BEFORE THE
SURFACE TRANSPORTATION BOARD

DOCKET NO. EP 722
RAILROAD REVENUE ADEQUACY

REPLY COMMENTS OF

ALLIANCE FOR RAIL COMPETITION
MONTANA WHEAT & BARLEY COMMITTEE
USA DRY PEA AND LENTIL COUNCIL
COLORADO WHEAT ADMINISTRATIVE COMMITTEE
IDAHO BARLEY COMMISSION
IDAHO GRAIN PRODUCERS ASSOCIATION
IDAHO WHEAT COMMISSION
MONTANA FARMERS UNION
NORTH DAKOTA GRAIN DEALERS ASSOCIATION
NEBRASKA WHEAT BOARD
OKLAHOMA WHEAT COMMISSION
OREGON WHEAT COMMISSION
SOUTH DAKOTA WHEAT COMMISSION
TEXAS WHEAT PRODUCERS BOARD
WASHINGTON GRAIN COMMISSION
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I. INTRODUCTION

At issue in this proceeding is whether this agency will keep a promise made almost 30 years ago to facilitate relief from unreasonable rail rates once railroads become long-term revenue adequate. Most captive shippers, including members of Alliance for Rail Competition ("ARC") and the other interests identified on the cover of these Reply Comments (collectively, "ARC, et al."), have waited for decades for an alternative to the stand-alone cost approach, which has worked, when it worked, for only a handful of shippers with millions of dollars to spend on consultants and lawyers. Even the few shippers who got relief in SAC cases would have gotten nothing if the railroad defendants in those cases had persuaded the ICC and STB to implement SAC more restrictively. Their efforts continue today.

For all other captive shippers, the ability of monopoly railroads to extract billions of dollars (over and above the cost of service) from shippers and producers' pockets has been essentially unchecked. No doubt this is why the railroads want to move the goalposts, or call the whole thing off, now that revenue adequacy has so clearly been achieved or exceeded. Their goal in this proceeding is obviously to rewrite Constrained Market Pricing so that captive shippers must either base rate complaints on Full-SAC or else pay whatever the railroads want to charge.

Some investments made by the railroads with the revenues they obtain from captive and non-captive shippers have certainly benefitted shippers, along with the railroads and their stockholders. But this is also true with unregulated monopolies, and the Staggers Rail Act was never intended to make railroads unregulated monopolies even when they were struggling financially. That result is far more objectionable today.

In this proceeding, the Board has the opportunity to restore some much-needed leverage to captive shippers, without jeopardizing the prospects of railroads for continued economic health. The Board should follow this proceeding with further proceedings designed to implement a revenue adequacy constraint on excessive rail rates.

II. ARGUMENT

A review of the opening comments of the railroad parties and the shipper parties in this proceeding reveals an unsurprising divergence of views. However, this is not a proceeding in which the optimal outcome is somewhere between the positions of railroads and shippers.

The railroads focus on an alleged danger that being found revenue adequate might deprive them of additional revenues which may be needed in the future (the possibility of collecting more than they need is ignored). They therefore argue that the regulatory status quo should not change even if they collect revenues at, or above, levels found adequate under 49 USC 10704(a)(2), as interpreted by the ICC and STB.

Shippers focus mainly on captive customers' need for protection from excessive differential pricing.[1] Such protection, which is mandated by 49 USC 10701(d)(1), has been inadequate in the past, but must be made more effective upon attainment of long-term revenue adequacy by one or more railroads. Implementation of the long-awaited revenue adequacy constraint adopted in Coal Rate Guidelines[2] would help achieve this goal.

The railroads concerns about inadequate revenues are either illegitimate or are so plainly unfounded as to be hyperbolic. Shippers' concerns, in contrast, are well-founded.

The railroads foresee impending disaster if the Board implements the revenue adequacy constraint, but the sky is not falling. In the first place, rail rates for captive traffic "must be reasonable", as a matter of law. To the extent that railroads seek to continue collecting unreasonable rates by opposing shippers' access to

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[1] Shippers also support the use of CAPM in cost of capital calculations, though ARC, et al. rely on WCTL and others to respond to the railroads' arguments on that issue in reply comments.

