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BEFORE THE
SURFACE TRANSPORTATION BOARD

Docket No. EP 665 (Sub-No. 1)

RAIL TRANSPORTATION OF GRAIN

RATE REGULATION REVIEW

REPLY COMMENTS OF UNION PACIFIC RAILROAD COMPANY

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Union Pacific Railroad Company ("UP") submits these reply comments in response to the opening comments submitted by other parties. In particular, we address proposals made by the National Grain and Feed Association ("NGFA") and Alliance for Rail Competition et al. ("ARC"), as well as comments submitted by the U.S. Department of Agriculture ("USDA"). These three commenters argue that special rules are needed to regulate maximum rates for transportation of grain, and NGFA and ARC propose rules that would also apply to many additional agricultural products.

UP fully recognizes the importance to our economy of grain, as well as the many other agricultural products mentioned in the opening comments. We value our agricultural products customers and devote extensive resources to meeting their needs, as described in our opening comments. But there is no need for special rate rules for grain or the other products encompassed by the shipper proposals.

The opening comments of other parties present no evidence to substantiate claims that grain rates are unreasonably high or that railroads are using high rates to shut some shippers out of markets. The record shows instead that rail transportation of grain is highly competitive and that rail rates are reasonable. Moreover, the specific proposals NGFA and ARC put forward are seriously flawed. They are designed not to improve the rate regulation process, but to produce a particular result – rate levels near or at the Board's jurisdictional threshold for regulation. These proposals are fundamentally inconsistent with the competitive market principles the Board must apply when it is necessary to regulate rates.

In these reply comments, we explain that the Board should not expand the scope of this proceeding in certain respects urged by shippers. We show that comments filed by other parties confirm that grain transportation is highly competitive and grain rates are reasonable. We then explain that NGFA, ARC, and USDA have failed to show that special rate rules are needed for grain, let alone the other products NGFA and ARC include in their proposals. We further show that the arguments and specific proposals NGFA and ARC put forward are inconsistent with competitive market principles. Finally, we explain that any revisions to the Board's rate reasonableness rules should be confined to measures that are consistent with competitive market principles.

I. The Board Should Focus This Proceeding on Rate Procedures for Grain Shippers.

The Board initiated this proceeding to address concerns about whether grain shippers have effective access to the Board's rate reasonableness process. NGFA and ARC seek to expand the scope of the issues in several respects. The Board should reject those efforts.

A. The Board should decline shippers' invitation to address rates for limestone, salt, freight cars, and grain products.

The Board should decline to address transportation of products other than grain – that is, other than corn, wheat, soybeans, and similar crops. NGFA and ARC argue that new rate rules should extend to all of the products covered by NGFA's Rail Arbitration Rules. *See* NGFA Comments at 26-27; ARC Comments, Fauth VS at 3. These rules cover not only grain, but also dozens of processed products, such as ethanol, corn syrup, soybean oil, and soybean meal, as well as products that are not even made from grain, such as limestone, salt, and "freight cars moving on own-wheels." *See* NGFA Comments, Crowley VS, Ex. 2. Some of the products on the NGFA list, however, have been exempted from rate regulation.[1] Furthermore, the arguments NGFA, ARC, and USDA rely on to support special treatment of grain – arguments that focus on the relationship between small grain farmers, local grain elevators, and railroads, and the volatile nature of grain movements – do not fit most of the products on NGFA's long list. As discussed below, most of the products covered by NGFA's rules are shipped by large producers, and these movements are more regular (less variable) than movements of crops such as corn, wheat, and soybeans. Rail service for these other products is not comparable to grain service; it is more comparable to the service UP provides for the majority of its chemicals and industrial products customers, and even many coal customers.

While the Board did not define "grain" in its order initiating this proceeding, we believe it intended to limit the proceeding to "grain" as defined in the United States Grain Standards Act.

[1] The exempt products covered by NGFA's arbitration rules include: all products shipped under STCC 01, except grain (STCC 0113), soybeans (STCC 01144), and sunflower seeds (STCC 0114940); grease/inedible tallow (STCC 20143); bakery products (STCC 20511); fish meal (STCC 20942); animal protein products (STCC 20144); and salt (STCC 2899112). *See* 49 C.F.R. pt. 1039.

See 7 U.S.C. § 75(g) ("the term 'grain' means corn, wheat, rye, oats, barley, flaxseed, sorghum, soybeans, mixed grain, and any other food grains, feed grains, and oilseeds for which standards are established under section 76 of this title"). The Board's governing statute distinguishes between "grain" as defined in the Grain Standards Act and a broader group of "agricultural products." *See* 49 U.S.C. § 11101(d).

B. The Board should decline shippers' invitation to revisit issues presented in separate revenue adequacy, URCS, and service proceedings.

The Board should reject NGFA's and ARC's efforts to use this proceeding to consider issues that are already being addressed in other pending Board proceedings and that present no aspects unique to grain. In particular, NGFA and ARC argue that new rate rules are appropriate when railroads are revenue adequate. Revenue adequacy issues, including the implications for rate regulation if rail carriers become revenue adequate, are more properly addressed in Ex Parte No. 722, *Railroad Revenue Adequacy*, where parties will address these issues in depth. In addition, ARC criticizes several aspects of the Board's URCS methodology, but these issues are being considered in Ex Parte No. 431 (Sub-No. 4), *Review of the General Purpose Costing System*. The URCS issues ARC raises are relevant to all types of shipments, not just grain movements. NGFA and ARC also complain about recent service problems that have affected grain shipments on some railroads, but the Board is already considering those issues in Ex Parte No. 724 (Sub-No. 2), *United States Rail Service Issues – Grain*.

C. The Board should decline shippers' invitation to disregard competitive market principles and the need for differential pricing.

