ASSOCIATION OF AMERICAN RAILROADS
425 3rd Street, SW, Suite 1000
Washington, D.C. 20024

Timothy J. Strafford
Assistant General Counsel

Phone: (202) 639-2506
Fax: (202) 639-2868
E-mail: tstrafford@aar.org

242040

November 14, 2016

ENTERED
Office of Proceedings
November 14, 2016
Part of
Public Record

Ms. Cynthia T. Brown
Chief, Section of Administration
Office of Proceedings
Surface Transportation Board
395 E Street, S.W.
Washington, DC 20423

Re: STB Docket No. EP 665 (Sub-No. 2), *Expanding Access to Rate Relief*

Dear Ms. Brown:

Pursuant to the Advance Notice of Proposed Rulemaking served in this proceeding on August 31, 2016, attached please find the supplemental comments of the Association of American Railroads.

Respectfully submitted,

Timothy J. Strafford
Counsel for the Association of
American Railroads

BEFORE THE
SURFACE TRANSPORTATION BOARD

STB Ex Parte No. 665 (Sub-No. 2)

EXPANDING ACCESS TO RATE RELIEF

COMMENTS OF THE
ASSOCIATION OF AMERICAN RAILROADS

Introduction

In an Advance Notice of Proposed Rulemaking ("ANPRM") served on August 31, 2016, the Surface Transportation Board ("STB" or "Board") sought comment on proposals to modify its rules regarding railroad rate reasonableness proceedings. The Association of American Railroads ("AAR") respectfully submits these comments as a party of record in accordance with the Board's ANPRM.

The AAR is a trade association representing the interests of North America's major freight railroads, and often presents comments and testimony in STB proceedings. The AAR and its freight member railroads have a strong interest in this proceeding and ensuring that the Board's rate reasonableness process conforms to the statutory directives of the Rail Transportation Policy ("RTP") and is consistent with the Board's established Constrained Market Pricing ("CMP") regulatory regime and sound economics.

The ANPRM puts forth proposals to establish a new revenue to variable cost ("R/VC") comparison test for rate reasonableness for undefined "very small" cases, with the goal of further simplifying and expediting what the Board has long acknowledged is an already "crude"[1] Three Benchmark test. In light of the conclusions of the independent contractor retained by the Board to evaluate its rate reasonableness methodologies that further simplification of the Three Benchmark test would undermine the economic foundation of the test, the Board should not proceed to propose new rules and should discontinue this proceeding.[2] If the Board does continue this proceeding, the AAR submits that the Board should examine and precisely define the problem it is trying to solve before proposing new rules. Unless and until the Board clearly establishes its goals, it will be difficult for stakeholders to meaningfully comment in ways that can further those objectives. The Board should establish by empirical study that a problem exists and then consider the potential impacts of proposed rules, and how those rules will interact with the other regulatory proposals it is considering.

Moreover, any proposal with regard to rate reasonableness should be based on sound regulatory economics. The Board and its predecessor agency, the Interstate Commerce Commission ("ICC") have long rejected formulaic cost-based rate standards and recognized that railroads must be permitted to apply demand-based differential pricing in order to allow them the opportunity to recover their total costs, including a return on investment.[3] Since the adoption of

---

[1] *See, e.g., Simplified Standards for Rail Rate Cases*, EP 646 (Sub-No. 1), slip op. at 28, 52, 73 (STB served Sept. 5, 2007) ("*Simplified Standards*") (referring to the crudeness of the Three Benchmark test).

[2] InterVISTAS, *Surface Transportation Board, An Examination of the STB's Approach to Freight Rail Rate Regulation and Options for Simplification*, Project FY 14-SB-157 (Sept. 14, 2016) ("InterVISTAS Report") at 132 ("Further simplification to the Three-Benchmark Test would likely reduce its adherence to CMP principles.").

[3] *Coal Rate Guidelines - Nationwide*, 1 I.C.C.2d 520, 526 (1985) ("*Coal Rate Guidelines*"), *aff'd sub nom. Consolidated Rail Corp. v. United States*, 812 F.2d 1444 (3d Cir. 1987) (concluding that "the cost structure of the railroad industry necessitates differential pricing of rail services.").

CMP in *Coal Rate Guidelines*, this sound economic principle has been reaffirmed by the ICC and STB, and approved by the courts, in numerous cases and rulemakings.[4]

The recognition that demand-based differential pricing was necessary was a conclusion regarding the structural reality of the railroad industry, not a temporary salve to aid an industry in financial peril. The application of demand-based differential pricing has helped the rail industry improve its operating efficiency and financial health, by permitting railroads to make needed investments in physical capacity to accommodate increases in freight volume, while at the same time offering competitive rates and providing improved service to shippers. But that improvement has in no way altered the fundamental economics of the railroad industry that requires differential pricing based on demand. Thus, demand-based differential pricing remains and will continue to remain necessary for the railroad industry. Moreover, today, railroads face a changing marketplace. Shifts in demand for rail service will require new investment to serve new and dynamic markets. Particularly at this time of substantial change, the AAR respectfully submits that the Board should take care to ensure fidelity to first principles of rail rate regulation, including sound, time-tested and judicially-approved principles of demand-based differential pricing.