[2] Coal Rate Guidelines, Nationwide, 1 I.C.C 2d 520 (1985), aff'd sub nom. Consolidated Rail Corp. v. United States, 812 F.2d 1444 (3d Cir. 1987).

effective regulatory remedies, their efforts are in clear violation of the intent of Congress.

Second, the revenue adequacy constraint the railroads oppose would apply to a relatively small percentage of the railroad industry's customer base. Even if applied to all captive customers, the revenue adequacy constraint would be inapplicable to over 70% of rail customers, leaving railroads free to impose unrestricted rate increases on virtually all of the customers they serve. And the actual percentage of shippers able to invoke the revenue adequacy constraint is far smaller, because a prerequisite to rate relief is a Board finding of market dominance.

Nor can the railroads credibly argue that raising rates on non-captive traffic is impossible, or inadequate to meet their needs. Rail rates on non-captive traffic have not been maximized, despite the Board's call for such pricing. See the Board's decision served October 30, 2006 in EP 657 (Sub-No. 1), Major Issues in Rail Rate Cases, aff'd sub nom. BNSF Ry Co. v. STB, 526 F.3d 770 (D.C. Cir 2008), citing "the important principle that a railroad should recover as much of its costs as possible from each shipper before charging differentially higher rates to its captive customers". STB decision at 12.

AAR Witness Kalt suggests that this is finally starting to happen. See his VS accompanying AAR's opening comments at 36-37, where he describes contributions as a percentage of revenue as "flat for regulated traffic" with R/VC percentages above 180%, but goes on to say that "[d]uring this time, the revenues from competitive traffic have generated an additional $2.5 billion in contribution above variable costs – half of the overall increase from 2008 to 2012."

See also the opening comments of UP, making the point (several times) that it has experienced more growth from exempt traffic than from captive traffic. UP opening comments at 22-23, 52 and 56. UP (like Kalt) suggests that this development proves there is no unreasonable differential pricing of captive traffic. It proves nothing of the kind. UP and other railroads may have maximized the rates captive shippers can afford to pay, or many non-captive shippers may have been paying rail rates for years that the railroads have chosen not to raise.

Other interpretations are possible, but ARC et al. have argued consistently that major railroads were too quick to raise the rates of their captive customers, who lack effective competitive alternatives and effective regulatory recourse. In the past, rate increases on captive traffic may have been the easiest way for railroads to increase their revenues, but there are good reasons (beyond UP's success in raising rates on exempt traffic) to expect that railroad revenue growth from non-captive traffic will become easier and more substantial.

The main competitor for major railroads' business has been the trucking industry. Air carriers are generally too expensive and cannot provide the necessary capacity, and water carriers could not provide the geographic coverage or year-round service required to offer significant competition.

Trucking, in contrast, has geographic and service advantages that often exceed those of railroads, but the ability of trucking companies to grow and provide needed capacity (one railroad covered hopper car holds more than five truckloads of wheat) has been slowed in recent years by driver shortages, burdensome regulation, highway congestion, financial weakness and other factors.

The federal government has helped railroads through policies intended to encourage the shift of freight volumes from trucks to trains. And, of course, as the country grows, and more people need more goods, overall freight demand is certain to increase. The railroads are well-positioned to see their freight volumes and revenues increase in the coming years.

There are other reasons to discount the railroads' dire predictions about being found subject to any new limits on differential pricing based on achieving revenue adequacy. The railroads overstate the likelihood of shipper rate challenges, suggesting that any rate that can be challenged will be challenged. They are wrong, for reasons summarized at pp. 32-33 of the opening comments of ARC, et al. Too many shippers with meritorious cases are deterred from filing complaints by the burdens of establishing market dominance (which railroads seek to increase), the high costs and inordinate delays of STB litigation, uncertainty about keeping enough (or any) of the relief that might be awarded, etc.

However, a more fundamental question is raised by the railroads' recent success in improving margins on non-captive traffic. If these new, more aggressive pricing initiatives as to non-captive shippers are so productive, why do the railroads argue so vigorously against implementation of the revenue adequacy constraint?