The Board should reject proposals that are at odds with the requirements of its governing statute. Under the statute, any rate regulation methodology must be consistent with competitive market principles. *See* 49 U.S.C. § 10101(1) (stating congressional policy "to allow, to the maximum extent possible, competition and the demand for services to establish reasonable rates for transportation by rail"). In other words, when shippers lack competition, rates should be set to simulate the results that a contestable market would produce. This is what the Board does when it applies the Stand-Alone Cost ("SAC") test, which it has consistently recognized as the "most accurate procedure available for determining the reasonableness" of rates. *McCarty Farms, et al. v. Burlington Northern Inc.*, 3 I.C.C.2d 822, 840 (1987); *see also Simplified Standards for Rail Rate Cases*, EP 646 (Sub-No. 1), slip op. at 13 (STB served Sept. 5, 2007) ("*Simplified Standards*") (SAC is "the most accurate procedure available"). Simulation of results in a contestable market is also what the Board does in the Simplified SAC ("SSAC") test, and what it attempts to do, albeit very crudely, in applying the Three-Benchmark ("3B") test. *See Simplified Standards*, slip op. at 13-14, 73-74.

The Board should reject proposals to revamp its rate methodology to achieve something other than a competitive market outcome. A crucial difference exists between improving the agency's rate regulation process by simplifying procedures to reduce burdens on the parties, on the one hand, and changing the rules in order to produce different results, on the other. NGFA and ARC are asking the Board for special grain rules because shippers want lower rates than they could obtain from application of the current rules. In an effort to achieve these lower rates, they propose mechanisms that have no connection to the competitive market principles that Congress mandated in the statute. Essentially, NGFA and ARC argue that the current rate reasonableness procedures are "unavailable" to grain shippers primarily because those procedures do not produce the results they desire.

As discussed further below, the NGFA and ARC proposals should be rejected. The Board should confine its consideration to proposed changes that are consistent with the statutory standards Congress established for rail rate regulation.

II. The Record Confirms That Extensive Competition in Grain Transportation Markets Constrains Rail Rates and Provides the Most Logical Explanation for the Absence of Grain Rate Cases.

UP's opening comments described the highly competitive nature of grain transportation and the many ways in which our operations benefit grain shippers. As described below, the opening comments of other parties, including those submitted by shippers, confirm that grain transportation markets are highly competitive and that grain shippers pay reasonable rates as a result.

A. Grain shippers have competitive alternatives that constrain rates.

1. Our customers have alternatives to shipping on UP.

We explained in our opening comments that UP must price its grain transportation in response to significant competitive alternatives. In short, every grain producer initially ships by truck, and many can truck their grain to a nearby destination, such as an ethanol plant, a feed lot, or some other processing facility. Indeed, the availability of nearby ethanol plants is a key reason why rail has lost grain transportation market share over the last 15 years, as reflected in the USDA reports cited by UP and the Association of American Railroads ("AAR"). More than 90 percent of U.S. ethanol production capacity is located within a 50-mile radius of corn producing areas. *See* USDA, *Study of Rural Transportation Issues* 36 (2010). Cattle feed lots have been increasingly located within short distances of grain production. *See id.* at 192. And USDA has also reported that agricultural processors, such as grain and oilseed milling facilities, are often located near agricultural producers. *See id.* at 33.

Nearly all grain producers and elevators have a wide range of competitive options for moving grain to both nearby and distant destinations, with rates that are constrained by those options. The relatively few producers that may be beyond trucking distance to any destination except UP-served elevators also enjoy competitive rail rates because there is such extensive geographic competition for grain. If UP imposed unreasonably high rates on such producers or their UP-served elevators, the producers would lose business to others who were able to ship to the same destination at lower rates, and we would lose that business, too. We have no incentive to foreclose any shipper from any market. To do so would drive that shipper or its customer to an alternative, and we would be deprived of the revenue. *Cf. Union Pac. Corp. – Control – Chi. & N.W. Transp. Co.*, FD 32133, Decision No. 25, slip op. at 57 (ICC served Mar. 7, 1995) ("[G]rain grown in Iowa competes with grain grown elsewhere (both in the United States and throughout the world) . . . .").

Significantly, most UP grain shippers have numerous choices. The bulk of our grain business involves large, integrated companies or traders with global networks. For the period July 2013 through June 2014, UP's top 20 grain customers accounted for more than 82 percent of our grain revenues.[2] These high-volume shippers have multiple sourcing and destination options on both UP and our competitors.

2. Transportation alternatives constrain rail rates.

NGFA, ARC, and USDA all fail to explain why the alternatives available to virtually all grain shippers and receivers – direct competition between UP and other railroads, competition between UP and trucks and barges, and geographic competition – do not provide effective constraints on the rates railroads charge. NGFA argues that transportation rates are established between an elevator/aggregator and the railroad and that a captive elevator must bear rail rate increases or pass them back to the farmer through reduced prices. *See* NGFA Comments at 7-8. In fact, the bulk of our freight bills are paid not by elevators, but by receivers or brokers that can buy from multiple origins. If we tried to charge unreasonable rates to a UP-served elevator that

[2] This concentration of freight payers is typical for other time periods as well.

then attempted to pass along the cost to farmers, the farmers could truck their grain to elevators served by other railroads or by barge, or to local feed lots or processors. And if farmers do so, they deprive UP of revenues.

Options are similarly available in connection with movements of other agricultural products. According to NGFA, grain processors are frequently captive to a single railroad and have no viable alternative for moving outbound product. *See id.* at 8. But in UP's experience, most grain processors have multiple facilities served by different railroads, and they are in a position to shift production among their facilities if our rates are too high. As in the case of grain, the great majority of our agricultural products business involves large, integrated companies with multiple facilities at various levels of the logistics chain served by different railroads: just 8 customers account for more than 80 percent of UP's ethanol volume; just 5 customers account for more than 80 percent of UP's soybean meal volume; and just 2 customers account for nearly 90 percent of UP's corn syrup volume.