---

[4] *See, e.g., Consolidated Rail Corp. v. United States*, 812 F.2d at 1448-49; *Potomac Electric Power Co. v. ICC*, 744 F.2d 185, 193 (D.C. Cir. 1984) (in enacting the Staggers Act, Congress understood the "necessity of such differential pricing"); *id.* at 194 (the "concept of differential pricing ... necessarily contemplates that the carrier will maximize its profits on traffic for which it has no competition so as to offset its lower earnings on competitive traffic"); *Carolina Power & Light Co. v. Norfolk Southern Ry. Co.*, NOR 42072, slip op. at 33 (served Dec. 23, 2003) ("[d]emand-based differential pricing is essential in the railroad industry because railroads serve a mix of captive and competitive traffic"; non-demand-based cost apportionment methods do not necessarily permit carriers to recover costs) (reconsideration granted on other grounds in STB Decision served October 20, 2004); *Major Issues in Rail Rate Cases*, EP 657 (Sub-No. 1) (STB served Oct. 30, 2006) ("The need for such demand-based differential pricing is due to the presence of traffic with competitive alternatives. If the carrier were required to charge all its shippers the same markup over cost, the competitive traffic with lower-cost alternatives would be diverted to those other transportation alternatives.").

The AAR has consistently supported Board efforts to streamline its rate reasonableness procedures, consistent with sound economics, and eliminate unnecessary expense and delay. As such, the AAR supports proposals in the ANPRM to the extent they reflect procedural improvements on the Board's existing processes for small cases. To the extent the proposals reflect a weakening of the already limited substantive connections between the Three-Benchmark rate comparison test and the sound economic underpinnings of the long-standing CMP principles, however, the AAR has grave concerns that aspects of the ANPRM are steps in the wrong direction. Moreover, the AAR remains concerned that the Board is embarking on substantial regulatory changes in a myriad of proceedings without any empirical analysis that either establishes a problem to be solved or that considers the impacts of the proposed changes. In this and other proceedings,[5] the Board has failed to consider the cumulative impacts of the host of regulatory changes that it is considering for the railroad industry, such as the impacts on the industry's ability to invest to continue to meet the demand for transportation services by its customers now and in the future, and on the industry's ability to safely and efficiently operate to meet that demand.

In the comments below, the AAR submits that the ANPRM proposals may not actually reach the goals they are intended to reach. The ANRPM also misstates aspects of the law and the role of the Board in railroad rate setting. The AAR argues that even very-small rate case procedures must comport with the market dominance standards of 49 U.S.C. § 10707.
The AAR also contends that any proposed rules for very-small rate cases should adhere to sound economic principles of railroad rate-making. Finally, if the Board proceeds to propose a new

---

[5] *See, e.g., Reciprocal Switching*, EP 711 (Sub-No. 1); *Revenue Adequacy*, EP 722; *Review of Commodity, Boxcar, and TOFC/COFC Exemptions*; EP 704 (Sub-No. 1); *Review of the General Purpose Costing System*, EP 431 (Sub-No. 4); *Expediting Rate Cases*, EP 733.

methodology for very small cases, that proposal should adhere to its stated methodology for establishing limits on awards.

Background

In *Coal Rate Guidelines*, the ICC rejected formulaic, fully-allocated cost approaches to rate reasonableness that do not take account of market demand conditions. The ICC held,

> a meaningful maximum rate policy could not be founded on a strictly cost-based approach. Because competition compels the railroads to price some of their services below an arbitrarily assigned 'cost', they must be able to price other services above their assigned 'cost' in order to compensate.[6]

As the Board has succinctly stated,

> a strictly cost-based approach would not reflect the carrier's ability (or inability) to impose the assigned allocations and cover its costs. If a carrier sought to apply the formula price to all its traffic, it would lose that traffic for which the demand could not support the price assigned. Therefore, following the directive from Congress in the Staggers Rail Act of 1980, unattributable costs must be covered through demand-based differential pricing.[7]

CMP's adoption of the theory of contestable markets, as adopted and implemented by the agency, meets this goal by placing constraints on the ability of railroads to price their services while taking into account market demand. The Stand Alone Cost ("SAC") test does this by simulating the competitive rate that would exist in a contestable market, one that is free from barriers to entry.[8] Under the SAC constraint as applied by the Board, a challenged rail rate will be found to be unreasonable if a complainant can show that it is higher than the rate a Stand Alone Railroad would need to charge the complainant to serve it and a subset of the defendant

[6] *Coal Rate Guidelines*, 1 I.C.C.2d at 523.

[7] *Major Issues in Rail Rate Cases*, EP 657 (Sub-No. 1) (STB served Oct. 30, 2006) ("*Major Issues*") (citing *Coal Rate Guidelines*, at 526).