The simplest summary of how that constraint could work is set forth in the following sentence from Coal Rate Guidelines, 1 I.C.C. 2d at 536:

> A railroad seeking to earn revenues that would provide it, over the long term, a return on investment above the cost of capital would have to demonstrate, with particularity: (1) a need for the higher revenues; (2) the harm it would suffer if it could not collect them; and (3) why captive shippers should provide them.

As is clear from the opening comments of UP and AAR, the railroads have finally learned that they can in fact recover costs from all shippers before charging differentially higher rates to their captive customers, consistent with the Board's directive in Major Issues in Rail Rate Cases. What then accounts for their fierce opposition to any relief at all for captive shippers once revenue adequacy is achieved or exceeded? After 35 years of paying higher rail rates than their non-captive competitors, captive shippers should be able to seek relief from further excessive rate increases based on a railroad's lack of need for additional revenues, or its ability to obtain additional revenues, if needed, from non-captive customers.

Just as the railroads overstate the impacts on their bottom lines of a revenue adequacy constraint, they also overstate the effectiveness of other forms of STB rate regulation. See, e.g., the opening comments filed by CSX in this proceeding, at 29: "The Board's three existing rate reasonableness case methods (SAC, SSAC and Three-Benchmark) provide ample opportunity for shippers to challenge rates they believe are unreasonable."

In fact SSAC has proved useless to captive shippers, and Three-Benchmark remains ineffective for many shippers of grain and other agricultural commodities, and other products subject to generally uniform rates, rate structures or R/VC percentages. These defects are not cured by the Board's recent decision to raise the relief cap (no thanks to CSX, which argued for a five-year relief cap of $200,000, less than the cost of litigating a Three-Benchmark case[3]). The cost of developing a

[3] See the opening comments filed October 23, 2012 by CSX in EP 715, Rate Regulation Reforms, at page 23, n. 14.

comparison group, and rebutting "other relevant factors" cited by railroad defendants, disenfranchise many if not most smaller potential complainants.

The Board should also consider how much protection captive shippers can expect from a methodology which effectively approved rail rates up to (though not exceeding) 350% of variable cost in Docket No. 42114, US Magnesium, LLC v. Union Pacific R. Co., decision served January 28, 2010, aff'd sub nom. Union Pacific R. Co. v. S.T.B., 638 F.3d 597 (D.C. Cir. 2010).

In comments filed in EP 665 (Sub-No. 1), Rail Transportation of Grain, Rate Regulation Review, ARC, et al. suggested ways of making Three-Benchmark rate cases a more effective test of rate reasonableness. Two suggestions were to allow comparison groups to include traffic moving via other railroads, and to include traffic moving at R/VC percentages below 180%. It would seem that these changes would help Three-Benchmark analyses more closely match the goal of "mimic competition regulation" recommended by the AAR in its opening comments, and more closely reflect contestable market principles. However, the railroads in that proceeding, and in this one, evidently regard Full-SAC as the only legitimate test of maximum reasonable rail rates, so defects in Three-Benchmark are fine with them. Shippers with litigation budgets below $5 million must expect poor (or no) rate relief, and the second-class service that accompanies captivity.

In any event, the Three-Benchmark test would do nothing to prevent railroads from continued or increased differential pricing of captive traffic through otherwise unchallengeable future rate increases even after a railroad has achieved long-term revenue adequacy. Only the revenue adequacy constraint (and the management efficiency constraint) can achieve this goal at a cost, and on a timetable, affordable for smaller captive shippers, and those with multiple origins or destinations.

Perhaps the most objectionable position taken by the railroads is that only Full-SAC has any validity, and that any shipper unable or unwilling to challenge rates using Full-SAC deserves either no relief, or minimal relief (e.g., relief from, at best, rates triple or quadruple the variable cost of service, as in US Magnesium). These arguments are wrong, for a number of reasons.

First, in praising Full SAC and denigrating any other approach, the railroads are effectively establishing a multi-million dollar filing fee for any captive shipper which believes any of its rail rates includes excessive differential pricing. Evidently, the railroads would have the Board believe that too much differential pricing cannot exist unless and until it is identified through a Full-SAC analysis.