USDA data presented in the AAR comments confirm that grain transportation markets are competitive and that rail rates are reasonable. These data show that railroads' share of total grain transportation in the United States is only 28 percent and that over time rail's share of the business has declined relative to truck and barge shares. *See* AAR Comments at 7-8. Railroads are vulnerable to losing additional share if their rates increase relative to other modes. The data further show that rail rates for grain have risen much more slowly than the prices of important farm inputs such as seed, fertilizer, and fuel. *See id.* at 13. The data also show that in the past few years net farm income has increased significantly, while Class I railroad revenue from grain as a percentage of net farm income, and as a percentage of the value of grain production, has dropped. *See id.* at 14.[3]

B. Shipper comments confirm that grain transportation is highly competitive and that this competition constrains rates.

While they assert that grain shippers have limited alternatives, the shippers themselves suggest that grain transportation markets are highly competitive and that rail rates are reasonable.

1. Shippers acknowledge that most grain rates are low and that geographic competition exists.

ARC's expert Mr. Fauth offers as a rationale for a special grain rate methodology the fact that "most grain and grain products movements have revenue-to-variable cost (R/VC) ratios falling below 180%." ARC Comments, Fauth VS at 5. That is, most grain already moves at rates that are below the level at which any relief could be granted. This fact alone would explain why there are few rates complaints involving grain transportation. Mr. Crowley's calculations for NGFA illustrate the same point. *See* NGFA Comments, Crowley VS at 3, Table 1.

Mr. Fauth further acknowledges that even grain shippers with R/VC ratios over 180 percent enjoy effective competition:

> Many grain and grain products movements with high R/VC ratios . . . could have problems proving market dominance. Many large volume railroad grain movements involve relatively short distances

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[3] In their reply comments, USDA discusses the relationship between grain rates and railroad costs between 2003 and 2012. *See* Reply Comments of the U.S. Department of Agriculture at 4-5. UP has not audited USDA's calculations, but there should be no surprise that rail rates have increased faster than costs. Railroads could not have improved their financial health in recent years unless revenues increased faster than costs.

Notably, according to data in the Board's Commodity Stratification Report, the improvement in rates for agricultural products came from movements with low R/VC ratios in the first place. According to the data, between 2003 and 2012, the average R/VC ratio for traffic with R/VC ratios below 180% increased from 1.26 to 1.34, while the average R/VC ratio for traffic with R/VC ratios of 180% or more *decreased* from 2.34 to 2.18. In other words, gains appear to have come from competitive traffic.

> to processing facilities and river terminals and many large grain destinations have two or more railroads serving the facilities.

ARC Comments, Fauth VS at 15. NGFA acknowledges the presence of geographic competition, a powerful force that keeps rail rates in check:

> Significantly, as noted previously, Ag Commodity markets are both national and global in scope. For example, captive wheat and other commodity producers and elevators in Montana compete not only against each other to sell their crops, but also with shippers and receivers from other states and Canadian provinces.

NGFA Comments at 8. NGFA recognizes that "delivery points to which many Ag Commodities are shipped often have multiple sources of supply." *Id.* at 9.

Again, the NGFA and ARC statements strongly suggest that the absence of rate complaints filed by grain shippers is due not to any problem with the Board's process, but to the fact that markets for grain transportation are highly competitive. Of course, the real-time market options available to shippers and receivers are a more effective, lower cost path to reasonable rates than any Board rate proceeding.

2. Most grain rates fall below the jurisdictional threshold despite ARC's misguided claim that URCS costs should be restated.

ARC and Mr. Fauth attempt to dismiss the significance of these facts by arguing that R/VC ratios for grain shippers would be higher if the Board's URCS methodology were revised to reflect efficiencies associated with trainload service. *See* ARC Comments at 21 & Fauth VS at 5. But the assertion that URCS fails to account for such efficiencies is wrong. URCS includes adjustments designed to reflect efficiencies of higher-volume movements. *See Review of the General Purpose Costing System*, EP 431 (Sub-No. 4), slip op. at 3 (STB served Feb. 4, 2013) (explaining that "URCS applies 'efficiency adjustments' to higher-volume movements (multi-car and trainload), thereby reducing the system-average unit costs of such movements").[4]

In fact, R/VC ratios for grain shipments are *overstated* in several respects. Most obviously, R/VC ratios for shuttle train movements – the great bulk of UP's grain movements – are overstated because the reported revenue data in the Board's Waybill Sample do not reflect incentive payments made by UP (and presumably other railroads, *see* BNSF Comments at 27) to shippers for timely loading and unloading of these trains. Volume incentives paid to shippers also are not reflected in the waybill data. *See* USDA, *Study of Rural Transportation Issues* at 251 ("It is important to recognize, however, that volume discounts paid later in the year, after the bill is paid, are not captured by the Waybill sample.").

Moreover, shippers acknowledge other facts that suggest URCS costs to handle grain are understated, causing R/VC ratios for grain movements to be artificially high. In particular, the variability and volatility of grain movements generate significant costs that are not fully reflected in URCS costs for these movements. If adjustments were made to reflect the higher costs grain transportation imposes on railroads, more grain rates would likely fall below the jurisdictional threshold, further confirming the highly competitive nature of grain transportation.

NGFA emphasizes the variability of grain shipments:

> [T]he output of Ag Commodities is highly variable because of their dependence upon weather, variable producer-planting decisions in response to market signals and other factors, and government policies. . . . The supply and thus price of an agricultural

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[4] Mr. Fauth also asserts that some grain movements in the Board's Waybill Sample appear to be billed incorrectly as higher-cost, single car movements. *See* ARC Comments, Fauth VS at 20-21. However, any such errors are attributable to the shipper, which is the party that determines how its cars will be described on the waybill. *See* Reply Comments of Union Pacific Railroad Company at 2 & n.6, *Review of the General Purpose Costing System*, EP 431 (Sub-No. 4) (Sept. 5, 2013).

> commodity like corn, wheat or soybeans . . . may fluctuate significantly between or within crop years because of an unforeseen drought in a critical growing area of the world, or a government closing its borders to trade . . . .