[8] *Coal Rate Guidelines*, at 528 (citing William J. Baumol, John C. Panzar & Robert D. Willig, *Contestable Markets and the Theory of Industry Structure* (1982)).

railroad's traffic while fully covering all of its costs, including a reasonable return on investment.[9] In this way, a rate is unreasonable only if it is forcing shippers to bear costs of inefficiencies or from cross-subsidizing other traffic by paying more than the revenue needed to replicate rail service to a select subset of the carrier's traffic base and generate a reasonable return.[10]

Because the task of simulating the complex network and differentiated service offerings of a railroad in a SAC analysis is necessarily a fact-intensive and complicated task,[11] Congress directed the agency in the ICC Termination Act ("ICCTA")[12] to develop "a simplified and expedited method for determining the reasonableness of challenged rail rates in those cases in which a full stand-alone cost presentation is too costly, given the value of the case."[13] The agency soon developed a simplified Three-Benchmark methodology, under which the reasonableness of a challenged rated would be determined by examining that rate in relation to three benchmark figures.[14] Each of the three benchmarks were selected because they each drew on CMP principles in different ways.[15] In 2007, the Board substantially overhauled the Three-Benchmark test and created a Simplified-SAC test in *Simplified Standards.* The Board explained

---

[9] *Id.* at 542.

[10] *Id.* at 542-46.

[11] InterVISTAS Report at 40. *See also id.* at 44 (noting that the "complexity of [SAC] is a necessary exercise for those who want to estimate an economically efficient rate for the traffic in a network industry").

[12] Pub. L. No. 104-88, 109 Stat. 803 (1995).

[13] Former 49 U.S.C. § 10701(d)(3).

[14] *Rate Guidelines—Non-Coal Proceedings,* 1 S.T.B. 1004 (1996), *pet. to reopen denied,* 2 S.T.B. 619 (1997), *appeal dismissed sub nom. Ass'n of Am. R.Rs. v. STB,* 146 F.3d 942 (D.C. Cir. 1998) ("*Simplified Guidelines*").

[15] InterVISTAS Report at 45.

that "precision must be sacrificed for simplicity, and any simplified procedures will necessarily be very rough and imprecise."[16] But because of the substantive limitations of the Three Benchmark test, the Board set limits on potential awards, stated that it did not intend wide-spread application of the test and promised to guard against an avalanche of cases.[17]

Comments

I. The ANPRM's Proposals Would Not Meet the Rail Transportation Policy Goals

A. The Board Has Not Established a Problem to be Solved

The Board appears to have instituted this proceeding because it is concerned that some small shippers believe they are eligible for rate relief but do not bring cases because of the expense or complexity of the tests the Board uses to judge the reasonableness of rates. The ANPRM expressed concern that "litigation costs required to bring a case under the Board's existing rate reasonableness methodologies can quickly exceed the value of the case."[18] In part, these concerns appear to have motivated the Board's decision to engage an independent consultant to review the Board's current methodologies and consider alternatives.[19] That InterVISTAS report concluded that the Board's simplified procedures are "available to shippers"[20] and that the Three Benchmark test in particular is a cost-effective means for shippers with small claims to challenge the reasonableness of their rates.[21] Nonetheless, the ANPRM states, "[b]ased on the comments and testimony received, the Board believes that the existing

---

16 *Simplified Standards* at 72, (citing *Simplified Guidelines*, 1 S.T.B. at 1021).

17 *Id.* at 73-74.

18 ANPRM at 3.

19 InterVISTAS Report at iv-v.

20 *Id.* at 134.

21 *Id.* at 128-29.

rate review process presents accessibility challenges for not only grain shippers, but also small shippers of any commodity."[22] The Board cites no empirical analysis of rates for this conclusion, instead reciting the anecdotal claims put forth by the trade associations and interest groups representing agricultural interests in the EP 665 (Sub-No. 1) docket that the Board's existing rate reasonableness are inaccessible.[23]

There is no evidence that the Board's process is inaccessible for small shippers or for others. Informal assistance and mediation are available to shippers of all sizes through the Board's Rail Customer and Public Assistance program. If a rail customer believes its rate would be found unreasonable under one of the Board's test, it can file a complaint with a minimal filing fee.[24] The customer can choose which of the Board's three tests to use in its complaint based on the size of its claim and other individualized factors.[25] The filing of the complaint obligates the railroad to engage in mandatory mediation. In response to requests by shippers, the Board increased limits on awards on simplified cases by eliminating the limit on Simplified-SAC and nearly quadrupling the limit in Three Benchmark cases to $4 million.

Moreover, the Board's rate reasonableness process is simply a regulatory backstop for those relatively rare instances when the competitive marketplace is not already constraining railroad pricing. Under the regulatory paradigm established by Congress, the agency is not

---

[22] ANPRM at 3. Despite the ANPRM's stated concerns for small shippers, the proposals put forth are not limited to small shippers. Instead, shippers of any size would be eligible to utilize the procedures under the proposals.

[23] *Compare* ANPRM at 6-8 *with Simplified Standards* at 34-35 (estimating the potential value of cases and amount of traffic eligible for simplified methodologies).