ARC, et al., do not object to retaining Full-SAC as one approach for rate cases, and we assume it will continue to be used assuming the Board also implements the other constraints of Constrained Market Pricing. However, the idea of making SAC the only effective constraint is absurd, and was rejected by Congress when it amended the Act to require alternative relief for captive shippers for whom “a full stand-alone cost presentation is too costly, given the value of the case.” 49 USC 10701(d)(3). Nothing in the ICCTA indicated that alternatives to Full-SAC could work less well, or not at all, for most of the shippers Congress intended to help.

Not only is SAC the least accessible, most costly rate reasonableness test, but if the railroads had their way, it would also restrain only the most astronomical rates. In Coal Rate Guidelines, the ICC recognized that the “ability to group traffic of different shippers is essential to the theory of contestability”, allowing shippers “to identify areas where production economies define an efficient subsystem whose traffic is divertible to a hypothetical competitor”. 1 I.C.C 2d at 544. [4] Ever since then, however, railroads have sought to restrict shipper defendants’ ability to use groups large enough to generate the necessary densities for relief, thus making Full-SAC workable, at best, for only a handful of high-volume coal shippers. For

[4] Put another way, if the only limit on how much Honda could charge for Civics was what it would cost you to build one yourself from a parts catalog, Honda could justify charging over $100,000 for Civics.

everyone else, Full-SAC is likely to constrain only rates that no shipper could pay and still survive.

Rates exceeding SAC are assuredly indefensible, but regarding any lower rate as therefore reasonable and lawful, or equivalent to rates charged in competitive markets, is far too restrictive. It is like defining water as “hot” only when it reaches the boiling point. Water at the boiling point is certainly hot (under normal circumstances, it cannot get any hotter because it is becoming steam). But water will also cause burns at significantly lower temperatures that many would regard as too high.

As stated by Professor Faulhaber in the VS attached as Appendix A to the opening comments of Concerned Shipper Associations, “In the context of cross-subsidy and contestable markets, then, stand-alone costs are an absolute upper limit on pricing, which in themselves do not permit the sharing of the benefits of the scale and scope of the firm.” VS at 8.

No wonder the railroads like Full-SAC so much, and want to continue to undermine or eliminate the other constraints that have always defined Constrained Market Pricing. Indeed, the AAR, in its opening comments at 46, urges the Board to adopt SAC as a permanent floor on rates (“it would not make economic sense to require revenue adequate carriers to charge rates lower than the SAC minimum”).

It is true that, years ago, there were decisions in SAC cases finding the stand-alone cost of service to be lower than 180% of variable cost for some shipments. If any railroad has ever acknowledged that such cases were correctly decided, the record is hard to find. Those decisions were issued over fierce objections by railroads, which have a long history of opposing features of the SAC approach that help shippers. See, e.g., the comments filed October 23, 2012 by BNSF and UP in EP 715, Rate Regulation Reforms, where both railroads argued against the use of cross-over traffic in Full-SAC rate cases, and UP argued that only the Full-SAC (without cross-over traffic) should be allowed in large rate cases (UP opening comments at 17).

In addition, in its decision served February 13, 2009 in Docket No 42088, Western Fuels Ass'n. and Basin Electric Power Coop. v. BNSF Ry. Co., the Board prescribed maximum reasonable rates subject to R/VC percentages that are, for the most part, in excess of 240%.

The railroads are thus arguing for changes in the regulatory status quo that would reduce regulation and the possibility of rate relief at a time when a record five Class I railroads have just been found revenue adequate and are posting some of the highest returns in their history. The alternatives to Full-SAC, which already fail to serve their intended purpose, would be rendered virtually useless, and Full-

SAC, which is already prohibitively expensive for the vast majority of captive shippers, would be undermined further.[5]

Of course, we are also seeing resistance to any increase in effective competition among railroads, as proposed in a modest way in EP 711, Petition for Rulemaking to Adopt Revised Competitive Switching Rule.[6] The railroads also object to legislation pending in Congress that would eliminate their antitrust immunity, arguing before Congress for continued immunity based on alleged STB regulatory oversight that they are telling the Board should be gutted.