NGFA Comments at 8-9. But NGFA ignores the fact that this variability imposes extra costs on UP and other railroads and increases the risk railroads face in investing to serve grain customers. For example, in order to help shippers cope with variability in output and demand, UP provides the variety of flexible car allocation arrangements described in our opening comments, offering customers a wide range of options to fit different circumstances. These programs allow our customers to shift trains and cars between origin/destination pairs in response to changing market demand and to resell their rights to rail service in secondary markets or purchase such rights from others.[5] But offering these flexible options to our customers creates administrative and operating costs for UP.

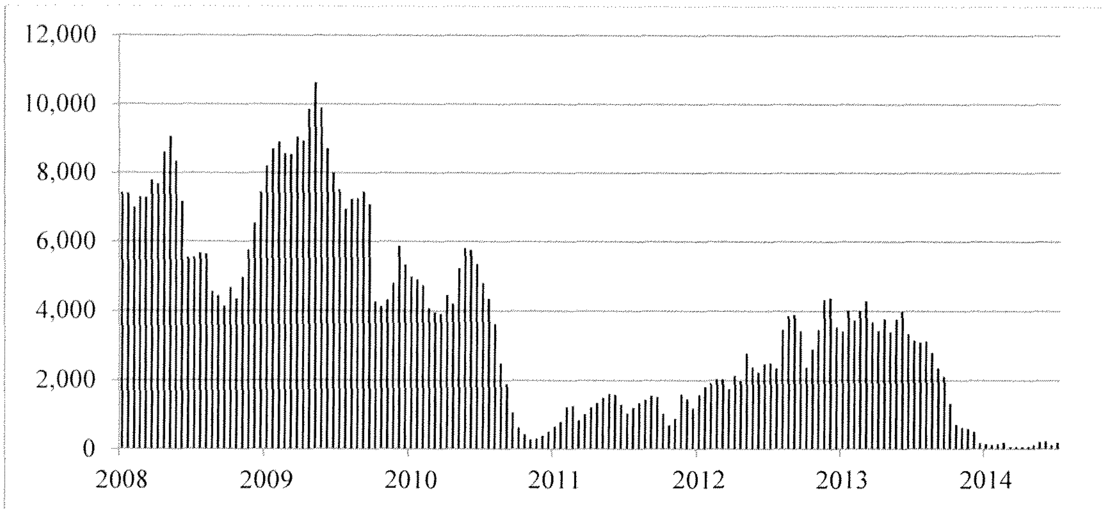
This includes significant costs UP incurs due to underutilization of equipment when grain volumes drop. We invest heavily in covered hoppers to serve grain customers. But we cannot obtain full utilization of our covered hoppers much of the time. In years with smaller harvests, and within each year during months of low demand for grain transportation after the harvest, we end up storing large numbers of the covered hoppers we had acquired to support grain shippers' needs in years of large harvests and periods of high demand. These stored cars do not generate revenue, and they occupy track that cannot be used to support revenue moves.[6] Figure 1 below

[5] UP receives no proceeds from transactions in these secondary markets. But our customers can hedge or sell at a profit, thereby reducing their shipping costs.

[6] UP also incurs additional operating costs when moving empty grain cars from revenue service into storage, and then again when moving the cars out of storage and repositioning them to begin revenue service.

shows how much of UP's covered hopper fleet has sat idle over the period from 2008 to the present.

Figure 1: UP Grain Hopper Storage Count



As shown in Figure 1, the underutilization of covered hopper cars can be substantial and long-lasting. In 2008 and 2009, UP had over 4,000 covered hoppers in storage at all times, with the number soaring to over 10,000 cars (more than 50 percent of our fleet) in May 2009. In 2011, we had between 650 and 1,600 covered hoppers in storage throughout the year. We nevertheless invested $124 million in acquisition of covered hoppers in the 2010-2012 period, in order to upgrade our fleet and to prepare for future customer needs.

As recently as August 2013, UP had over 3,000 covered hoppers – or more than 20 percent of our fleet – in storage. Now, with the record 2013 grain harvest still moving, UP essentially has no covered hoppers left in storage. In early 2014, we responded to customer demand by acquiring a large number of additional covered hoppers, committing $46 million for long-term leases.

Grain shippers benefit when UP maintains thousands of covered hoppers in preparation for peak years and the peak periods within each year. But this variability in the use of grain equipment generates extra costs that must be recovered from the rates that are paid when the cars are loaded. And the rate we collect only when the cars carry a load must recover the cost of the investment and storage for those times when the cars sit idle and generate no revenue. Shippers of other products could argue plausibly that URCS fails to attribute those special costs to grain shippers and that it is unreasonable to spread them among shippers of other products through use of system-wide URCS cost.

3. Shippers fail to show that rail rates exceed reasonable levels.

Grain shippers recognize that rail transportation is just one small element in an integrated chain that is global in scope. *See* NGFA Comments at 11 ("The Class I railroads are only one component of the integrated, international market environment for agricultural commodities produced by America's farmers."). But the shippers fail to acknowledge the significance for rail rates of this integrated environment. As BNSF's expert Professor Wilson points out, railroads are the only regulated entities in this integrated supply chain. *See* BNSF Comments, Wilson VS at 2. If any entity is capable of extracting monopoly profits in highly integrated global grain markets, it is not U.S. railroads.

The shippers imply repeatedly that rail rates for grain are too high, but they provide no facts to support that claim. NGFA asserts that railroads have the power to "de-market" certain grain movements by charging high rates. *See* NGFA Comments at 11. But it offers no evidence that railroads have actually taken such steps, or even an example of a market where this allegedly occurred. And shippers offer no reason why a railroad would have any incentive to "de-market" such business – especially if transportation of grain were as profitable as they allege elsewhere. UP certainly does not want to "de-market" any grain movements. We price grain transportation based on demand for service, at rate levels that will provide an adequate contribution to the joint and common costs we must recover. So long as UP can recover a contribution sufficient to allow us to reinvest, we want to win as much business from as many shippers as possible.