[24] In 2011, the Board lowered the filing fees for all complaints to $350. *See Regulations Governing Fees for Services*, EP 542 (Sub-No. 18) (STB served July 7, 2011). The filing fee for a Three Benchmark complaint has remained at $150. *Id.*

[25] *See supra* note 22.

charged with evaluating every rate established by railroads. At any given moment there are hundreds of thousands of rates associated with rail transportation between origins and destinations across the country. In establishing the Board, Congress created a small agency with a deregulatory mandate recognizing that most railroad transportation is subject to effective competition.[26] Notably, the RTP charges the Board to "allow, to the maximum extent possible, competition and the demand for services to establish reasonable rates for transportation by rail"[27] and "to minimize the need for Federal regulatory control over the rail transportation system and to require fair and expeditious regulatory decisions when regulation is required."[28]

Most railroad customers have competitive options when considering rail transportation, either by shipping by other railroads, shipping by other modes, utilizing a combination of both by transloading, substituting different products with different transportation costs or shipping to or from different markets. Railroads and their customers also often effectively contract for transportation services without ever coming near the Board's regulatory orbit. The record compiled in EP 665 (Sub-No. 1) does not support the conclusion that there are a significant number of shippers whose traffic is not subject to effective competition and who are being charged unreasonable rates. There is a fundamental difference between ensuring the regulatory process is accessible to all parties, and changing standards to lower the bar as to what constitutes a maximum lawful rate.

---

[26] For example in ICCTA, Congress sought to facilitate railroads' rate-making initiative under 49 U.S.C. §10701(c) by repealing rate suspension procedures that could freeze newly established rates pending review. Instead, Congress provided for rate making freedom for railroads subject to complaint.

[27] 49 U.S.C. § 10101(1).

[28] 49 U.S.C. § 10101(2).

B. The ANPRM's Proposals Would Not Result in a Significantly More Expedited or Lower Cost Regulatory Process

The ANPRM notes that the RTP directs the Board to balance somewhat conflicting directions "to promote a safe and efficient rail transportation system by allowing rail carriers to earn adequate revenues, as determined by the Board"[29] and "to maintain reasonable rates where there is an absence of effective competition and where rail rates provide revenues which exceed the amount necessary to maintain the rail system and to attract capital."[30] The ANPRM also notes that ICCTA added the direction "to provide for the expeditious handling and resolution of all proceedings required or permitted to be brought under this part."[31]

But there is no economically sound method of judging rates that can address the concerns raised by some grain shippers in the EP 665 (Sub-No.1) about *any* litigation cost or risk.[32] The complaint model established by Congress assumes some litigation cost and risk. The Board has already established a three-tiered approach that allows shippers of all sizes to select the methodology that matches the value of their case, including the imprecise Three-Benchmark test for small cases. The Board's consultant has recently warned that further simplification would compromise the economic soundness of the test.[33]

Moreover, it is unclear that the specific proposals contained in the ANPRM would accomplish considerable savings in time or expense. For example, though the Board would take the first pass at a comparison group under the ANPRM proposals, complainants and defendants

[29] ANPRM at 11 (citing 49 U.S.C. § 10101(3)).

[30] *Id.* (citing 49 U.S.C. § 10101(6)).

[31] *Id.* (citing 49 U.S.C. § 10101(15)).

[32] *See* EP 665 (Sub-No. 1), Hearing Tr. at 138-39.

[33] *See* InterVISTAS Report at 132.

alike would have to review the groups and would have the opportunity to offer alternatives. That process would likely still require complainants' to retain outside counsel due to Waybill confidentiality issues, thus driving up litigation costs.[34]

Finally, one of the limitations of an R/VC comparison approach is that it fails to account for specific market and operational conditions around the transportation that is subject to the complaint. For this reason, both shippers and railroads advocated for the use of "other relevant factors" in the Three Benchmark test.[35] Both railroads and shippers have advocated for and won relevant adjustments in Three Benchmark cases. Consideration of other relevant factors in any proposal for a rate comparison test for very small cases in order to ensure a semblance of accuracy, but such consideration with further contribute to cost and complexity.

II. The ANPRM Misstates the Law and the Role of the Board in Railroad Rate Setting

The language of the ANPRM incorrectly suggests that differential pricing is limited to traffic with effective competition.[36] Differential pricing is instead *required* by the mix of railroad traffic with different demand elasticities and competitive options.

Congress directed the Board in 49 U.S.C. § 10101(1) to allow, to the maximum extent possible, competition and the demand for rail services to establish reasonable rates for transportation by rail." That is, market forces, not governmental judgments, should determine rail rates. Thus, the Board is charged by Congress to allow competition and demand for

[34] *See* EP 665 (Sub-No. 1), Hearing Tr. At 193-94 (Commissioner Begeman noting that parties' use of the Confidential Waybill Sample ("CWS") can increase litigation costs).

[35] *Simplified Standards* at 77.

