacity tightened, the railroad was in a position to set new prices at reinvestable levels." . . . . "In short, Union Pacific's rate increases do not reflect a lack of competition – they reflected a changed market environment."[3]

[1] Koraleski, p. 19.
[2] Ibid., p. 20.
[3] Ibid., p. 20, 22.

Koraleski's "2003 market environment" explanation to the STB stands in direct contrast with UP's CEO and other top managers' contemporaneous statements made in 2003. Koraleski's version of history is also inconsistent with the substantial growth in shipping of Powder River Basin coal in the years before 2003. Obviously, UP and BNSF were making sufficient incremental investments then to accommodate rapid growth, even though prices were stable and low, at least by today's standards.

Consider the following from UP's 3Q03 Earnings Conference Call transcript. UP's Chairman, President, and CEO was queried about coal transportation contracts rolling back and forth between UP and BNSF, and about pricing strategy. Dick Davidson responded that UP's coal contracts were bid out "based on our all in cost, capital requirement, whatever else goes into it to meet an acceptable profitability standard for us. As I said many, many times coal was the second most profitable commodity we handle. That's our strategy pure and simple."[4] There is obviously no hint here that prices in 2003 were too low to cover UP's total, "all in cost."

Later in the transcript, UP's top executives were asked about new capacity costs for coal transportation, and whether contribution for coal covered increasing capital investment costs. The President of UP, Ike Evans responded that the coal contributions covered all capital costs. Also, he further elaborated, capacity and increased capital investments were not an issue for UP "well into the future." Mr. Davidson further responded that UP was so well situated on the capacity front, that "on a straightforward basis it will take less capital investment to grow the business."

[4] Q3 2003 Union Pacific Earnings Conference Call – Final, NewsRoom, Fin. Disclosure Wire (Oct. 23, 2003), p. 8.

GREGORY BURNS (ph): Just following up on the question about coal being higher contribution next year, is that an all in contribution including capital costs, sort of return on capital allocated coal will be higher next year?

IKE EVANS: Yes.

GREGORY BURNS (ph): Okay.

IKE EVANS: Actually, you know, one thing we ought to point out there is that the capital cost to do coal is going to be a declining issue for us going forward. If you are not familiar with it Greg because you just started following the railroads here recently but we had enormous costs early on building up capacity into the powder river basin and as of the end of this year our coal line is running from northwest Nebraska up to the joint territory will be 100% double track CPC [sic] railroad concrete ties and we'll have enough capacity there now to take us well into the future. We can accommodate a lot of growth with very little incremental capital. That's really a good news for us. We have a great property now connecting us with the joint track in Wyoming.

GREGORY BURNS (ph): If we looked at those as single business cap ex will continue to fall below depreciation in that business line essentially?

DICK DAVIDSON: I don't think about things in those terms. Just on a straightforward basis it will take less capital investment to grow the business.[5]

To sum up, UP's assessment in 2003 was that the then current prices were sufficient to cover its "all in" costs, including a return to capital. Further, it had just completed major investments to expand capacity, and anticipated that future capacity expansions would be far cheaper – circumstances under which 2003 rates, all else equal, would be more than sufficient to justify continued investment after 2003.

Koraleski identifies approximately $376 million dollars in capacity-enhancing investments made by UP for SPRB coal since 2003.[6] He also reports a total of $525 million in total coal capacity investments over the period, "most of it directed to SPRB coal corridors."[7] Even if one believed, contrary to the evidence, that the new capacity was more expensive per

[5] Ibid., p. 10.
[6] Koraleski, p. 23.
[7] Ibid., p. 22.

unit than capacity added earlier, one must ask, could the increase in market prices possibly be explained by the required return to recover these investments? The answer is clearly no. In our initial statement, we reported UP's and BNSF's combined annual contribution margin from transporting PRB coal has increased by about $2 billion between 2003 and 2010.[8] Since the companies have approximately equal shares of PRB coal traffic, UP's share is about $1 billion. It doesn't take a financial genius to determine that one does not need a billion dollar annual return to pay off a $376 million investment in long-lived assets.

Koraleski, and other railroad witnesses, also stress that marginal or variable costs were increasing over the period, which would put upward pressure on price. Again, however, none of these witnesses attempts to address whether pass through of increased marginal costs can explain the magnitude of the price increases. In fact, the price increases far outpace the increases in marginal or variable cost. Mr. Richards reports the relationship between price and marginal costs for Western coal shipments in 2004 and 2010.[9] In 2004, the prevailing rate was 8 mills per ton mile, and variable costs were about 6 mills per ton mile. By 2010, the rate had increased to 22 mills per ton mile, while variable costs had only increased from 6 to 8 mills per ton mile. 100% pass through of the increase in variable costs would have increased rates by 2 mills per ton mile, or only about one-seventh of the actual rate increase. The observed price increases simply cannot be explained as representing the typical operation of a reasonably competitive market experiencing an increase in variable costs.