The promise of the revenue adequacy and management efficiency constraints is precisely that they are more accessible than Full-SAC, SSAC or Three-Benchmark, and that implementation can be done without jeopardizing railroad revenue adequacy. These constraints, far from being novel theories, have been integral parts of Constrained Market Pricing for almost 30 years. After further proceedings, implementation could actually begin in a few more years.

In addition these constraints reflect two fundamental realities. First, not only is the threat of financial weakness a distant memory, but major railroads are enjoying

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[5] See the decision served June 20, 2014 in Docket NOR 42130, Sunbelt Chlor Alkili Partnership v. Norfolk Southern Ry. Co., for expressions of concern by all three STB members about the Full-SAC constraint.

[6] Of course, if the Board enhances rail-to-rail competition as urged by shippers in EP 711 (including ARC, et al.), most captive shippers would still need the ability to seek regulatory relief from excessive rail rates.

extremely high revenues, with increased profitability likely as the economy improves. See, in addition to the Board's own data, the opening comments filed in this proceeding by Senate Commerce Committee Chairman Rockefeller. Second, most captive shippers paying high rail rates have nowhere else to turn.

These realities notwithstanding, the position of the major railroads is that two of the only three significant constraints of Constrained Market Pricing should be summarily discarded. Notably, BNSF, CSX, UP and AAR did not even mention the management efficiency constraint in their comments, and NS mentioned it only in passing (at pp. 28-29). Compare with the railroads' dismissive attitude the discussion of this issue in Coal Rate Guidelines, 1 I.C.C 2d at 537-542, which begins as follows:

> Numerous parties have expressed concern that captive coal shippers not be required to shoulder an unreasonable share of carriers' revenue need shortfalls or to pay costs stemming from carrier inefficiencies. We share their concern. Indeed, the statutory concept of revenue adequacy is itself predicated on "honest, economical and efficient management" of the firm. See 49 USC 10704(a)(2).

The railroads obviously resist acknowledging that they no longer face a revenue need shortfall, though they cannot persist in denying reality forever. However, one would need to look no further than the Board's pending proceeding In EP 724, United States Rail Service Issues, for evidence of railroad mismanagement. How do the railroads think the Board should go about protecting captive shippers from rate increases swollen by management inefficiencies?[7] For almost all captive shippers, Full-SAC is not an acceptable or lawful answer.

And yet the only answer the railroads offer is Full-SAC, subject to modifications like no cross-over traffic that would insulate even higher rates from challenge. To the railroads, Three-Benchmark and SSAC are tolerable, if at all, only to the extent those methodologies serve to validate current railroad pricing decisions.

As for Constrained Market Pricing, it would shrink down to Full-SAC, or a version thereof that is palatable to the railroad industry. And if it adopts the view of the railroads and their economists that no other approach is needed or defensible, this Board would be limiting options available to the STB in the future. No matter how profitable the railroads get, or how abusive, any attempt to expand the options available to captive shippers to challenge their rail rates would have to overcome the hurdle of a prior (erroneous) finding that the only test with any

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[7] In Consolidated Rail Corp. v. United States, supra, 812 F.2d at 1449, the court of appeals observed: "It would probably be inconsistent with that [honest, economical and efficient management] standard, and with traditional notions about fair ratemaking as well, to permit rates to captive shippers which subsidized inefficiency or dishonesty in carrier operations in the competitive sector."

economic validity was the test most favored by railroads, and most inaccessible to shippers.

The result would be a swing of the regulatory pendulum from one extreme – the excessive, and discredited, pervasive regulation predating the 4-R Act of 1978 – to the other, in that such "regulation" as is left would be maximally costly and minimally accessible and effective. STB rate regulation might as well not exist for virtually all captive shippers.

But the guiding principle of the statute is not that if some deregulation is good, more is necessarily better, ad infinitum. Rather, the guiding principle is that rail rates should be deregulated where there is effective competition, and rail rate regulation should be preserved where effective competition is absent, consistent with the goal of railroad revenue adequacy under honest, economical and efficient management. Maintaining a regulatory status quo that does nothing to restrain the extraction of monopoly rents from captive shippers even after revenue adequacy is exceeded is contrary to law and precedent, and antithetical to the public interest.