[36] ANPRM at 3 ("Congress permitted differential pricing and removed regulatory controls over railroad pricing for traffic with effective competition so that carriers would have greater ability to earn the revenues necessary to attract capital and reinvest in the network.").

transportation services to establish rail rates and regulate rates only in those rare instances where competitive markets for transportation services are absent.[37] In those rare instances where regulation is necessary, the Board's regulation of rates should mimic the outcomes of competitive markets. U.S.C. § 10101(6) directs the Board "to maintain reasonable rates where there is an absence of effective competition and where rail rates provide revenues which exceed the amount necessary to maintain the rail system and to attract capital."

The economics of the railroad industry require differential pricing. The presence of significant joint and common costs and a heterogeneous traffic base mean that railroads cannot price based on average cost or would lose traffic with competitive options and ultimately fail to recover total costs.[38] "The need for. . . demand-based differential pricing is due to the presence of traffic with competitive alternatives. If the carrier were required to charge all its shippers the same markup over cost, the competitive traffic with lower-cost alternatives would be diverted to those other transportation alternatives."[39] To reflect this reality, the question for the Board in regulating rates simply is what *degree* of differential pricing should be allowed on traffic without effective competition.

III. Any "Very-Small" Rate Case Procedures Must Comport with the Market Dominance Standards of 49 U.S.C. § 10707

The ANPRM suggests that preliminary screens could "identify those movements for which truck transportation alternatives are unlikely and the rates are significant outliers" and by

[37] *See Assoc. of Am. Railroads v. ICC*, 978 F.2d 737, 741 (D.C. Cir. 1992) (noting that railroads are not a "heavily regulated utility" and most rates are not subject to maximum rate regulation).

[38] *See* InterVISTAS Report at 11. *See also*, EP 722, AAR Comments, Kalt V.S. at 24-25 (filed Sept. 5, 2014).

[39] *Major Issues in Rail Rate Cases*, EP 657 (Sub-No. 1), slip op. at 20 (STB served Oct. 30, 2006).

so doing, allow the Board "to make market dominance and rate reasonableness determinations based on abbreviated evidentiary submissions."[40] Though Congress has authorized the Board to create simplified and expedited methods for determining the reasonableness of challenged rates in those cases in which a full stand-alone cost presentation is too costly, given the value of the case, there is no statutory basis for the Board to shortcut the analysis of market dominance under 49 U.S.C. § 10707.[41]

Indeed, the Board's authority to judge the reasonableness of rates in the first place is limited to cases where it makes a finding under § 10707 that the carrier possesses market dominance. The statute provides, "[i]f the Board determines, under section 10707 of this title, that a rail carrier has market dominance over the transportation to which a particular rate applies, the rate established by such carrier for such transportation must be reasonable."[42] Section 10707 requires that the Board make an affirmative finding that the transportation to which a challenged rate applies lacks effective competition. "When a rate for transportation by a rail carrier providing transportation subject to the jurisdiction of the Board under this part is challenged as being unreasonably high, the Board shall determine whether the rail carrier proposing the rate

---

[40] ANPRM at 15.

[41] The Board's qualitative market dominance inquiry has been unnecessarily complicated and substantively undermined by the "limit price" rule applied in two recent cases. The AAR has set forth in detail the deficiencies of the limit price rule in comments filed in other proceedings. *See* AAR Comments, NOR 42123 (filed Nov. 28, 2012); AAR Amicus Comments, NOR 42121 (filed July 24, 2013). Accordingly, the AAR again respectfully submits that the Board should state unambiguously that it will not apply the limit price rule in future cases for several reasons, both procedural and substantive.

[42] 49 U.S.C § 10701(d)(1).

has market dominance over the transportation to which the rate applies."[43] Complainants bear the burden of proof to establish market dominance.[44]

The Board's proposed screens provide no basis for an abbreviated market dominance test. The ANRPM seeks comment regarding screens based on: (1) a minimum distance between origin and destination; (2) revenue per ton-mile of the issue movement compared with the revenue per ton-mile of a Board-established comparison group; and (3) prior litigation using the proposed methodology within a certain period of time. As a logical matter, even if these proposed screens would eliminate traffic that clearly face competitive forces – a point that the AAR does not concede – these screens do not inform the Board at all about the remaining movements that are not eliminated by the screens. That is, even if the Board could prevent movements for which the railroad obviously lacks market dominance from using the proposed simplified methodology, the screens do nothing to establish that whether a railroad possesses market dominance for those movements that are not filtered out by the screens. For those movements, 49 U.S.C. § 10707 still requires that the complainant establish the railroad lacks effective competition for its transportation service. Finally, for the proposal to rely on preliminary screens paired with an abbreviated process to establish market dominance would impermissibly deny railroad defendants' due process rights to challenge whether the STB has jurisdiction by restricting their ability to challenge market dominance.

Moreover, there seem to be arbitrary assumptions underlying the screens and practical problems raised by them. For example, the proposed revenue per ton-mile screen would not allow a complainant to know if its traffic would qualify for the proposed methodology until after

---

[43] 49 U.S.C. § 10707 (b).