Indeed, rather than "de-marketing" grain movements, UP is investing to provide more facilities to accommodate its grain customers. We described many of these investments in our opening comments. In addition, UP is currently investing in rail infrastructure to support new grain terminals in Lake Charles, Louisiana, and Hope, Minnesota. As noted above, UP recently committed $46 million to acquire additional covered hoppers to accommodate increased demand. And AAR's data showing strong growth in the level of farm income in recent years refutes the notion that railroads charge rates that are stunting the growth of the grain business. There is no evidence that shippers of grain or grain products have been foreclosed from any opportunities.

III. NGFA, ARC, and USDA Fail to Make the Case for Special Grain Rate Rules.

NGFA, ARC, and USDA all argue that the Board should establish special rate rules for grain transportation. But they do not provide persuasive justifications for special grain rules. And their arguments for such rules are inconsistent with competitive market principles.

A. Shippers fail to justify special rate rules for movements of grain or other agricultural products.

NGFA, ARC, and USDA argue that the unique characteristics of grain markets require special rate rules. But their profile of small shippers without any leverage in dealing with railroads and without the traffic volumes or resources to pursue a rate case[7] does not fit most movements of grain or agricultural products.

The great bulk of UP's grain revenue comes from large, vertically integrated shippers. UP's top 7 grain customers alone account for 60 percent of its grain volume, and UP's top 20

[7] *E.g.*, NGFA Comments at 7-8; ARC Comments at 6-9; USDA Comments at 5-6.

grain customers account for more than 80 percent of its grain volume. UP's top grain customers include well-known names such as Archer Daniels Midland and Cargill. These shippers are some of the largest agricultural businesses in the United States. They operate elevators and processing facilities at a wide range of locations, across many states. Some operate globally, with extensive export operations. The business of these customers is primarily high-volume shipments moving in shuttle trains. Other top UP grain customers are large resellers and trading companies such as Bartlett Grain, Gavilon, and Scoular, which can choose to buy where the delivered cost is most advantageous. These large shippers have substantial bargaining leverage. They ship between many origins and destinations, and they could access transportation alternatives readily if UP rail rates were unreasonable. *See, e.g.*, *Westmoreland Coal Sales Co. v. Denver & R.G.W.R. Co.*, 5 I.C.C.2d 751, 757 (1989) ("a railroad generally cannot exercise undue market power over a broker" because brokers can arrange shipments from numerous sources to numerous destinations, and thus "should be in a position to use two or more carriers").

NGFA, ARC, and USDA do not explain why these large businesses, which move many thousands of carloads each year, need a special rate methodology. Indeed, they say very little about these large shippers or the shuttle trains the shippers direct to various origins and destinations. In fact, there is no reason to provide large grain shippers with special rules. Large agribusinesses and grain brokers with high-volume shipments have sufficient resources and incentives to pursue rate relief using existing methodologies, if they believe their rates are too high.

Moreover, as noted above, NGFA and ARC sweep into their proposals not only crops like wheat, corn, and soybeans, but also a long list of other agricultural products. Most of these other products have transportation characteristics that are quite different from corn, wheat, and soybeans: they do not move from the same widely scattered collection of origins in the same highly variable manner described by the shippers. UP transports grain from nearly 500 hundred origins, and it takes 60 of those origins to account for 80 percent of the total volume. The picture looks very different for other agricultural products. Ethanol, soybean meal, corn syrup, and other agricultural products typically move in more stable patterns from a smaller number of larger processing facilities owned by large businesses. Just 21 origins account for more than 80 percent of UP's ethanol volume; just 8 origins account for more than 80 percent of UP's soybean meal volume; and just 5 origins account for more than 80 percent of UP's corn syrup volume. NGFA's and ARC's justifications for special grain rate rules do not apply to these other products.

If the Board concludes, however that new rules are needed, it must proceed with care, ensuring that any such rules are consistent with statutory requirements. As discussed in the following section, the arguments that NGFA and ARC are using to press for new rules are at odds with these requirements.

B. NGFA's and ARC's arguments for special grain rate rules disregard the competitive market principles embodied in the Board's governing statute.

Any change to the Board's rate reasonableness rules must be consistent with the competitive market principles that govern rail rates under the statute. Congress has provided that, "to the maximum extent possible," the Board must allow "competition and the demand for services to establish reasonable rates for transportation by rail." 49 U.S.C. § 10101(1).

Nothing in NGFA's, ARC's or USDA's opening comments shows that the Board's current approach to rate regulation is inconsistent with competitive market principles or that the methodologies it has approved are unsound. At most, the shippers and USDA raise a question whether the smallest grain shippers could realistically use the methodologies because in certain cases the litigation costs would overwhelm any potential rate reductions.

1. USDA and shippers exaggerate costs associated with 3B complaints for grain.

We believe 3B cases involving grain would be less costly to litigate than USDA assumes. *See* USDA Comments at 5-8. USDA's assumptions are based on a statement submitted by US Magnesium L.L.C. about the costs of litigating a 3B case involving two movements of chlorine on UP. But US Magnesium attributed much of the higher-than-expected costs to the fact that the parties submitted evidence addressing two "other relevant factors": (i) treatment of the costs to install Positive Train Control on lines carrying toxic inhalation hazards, and (ii) inclusion of traffic moving under contract rates in the comparison group. *See* Opening Comments of US Magnesium at 7, *Rate Regulation Reforms*, EP 715 (Oct. 23, 2012). UP believes the case was costly for the additional reason that there were difficulties in selecting appropriate comparison groups, given the limited number of chlorine shipments in the Waybill Sample. None of these issues would arise in a grain case: sample sizes would be larger, grain is not a toxic inhalation hazard, and the contract rate issue has been resolved.