Normally, administrative agencies must justify a departure from prior norms by citing changed circumstances. Atchison, T. & S. F. Ry. Co. v. Wichita Board of Trade, 412 U.S. 800, 808 (1973). It is hard to characterize as a changed circumstance a development that has been anticipated, and coming, for almost 30 years. And it would be highly anomalous for the Board to hold out the hope of a revenue adequacy constraint in rate case after rate case, year after year after year, only to claim changed circumstances as the reason for dashing shippers' legitimate expectations just as railroads reach revenue adequacy, and have less need for past levels (much less increased levels) of differential pricing.

In taking this position, ARC, et al., do not contend that railroad abuses of market power are ubiquitous. Nor do we deny that the railroad industry has invested billions of dollars in track maintenance, expansion of lines, new technology, etc. Poor service occurs, as recent events in the Midwest and Bakken region have demonstrated, but so does good service.

All that said, the Board should also not accept the railroads' arguments that the regulatory status is ideal without the revenue adequacy and management efficiency constraints, or would be if only "excessive" discovery requests by shipper counsel and consultants could be reined in, along with "frivolous" complaint cases.

Instances of overreaching by captive shippers are actually far more rare than instances of overreaching by market dominant railroads, as would be expected where the latter have more market power than the former. By definition, a captive shipper cannot impose anything on the railroad to which it is captive.

If there were a computer program that would quickly and inexpensively generate a Full-SAC number for any shipper, large or small, using a properly configured SARR and shipper group, certain high-rated, large volume captive shippers might be more comfortable with Full-SAC, even though, as explained above, many SAC levels represent not the center of a range of reasonableness but its absolute upper limit. However, the need for Full-SAC for revenue adequate railroads is limited. In any event, when the railroads last proposed their version of such a simplified version of SAC, the Board found that the railroads' black box could approve rates as high as 5000% of variable cost. See Rate Guidelines, Non-Coal Proceedings, 1 S.T.B. 1004, 1014-18 (1996). An alternative AAR proposal was found by the Board to be "nothing more than a profit-maximization tool for a monopolist rate setter." (Id.) The railroads are nothing if not consistent, and it looks like very little has changed in the railroads' thinking since 1996.

See also various proceedings involving concerns about railroad gaming of regulatory protections for captive shippers, including EP 657 (Sub-No. 1), Major Issues in Rail Rate Cases, supra, at pages 15-19; Docket 42124, State of Montana v. BNSF Ry. Co., decision served April 26, 2013; and EP 661, Rail Fuel Surcharges, decision served January 26, 2007.[8]

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[8] For other examples of adverse impacts on captive shippers from railroads' exercise of unrestrained or inadequately restrained market power, see the comments filed by ARC on

III. CONCLUSION

For 35 years in this area of law and regulation, justice has not been impartial. Rather, it has favored the more powerful parties – the railroads – because they were revenue inadequate. Such favoritism should not be prolonged now that the most important benefit the Staggers Act offered to the railroads – restoration of robust and durable financial strength – has been achieved. The costs have been significant, in the form of transfers of billions of dollars to railroads from captive shippers which could have strengthened their own businesses with the funds in question. There needs to be a next phase of this proceeding in which the Board proposes, and considers comments on, measures for real progress toward implementation of the revenue adequacy and management efficiency constraints of Constrained Market Pricing.

October 12, 2005 in STB Ex Parte 658, The 25th Anniversary of the Staggers Rail Act of 1980: A Review and a Look Ahead; on January 10, 2012 in EP 712, Improving Regulation and Regulatory Review; and on May 20, 2013 in EP 711, Petition for Rulemaking to Adopt Revised Competitive Switching Rules.

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CERTIFICATE OF SERVICE

I hereby certify that I have this 4th day of November, 2014, caused copies of the foregoing Reply Comments of ARC, et al., to be served on all parties of record by first class mail or by electronic means.

Terry A. Whiteside

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