[44] 49 U.S.C. § 10707; 5 U.S.C. § 556(d). *See also E.I. Dupont de Nemours v. Norfolk S. Rwy. Co.*, NOR 42125, slip op. at 29, (STB served Mar. 24, 2015).

it has filed its complaint and the Board has released the default traffic group. Notwithstanding that and other concerns, if the Board seeks to limit a new methodology to rates that are significant outliers compared to similar traffic, it should do so based on a statistically sound methodology for doing so, such as standard deviations. An arbitrary top percentage of rates does not actually determine if any of the rates are outliers, only that they are the highest of the group. Every group of rates will have a top 10 or 15 percent.

IV. Any Proposed Rules for Very-Small Rate Cases Should Adhere to Sound Economic Principles of Railroad Rate-Making

A. R/VC Comparisons are of Limited Value

Prior to the legislative reforms of the late 1970s, the ICC prescribed rates using its traditional, pre-reform rate criteria, i.e., rate comparisons with other similar movements, analysis of economic impacts to the community, and a determination of the railroad's fully allocated costs of moving the traffic.[45] As the Board well knows, this, along with other regulatory constraints, contributed to a railroad industry in severe financial distress. By 1978, the agency recognized that rate comparisons were "of limited value,"[46] and began the long effort to determine rate guidelines that would be consistent with the directives of the 3-R,[47] 4-R,[48] and Staggers Acts,[49] culminating in the 1985 *Coal Rate Guidelines* decision.[50]

---

[45] *See e.g., San Antonio, Tex. v. Burlington Northern, Inc.*, 355 I.C.C. 405 (1976), *aff'd sub nom. Burlington Northern Inc. United States*, 555 F.2d 637 (8th Cir. 1977).

[46] *San Antonio, Tex. v. Burlington Northern, Inc.*, 359 I.C.C. 1, 7 (1978)

[47] Regional Rail Reorganization Act of 1973, Pub. L. No. 93-236, 87 Stat. 986 (1973).

[48] Railroad Revitalization and Regulatory Reform Act of 1976, Pub. L. No. 94-210, 90 Stat. 35 (1976).

[49] Staggers Rail Act of 1980, Pub. L. No, 96-448, 94 Stat. 1895 (1980).

[50] *See, e.g., San Antonio, Tex. v. United States*, 631 F.2d 831 (D.C. Cir. 1980) (rejecting a 7-percent additive as an attempt to reflect differential pricing).

Even after *Coal Rate Guidelines*, the agency has at times sought to avoid the economic analysis of market demand and cross-subsidy by applying R/VC comparison approaches, but such approaches have been overturned by the courts. For example in *McCarty Farms,* the ICC tried to shortcut an economic analysis of the rates at issue and instead looked at whether the R/VC ratio generated by those rates was higher than those of comparison benchmark traffic.[51] The U.S. Court of Appeals for 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."[52] The Court concluded that R/VC comparisons cannot pass for reasoned decision making, and the Court remanded the case to the ICC.[53]

The agency and the courts have already explicitly recognized that the Three-Benchmark test is crude and imprecise. The D.C. Circuit has observed that the Three Benchmark process does not facilitate "a search for truth," and "there is good reason to believe that judgments rendered pursuant to the Three Benchmark framework more often than not will be the antithesis of mathematical certainty."[54] The only justifications for the use of R/VC comparisons at all have been their limited application and limits on relief.[55] But, those justifications should not mask the fact that rate comparisons are not an economically sound method of judging rate

[51] *Burlington Northern R.R. Co. v. Interstate Commerce Comm 'n*, 985 F.2d 589, 595 (D.C. Cir. Feb. 9, 1993).

[52] *Id.* at 597.

[53] *Id.* at 599.

[54] *Union Pac. R.R. v. STB*, 628 F.3d 597, 607 (D.C. Cir. 2010).

[55] *Simplified Standards* at 72.

reasonableness.[56] As the Board has acknowledged, most rates are set according to market forces and most regulated rates should be subject to the SAC test.

The extensive use of rate comparisons would lead to ratcheting and discredited rate equalization. Congress, in the 4-R Act and in subsequent legislation, effectively steered the ICC (and now the Board) away from the pre-1976 practice of regulating so as to equalize rates.[57] Indeed, the antidiscrimination provisions of what is now 49 U.S.C. § 10741 were expressly amended to sharply limit rate equalization practices.[58] Now, instead of having government-mandated rate levels, railroads have the right to set their own rates at levels based on market forces and, when shown to lack effective competition, have them judged without an increasing risk of departure from economically sound principles.[59]

B. Specific Problems in the ANRPM

1. A Commodity-Specific RSAM is Economically Unsound

The ANPRM seeks comment on "whether the Board should modify its revenue need adjustment factor to be commodity-specific, and if so, how we can effectively disaggregate the existing RSAM on a commodity-by-commodity basis."[60] The Board has not explained how it would calculate a revenue need broken out by commodity, though it cites to a proposal made by NGFA in EP 665 (Sub-No. 1) whereby NGFA advocated that the Board allocate the RSAM shortfall to commodities and place a greater burden of a revenue need adjustment factor to those

[56] *Burlington Northern R.R. Co. v. Interstate Commerce Comm'n*, 985 F.2d 589, 595-599 (D.C. Cir. 1993).