UP would support reasonable proposals to reduce the cost of litigating grain rate cases, but the shippers, for the most part, are not proposing ways to simplify the process; instead, they are seeking to distort the process with the aim of obtaining lower rates. The arguments they offer for such a change are at odds with competitive market principles. And their specific proposals for special methodologies are thinly veiled efforts to drive rates down to the 180 percent R/VC jurisdictional threshold, divorced from demand-based principles that Congress said should govern rail rates.

2. NGFA fails to justify special rules that would ignore statutory mandates against cross-subsidy and in favor of demand-based pricing.

It is notable that NGFA's complaints about SAC and SSAC rest in large part on the fact that many grain shippers are located on low-density rural branch lines, which makes it difficult for the shipper to prevail under those standards. *See* NGFA Comments at 13-14. Of course, rail rates for movements over those lines *should* be higher than for movements over higher-density lines; if they were not, other shippers would be cross-subsidizing grain shipments. The Board has made clear that such cross-subsidies are inconsistent with the statute. *See Otter Tail Power Co. v. BNSF Ry.*, NOR 42058, slip op. at 11-13 (STB served Jan. 27, 2006), *aff'd sub nom. Otter Tail Power Co. v. STB*, 484 F.3d 959 (8th Cir. 2007); *PPL Montana, LLC v. Burlington N. & S.F. Ry.*, 6 S.T.B. 286 (2002), *aff'd sub nom. PPL Montana, LLC v. STB*, 437 F.3d 1240 (D.C. Cir. 2006). That NGFA believes current rates for grain movements over low-density lines are below SAC or SSAC levels means competition *is* effectively restraining rates. NGFA's reliance on the fact that grain traffic often moves on low-density lines as a basis for objecting to the use of SAC and SSAC is strong evidence that it is simply looking for rates that are even lower than grain shippers currently pay, not rates based on competitive market principles.

In fact, NGFA expressly argues for an entirely different pricing regime for grain than what Congress has specified. It is not clear from its comments just what NGFA wants rate regulation to achieve for grain shippers, other than lower rates. It appears that, in place of demand-based pricing, NGFA wants some form of equalization or uniformity: "[R]ate rules for Ag Commodities must set maximum reasonable rates taking into account a consideration of the rail transportation costs all other shippers of the same commodity are incurring to access the overall market." NGFA Comments at 16. Mr. Crowley expresses concern about rates that "deviat[e] from the average cost of production and transportation." *Id.*, Crowley VS at 7.

Whether NGFA is seeking equalized rates, or uniform mark-ups, or uniform R/VC ratios, its argument ignores the fact that "the cost structure of the railroad industry necessitates differential pricing of rail services." *Coal Rate Guidelines, Nationwide*, 1 I.C.C.2d 520, 526 (1985). The Interstate Commerce Commission recognized long ago that railroads must allocate their "unattributable costs" – that is, their costs that "cannot be assigned directly to specific movements by any conventional accounting methodology" – based on "actual market demand." *Id.* If a railroad tried to charge shippers uniform rates or the same mark-up, "it would lose that traffic for which the demand could not support the price assigned." *Id.* "In that event, the remaining shippers might be required to pay a larger portion of the carrier's unattributable costs because they would lose the benefit of sharing these costs with the lost traffic." *Id.* In short, demand-based differential pricing is consistent not only with Congress's direction that rates should be established by competition and the demand for services, but also with the economic interests of both railroads and shippers in assuring the efficient recovery of unattributable costs. *See id.* Driving down rates, or mark-ups, or R/VC ratios, to uniform levels will not serve these interests.[8]

3. ARC fails to justify special rules that ignore the statutory mandate for demand-based pricing and efficient movements.

ARC's arguments similarly depart from competitive market principles, even more explicitly. ARC argues expressly that revenue adequate railroads no longer need to engage in differential pricing. *See* ARC Comments at 12, 14, 17. But ARC is incorrect. The economic

[8] NGFA's argument for equalization or uniformity is reminiscent of arguments for the ICC's "ratio method," in which a railroad's unattributable costs were assigned to specific movements "in proportion to the variable costs of those movements." *Id.* at 523 n.6. The "ratio method" was long-ago consigned to the scrap heap of history.

fundamentals of the railroad industry would not change if a carrier were revenue adequate.[9] A revenue adequate railroad must continue to engage in differential pricing to recover its unattributable costs, or it will drive away the traffic with more competitive options, to the detriment of both the railroad and remaining shippers.

ARC also complains that shippers using shuttle trains receive more favorable rates (presumably a reference to volume incentives). *See* ARC Comments at 7. But this is entirely appropriate. With high-volume repetitive movements, there is little need for classification of cars or for building a full train, which results in a more efficient, lower cost operation and maximizes the revenue movements for the cars. There is nothing wrong with providing shippers with more favorable terms when they request a more efficient movement that puts less strain on a railroad's operations and improves utilization. UP's volume incentives are contractual arrangements that are available to any shipper willing to meet the terms. And when used in combination with other car allocation systems, UP's shuttle train program not only allows us to move more grain; it optimizes access to cars for all of our grain customers.

Use of equalized rates, mark-ups, or R/VC ratios in place of demand-based pricing is not only contrary to the statute and sound economics, it also presents a significant risk of reducing railroad investment that benefits grain transportation. Ordinarily, rising rates in response to growing demand signal a need for additional investment on particular routes and for particular equipment, and they provide the returns needed to justify the investment. If returns on grain transportation are limited based on considerations other than competitive market principles, market signals are suppressed, and railroads will lose the ability to allocate resources where the

[9] As the record in Ex Parte No. 722 will demonstrate, railroads are not earning economic returns, properly measured, that are sufficient to meet their cost of capital.

market would say investment is needed most. Instead of the robust investment in the capacity and service improvements they claim to want,[10] grain shippers will find that lower rates for grain transportation will lead railroads to invest in improvements to benefit other traffic or to reduce investment and return more cash to shareholders.