[8] Richards Initial Statement, p. 5.
[9] Written Testimony of Duane Richards, p. 7.

Koraleski objects to WCTL's claim that up until 2003, competition between UP and BNSF would frequently result in business switching from one railroad to the other, but that this process largely stopped after 2003. He states that:

> WCTL and certain coal shippers argue that Union Pacific and BNSF are not actively competing for coal business because contracts are not shifting between carriers as frequently as they once did. However, the examples provided above refute that claim. (p. 25)

He provides four examples (one of which is completely redacted) of customers switching between UP and BNSF since 2004. Four examples of customers switching over seven years do not "refute" the claim that "contracts are not shifting between carriers as frequently as they once did." To support that claim, Koraleski would need to report data about the actual incidence of switching before 2004. Interestingly, Koraleski, who has access to far better data than we do on the actual incidence of customer switching before 2004, reports no information on the incidence of switching before 2004. His examples of customer switching are for relatively small volumes, and all involve either intermodal traffic, or traffic where another railroad serves part of the end-to-end route. This suggests that the switching that does occur is minor, entails another carrier whose interests might influence the outcome, or involves circumstances where BNSF and UP are serving the ultimate customer from different coal sources. This latter factor introduces an independent reason for customer switching between rail carriers beyond their control.

We now turn to Dr. Willig's objections to the collusion hypothesis. First, he lumps our analysis with that of witnesses for shippers of other commodities, and asserts that we merely count railroad competitors, which is a "deeply flawed" measure of competition or market structure. With all due respect, whatever the merits of Dr. Willig's claim with regard to other witnesses who represent shippers with intermodal alternatives, exactly what source of competition does Dr. Willig see, other than BNSF and UP, for shipping PRB coal to the mid-west? We know how to count. We counted to two, and saw no more competition from any source. On this, at least, we and Mr. Lanigan agree. "The PRB has never been served by more than two railroads—first, BN and the Chicago and North Western Transportation Company ("CNW"), and then BNSF and UP (as a result of the BN/ATSF merger and the UP/CNW merger)."[10] Moreover, the fact that UP and BNSF found it profitable to treble prices is strong evidence that competition from either other railroads or other transportation modes was not sufficient to prevent very large price increases. If competition from other sources was capable of preventing a massive price increase unrelated to costs, it would have done so, and the trebling of prices would not have occurred.

Dr. Willig appears to propose a new test for the presence of abusive conduct, such as collusion: if output is expanding, collusion or other abusive conduct can't be occurring. He states

> The conduct at the heart of market power abuse is withholding supply to drive up price. Therefore perhaps the most compelling piece of evidence refuting claims of abusive conduct is that the upticks we see in rail rates starting in 2003-04 occurred during a period of rapidly *growing* overall rail traffic volumes.[11]

Dr. Willig's test for collusion is flatly wrong. It is seriously prone to error, i.e. a false finding that collusion has been "refuted" when in fact it is present. He is right that the exercise of market power entails an output restriction, *everything else held constant*. But in the real world, and certainly in the real world for transportation of Western coal, everything else was not held constant over the 2004 – 2011. In particular, demand was growing rapidly. Outward shifts in demand will generate growth in sales volumes. If collusion also starts when demand is shifting

[10] Lanigan, p. 8.

[11] Willig, pp. 9-10. We find amusing Dr. Willig's suggestion that a trebling of prices is an "uptick."

out, then collusion results in lower market volumes than would occur under competition. But there is simply no reason that the output-reducing effects of collusion should necessarily outweigh the output-increasing effects of higher demand. Dr. Willig's test for collusion is deeply flawed, and the STB should not use it.

Conclusion

Our analysis finds that there have been excessive increases in the prices for transporting Western coal since 2004, that these increases are consistent with tacit or explicit collusion, and that these price increases cannot be reconciled with the ordinary working of reasonably competitive markets. None of the railroads' arguments or evidence refutes our findings, and in fact, the railroads' statements actually confirm and clarify that the state of railroad competition for western coal is bleak, at best. We remain dubious that "access regulation" remedies will offer any significant prospects for improved performance in this particular duopoly market. We suggest that the STB adopt WCTL's proposal to clarify that the Board's market dominance rules apply to non-captive shipments of Western coal. This clarification would provide modest, but improved assurance against further price increases than the status quo competition between UP and BNSF, since that competition is so obviously lacking.