[57] *See American Short Line Railroad Ass'n v. United States*, 751 F.2d 107, 109-110 (2d. Cir. 1984).

[58] *See, e.g.*, the Conference Report accompanying the Staggers Rail Act of 1980, H.R. Rep. No. 1430, 96th Cong., 2d. Sess. at 104 (1980).

[59] *Ariz. Pub. Svc. Co. v. Burlington N. & S. Fe Rwy. Co.*, NOR 42077 (STB served Oct. 14, 2003).

[60] ANPRM at 22.

commodities that provide the most revenue.[61] The ANPRM states that "[b]ecause some commodities have a higher R/VC ratio than others, the adjusted revenue need adjustment factor should allocate the revenue shortfall in ways that reflect the different demand elasticities faced by different commodities. However, the weighted average of all commodities when totaled should equal the overall RSAM."[62] Such an approach is flawed and should be rejected.

Different shippers of the same commodity can and do have different demand characteristics. The AAR has detailed its concerns with relying on R/VC ratios as a proxy for demand elasticities in many proceedings.[63] But even if average R/VC ratios may vary by commodities in the aggregate, they also vary within each commodity by market and by customer. Calculating a commodity-specific RSAM suggests that the Board believes that it can allocate joint and common costs appropriately by commodity. But the Board long ago realized "[h]ow a particular carrier's revenue requirements can and should be allocated within its traffic base - i.e., the proper markup to be applied to individual traffic components - is affected by such factors as the mix of competitive and captive traffic handled by that carrier, the degree of competition that it faces on its competitive traffic, and the relative density of the routes that it operates."[64] The Board should not embark on such a wholesale rejection of first principles to create a very small case procedure.

2. Comparison Group

In addition to the questions raised above regarding whether the ANPRM's Board-established default comparison group would actually decrease litigation costs, the default

---

[61] *See* EP 665 (Sub-No. 1), NGFA Comments, Crowley V.S. at 12 (filed June 26, 2014).

[62] ANPRM at 22.

[63] *See, e.g.,* EP 704 (Sub-No. 1), AAR Comments, (filed July 26, 2016).

[64] *Simplified Guidelines*, 1 S.T.B. at 1033-34.

parameters suggested by the Board raise questions of their own. For example, rigid application of a Standard Transportation Commodity Code ("STCC") procedure may present implementation problems based on the availability of data in the waybill sample. The ANPRM proposes to base the default comparison group on movements of the same commodity at the five-digit STCC. The ANPRM notes correctly that some commodities are highly varied at the five-digit STCC designation and therefore may require a finer degree of distinction when selecting an initial comparison group. Similarly, for many commodities, the CWS will not contain enough movements at the five-digit commodity level to get to the 20 observation number the Board seems to believe is statistically significant.[65]

The proposed solution to this problem – relaxing the default STCC limitation to the next most specific STCC level that yields sufficient observations for the comparison group – may result in commodities with very different markets being considered as comparisons. The AAR submits that the party-driven Three Benchmark procedure of final-offer submissions for the comparison group, despite its flaws, at least allows the parties to shape the most appropriate comparison group.

The lack of availability of a sufficient number of observations in the CWS should not drive any substantive decisions about movements that can be included in a comparison group in a very small case. If the Board moves forward with a proposal to adopt rules for very small cases, it should simultaneously move forward with modifications to the sampling rate and should not put changes off until some later proceeding at an undefined time.[66] If the Board increases the sampling rate, there would be no reason to consider allowing complainants to include

---

[65] *See* ANPRM at 14 (citing *E.I. du Pont de Nemours & Co. v. CSX Transp., Inc.*, NOR 42101, slip op. at 13 (STB served June 30, 2008)).

[66] ANPRM at 15 & n. 14.

movements in the comparison group movements on other railroads, contract movements or movements traveling under rates that generate R/VC ratios under 180%.

Allowing such movements in the comparison group introduces significant bias in the analysis by introducing fundamentally incomparable factors into the test. The central assumption of the R/VC comparison approach in the first place is that by comparing markup over variable cost of traffic moving in similar market conditions and with similar operating characteristics the test will demonstrate the reasonable level of contribution to fixed costs for a particular movement for which the railroad possesses market dominance.[67]

The introduction of traffic of a non-defendant railroad would introduce an "apples to oranges" comparison of R/VC ratios. There are two fatal flaws with comparing R/VC ratios of different railroads for this purpose. First, railroads have different traffic bases and business practices. The necessary contribution to fixed costs is different for each railroad. Thus, by its own terms, a rate comparison methodology should generate different R/VC results for different railroads. As the Board has recognized, "the reasonable degree of differential pricing one carrier can exercise is also a function of the mix of traffic; for example, a carrier with little revenue from competitive traffic will need to recover a larger share of joint and common costs from its potentially captive traffic."[68] Second, comparing R/VC ratios of railroads with different costs would penalize railroads that become more efficient by lowering their costs.[69] Simply put, the Board has consistently and correctly found that the R/VC ratios of different railroads do not

---

[67] *Simplified Standards* at 73; InterVISTAS Report at 49.