Shippers would find that an equalization regime disrupts markets in other ways. In particular, uniform R/VC ratios are not the same as uniform rates per car. As explained in our opening comments, UP generally charges the same rates for shippers within defined geographic groups, so that their shipping costs are the same. This allows the shippers to compete with each other, although UP then has different R/VC ratios for the different movements. Implementation of NGFA's proposal might leave grain shippers in the same geographic region that otherwise would have paid the same rate to a destination all paying different per car rates, due to their different mileages (and thus different variable costs). In other words, some grain shippers will be at a disadvantage compared with others in the same region.

Finally, there is no basis in the statute for granting the relief NGFA and ARC seek – a more favorable rate methodology for grain shippers than for other shippers. All shippers should contribute to a railroad's fixed and common costs as determined by competitive market principles. It is neither credible nor consistent with the statute to suggest that grain shippers are entitled to rates below the levels that would prevail in a competitive market.

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[10] *See, e.g.*, *United States Rail Service Issues*, EP 724, Hearing Tr. at 49 (Apr. 10, 2014) (testimony of North Dakota Grain Growers Association) ("We sincerely hope and trust that the railroads are working to upgrade their systems …."); *id.* at 96 (testimony of South Dakota Secretary of Agriculture) ("[N]ow is the time to build up the rail infrastructure to handle this increased production."); *id.* at 155 (testimony of NGFA) ("The NGFA commends rail carriers for investing in their infrastructure ….").

IV. NGFA's and ARC's Specific Proposals Are Inconsistent With Competitive Market Principles.

The specific proposals for special grain rate rules that NGFA and ARC put forward in their opening comments are plainly inconsistent with the statute. These proposals bear little or no relationship to competitive market principles. The Board's 3B test itself has only a tenuous connection to those principles. NGFA's proposal is a modification of the 3B test that would remove any such connection. ARC's proposals are even more arbitrary. NGFA and ARC portray their proposals as suggestions for simplifying rate regulation, but in reality, their proposals are designed simply to produce lower rates.

A. The Board should reject NGFA's proposal, which would force rates to the jurisdictional threshold and disregard market principles.

NGFA's proposal removes any arguable connection between the 3B test and competitive market principles. As described below, the proposal, which has as its centerpiece the inclusion of traffic with R/VC ratios below 180 percent in comparison groups, is a thinly disguised mechanism for reducing grain rates to levels at or near the jurisdictional threshold. This result is guaranteed because NGFA advocates an entirely mechanical process that would be unconstrained by any limits on relief.

Mr. Crowley's calculations confirm that rates would quickly drop to R/VC levels of 180 percent if the NGFA proposal were implemented. For example, the calculations show that if all UP's corn rates were challenged simultaneously, UP's 2012 revenues for corn would be reduced by ${ }.[11] That is equivalent to capping UP's R/VC ratios for corn at 184 percent.[12] If

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[11] *See* NGFA Comments, Crowley VS, Ex. 7. Material in brackets has been redacted from the public version of this filing.

UP has not audited Mr. Crowley's calculations. There are some apparent inconsistencies between his description of his method for selecting comparison traffic and the examples provided in his Exhibit 6. Specifically, his sample comparison groups include traffic that moves (continued…)

rates with higher R/VC ratios were challenged first, UP would end up with all of its grain rates at R/VC levels of 180 percent through a quick ratcheting process. Moreover, all grain and grain products shippers presumably would invoke this entirely mechanical process to reduce future rates (and obtain reparations, for those shippers that had paid the rates). Thus, if the Board adopts NGFA's proposal, railroads would become automated teller machines, required to refund what Mr. Crowley calculates as 8 to 18 percent of agricultural products revenue and to maintain rates at the jurisdictional threshold.

The specific changes NGFA would make to the 3B test to obtain this result are objectionable for numerous reasons, summarized briefly below.

1. NGFA's inclusion of traffic with R/VC ratios below 180 percent in comparison groups is wholly inappropriate.

NGFA's proposal to include traffic with R/VC ratios below 180 percent in comparison groups would play a central role in driving grain rates down to the jurisdictional threshold because so much grain traffic already moves at R/VC ratios below 180 percent.

NGFA argues that comparison groups must include movements with R/VC ratios below 180 percent to "provide a sufficient representation of the market rail rates for the commodity in question." NGFA Comments at 29. However, NGFA ignores a fundamental point: traffic with similar operating characteristics often moves in very different market conditions. The only reason a comparison group approach has any connection to demand-based differential pricing

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more than 20% over or under the distance that the issue traffic moves. In addition, his calculation of UP's wheat-specific revenue adequacy adjustment factor in Exhibit 5 relies on an incorrect figure for UP's revenues from wheat traffic with R/VC ratios above 180%.

[12] *See* NGFA Comments, Crowley VS, Ex. 3. This figure can be calculated by taking UP's total revenue for corn waybills with R/VC ratios greater than or equal to 180%, subtracting the revenue reduction from Exhibit 7, and then dividing by UP's total variable cost from corn waybills with R/VC ratios greater than or equal to 180%, *i.e.*, {

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principles is that R/VC ratios for the issue traffic, over which railroads may have market dominance, are being compared with R/VC ratios for traffic moving under similar demand conditions (under rates that are constrained by SAC or SSAC).[13] The comparison makes no sense when the comparison group includes traffic that is presumed competitive (because the R/VC ratio is less than 180 percent) and that presumably has a higher elasticity of demand. By assuming away differences in market conditions, NGFA would eliminate the tenuous connection that exists between the comparison group approach used in the 3B test and competitive market principles. That is, NGFA would have the Board abandon competitive market principles for a simple rule that results in all grain traffic with similar operating characteristics moving at the same R/VC ratio.