[68] *Simplified Standards* at 82.

[69] *See* 49 U.S.C. § 10101(9) (directing the Board "to encourage honest and efficient management of railroads").

provide a comparison of the degree of differential pricing that any particular railroad is allowed to engage in by the law.[70]

Similarly, contract traffic does not provide an appropriate comparison to common carrier traffic. A contract represents the sum of agreements between a railroad and its customer and reflects the give and take of negotiation. A host of considerations may go into the contract, affecting the ultimate rate. Inclusion of contract traffic in the comparison group also discourages railroads from agreeing to lower rates in contracts, which runs counter to the Congressional intent that the Board encourage contracting.[71] If, despite all this, contract traffic is included in the comparison group, it must be adjusted to reflect the difference between contract and common carrier rates.[72]

Finally, the inclusion of traffic below 180% would sever one of the tenuous links between the rate comparisons in the Three Benchmark test and CMP. *Simplified Standards* justified R/VC comparisons in limited circumstances by arguing that R/VC ratios of other "potentially captive traffic" (i.e., traffic priced above the 180% R/VC level) can be used as "evidence on the degree of permissible demand-based differential pricing needed to provide a reasonable return on the investment."[73] Traffic that has similar operating characteristics can move in wholly different market conditions, even traffic of the same commodity. Thus, traffic

---

[70] *Simplified Standards* at 82-83.

[71] *See Interpretation of the Term "Contract" in 49 U.S.C. 10709*, EP 669 (STB served Mar. 29, 2007); *see also* H.R. Rep. No. 96-1035, 96th Cong., 2nd Sess. (May 16, 1980) at 57; S. Rep. No. 96-470, 96th Cong., 1st Sess. (Dec. 7, 1979) at 24 (the changes are "intended to clarify the status of contract rate and service agreements in an effort to encourage carriers and purchasers of rail service to make widespread use of such agreements").

[72] *See U.S. Magnesium v. Union Pacific R.R.*, NOR 42114, slip op. at 18-19 (STB served Jan. 28, 2010).

[73] *Simplified Standards* at 17.

that moves below 180% cannot inform the Board as to the degree of permissible demand-based differential pricing needed to provide a reasonable return on investment. Inclusion of traffic below 180% would impermissibly eliminate consideration of market demand in establishing the maximum lawful rate.[74]

3. *Process*

Despite the many problems with the proposals in the ANPRM, the Board should consider opportunities to improve the Three Benchmark process and eliminate unnecessary expense and delay. In the interests of expediting Three Benchmark cases, the Board should consider use of two rounds of simultaneous filings rather than three. Similarly, staff led evidentiary hearings could be useful if they are designed to ensure all parties' due process rights. However, the Board should in no way limit parties' ability to present "other relevant evidence." As discussed above, the comparison group must compare apples to apples and the parties must have full due process rights to assemble the best comparison group for the circumstances and allow the analysis to include relevant market information.

V. If the Board Proceeds to Propose a Methodology for Very Small Cases, That Proposal Should Adhere to its Stated Methodology for Establishing Award Limits

The ANPRM states that its proposed very small rate case process "would be significantly more streamlined than the process required to bring a Three-Benchmark case. As such, the relief available under this method would likewise need to be significantly less than the relief available under the Three-Benchmark approach."[75] The Board has stated that a limit on relief should be

[74] *Rate Guidelines – Non-Coal Proceedings*, 1 S.T.B. 1004, 1026 (1996) (holding that using traffic with R/VC ratios below 180 percent in a comparison group "would be inconsistent with the statute . . . which contains an express legislative determination that no traffic with rates set below 180% is captive.").

[75] ANPRM at 23.

based on the cost of bringing the next more expensive type of case.[76] The Board should adhere to its stated policy on limits on relief if it moves forward with a proposal to develop a new test in this proceeding. In EP 715, a complainant that litigated a Three Benchmark complaint, U.S. Magnesium, testified that it spent less than $500,000 to bring a Three-Benchmark complaint.[77] As an early adopter, U.S. Magnesium likely incurred expenses that later litigants will not. Similarly, the fact that U.S. Magnesium challenged rates to move toxic-by-inhalation hazards likely complicated the litigation. Should the Board adopt procedures for very small rate cases in this proceeding despite the strong objections raised by the AAR above, it should set the limit on awards significantly below $500,000 over five years.

Conclusion

The AAR submits that the Board should withdraw its proposal and discontinue the proceeding. If the Board pursues further action in this proceeding, it should modify its proposal based on the foregoing.

Respectfully submitted,

Kathryn D. Kirmayer
Timothy J. Strafford
Association of American Railroads
425 Third Street, S.W.
Suite 1000
Washington, DC 20024
(202) 639-2506
Counsel for the Association of American Railroads

November 14, 2016

---

[76] *Simplified Standards, at 28. Rate Case Reforms*, EP 715, slip op. at 11 (STB served July 18, 2013).

[77] *See* EP 715, U.S Magnesium Comments, Kaplan V.S. at 4 (filed Oct. 23, 2012).