The Board has previously addressed this issue, and it has correctly recognized that traffic with R/VC ratios below 180 percent must be excluded from comparison groups if a comparison method is to serve its purpose: to identify the degree of permissible demand-based differential pricing. As the Board explained in *Simplified Standards*:

> The purpose of [a comparison group approach] is to use the R/VC ratios of other 'potentially captive traffic' (i.e., traffic priced above the 180% R/VC level) as evidence of the reasonable R/VC levels for traffic of that sort. As such, the comparison group should consist of only captive traffic over which the carrier has market power. The rates available to traffic with competitive alternatives would provide little evidence of the degree of permissible demand-based differential pricing ....

[13] *See Simplified Standards*, slip op. at 73 ("A comparison approach can be instructive as to the reasonable level of contribution to fixed costs (the R/VC ratio) for a particular captive movement when a second, cost-based approach is also employed to constrain rates. We can assume that, in setting rail rates on captive traffic, a carrier will not exceed substantially the level permitted by the SAC constraint.").

Simplified Standards, at 17; *see also 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").

In short, NGFA is proposing that the Board set rates for traffic over which railroads have market dominance based on rates for traffic that does not face similar demand conditions. Thus, the proposal is inconsistent with demand-based, competitive market principles.

2. NGFA's inclusion of non-defendant railroads' traffic in comparison groups makes no sense.

NGFA also argues that comparison groups should include traffic of non-defendant railroads, and should even allow the mixing of data from Class I and non-Class I railroads. The Board has previously rejected the use of non-defendant railroads' traffic in a comparison group, again with good reason.

Whether a defendant's rate for a particular movement is reasonable depends not only on the movement's characteristics, but also on the characteristics of the defendant railroad, and in particular, its revenue needs and mix of traffic. If the defendant has to cover high fixed and common costs, it must be allowed to charge higher rates for the same traffic than the rates of a railroad with lower fixed and common costs; if the defendant has fewer high-demand shippers, it must be allowed to charge those few shippers higher rates for the same traffic than a railroad that is able to spread its fixed costs among a larger group of high-demand shippers.

In *Simplified Standards*, the Board agreed that non-defendant traffic must be excluded from comparison groups because "R/VC ratios of one carrier cannot fairly be compared with the R/VC ratios charged by another railroad." *Simplified Standards* at 82. It recognized that "[t]he reasonable level of contribution to joint and common costs (reflected by the R/VC ratio) is first and foremost a function of the amount of joint and common costs that need to be recovered," and "[t]his will vary between carriers, creating inevitable and proper differences in R/VC ratios." *Id.*

Mr. Crowley takes issue with this rationale. He says his analysis shows that different Class I railroads have ratios of fixed costs to total costs that are "fairly consistent." NGFA Comments, Crowley VS at 8. However, he does not deny that there are differences among these ratios. And he fails to consider how relatively small differences in ratios become significant absolute differences in the actual fixed costs that railroads must recover through differential pricing. Even if the proportion of fixed and common costs relative to variable costs is roughly the same among Class I carriers according to URCS, that says nothing about the respective unit costs of the railroads, which can still be very different. And it is the unit costs, applied to the movement characteristics, that produce the denominator for R/VC ratios.

The Board further recognized in *Simplified Standards* that the R/VC ratios of one carrier cannot fairly be compared with R/VC ratios of another railroad because "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." *Simplified Standards* at 82.[14]

Mr. Crowley's response to this second rationale is an effort at misdirection: he says that traffic mix does not affect a railroad's pricing of individual movements; rather, railroads set rates based on competitive forces and operating constraints. *See* NGFA Comments, Crowley VS at 8-

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[14] Along the same lines, using traffic from non-defendant railroads would produce absurd results in connection with adjustments to the R/VC ratios of comparison group traffic that are designed to account for revenue adequacy. That is, it makes no sense to reduce Railroad A's rates because Railroad B is revenue adequate. Indeed, it would impair Railroad A's ability to attain revenue adequacy. Similarly, it makes no sense to allow Railroad B to charge higher rates because Railroad A is not revenue adequate.

9. However, the relevant issue is not how railroads set their rates, but whether those rates are reasonable. And whether rates are reasonable depends in large part on the traffic available to cover the railroad's joint and common costs.[15]

There are likely to be even greater differences between appropriate R/VC ratios for movements of Class I carriers and movements of Class II and Class III carriers. NGFA and Mr. Crowley include movements on these smaller carriers in the comparison groups they would use to evaluate the rates of Class I railroads. *See* NGFA Comments, Crowley VS, Ex. 6. But there is no indication that Mr. Crowley ever examined the ratio of fixed costs to total costs of the smaller railroads to determine whether these ratios were similar to those of Class I railroads. And the traffic mix of any smaller railroad would undoubtedly be far different from that of a Class I railroad.

There are also important practical objections to the use of non-defendant movements in comparison groups. First, railroads would be less able to avoid litigation by establishing rates they know in advance will be found reasonable. A railroad would have no way of knowing in advance the level at which its rates would be deemed unreasonable because it would not have access to all other railroads' data. There are also fairness and due process issues. If movements of non-defendant railroads were included in the comparison group, the defendant railroad's in-house personnel presumably could never see the key data used to evaluate the defendant's rates.

3. NGFA's new Revenue Adequacy Adjustment Factor ("RAAF") is inappropriate, unnecessary, and improperly based on a single year.

NGFA proposes that the 3B methodology be modified to include application of a new factor that allegedly would account for a railroad's revenue adequacy status on a commodity-

[15] As the Board is well aware, a railroad's mix of non-issue traffic, and the relative contribution that traffic makes to joint and common costs, is often the critical factor in SAC cases.

specific basis. *See* NGFA Comments at 31-32 & Crowley VS at 9-13. The concept of commodity-specific revenue adequacy is wholly inconsistent with the network nature of the railroad industry, in which assets are shared by a range of traffic and joint and common costs must be recovered using demand-based differential pricing. This aspect of NGFA's proposal appears to be just a backdoor ploy to introduce an inappropriately abbreviated one-year snapshot for judging revenue adequacy, rather than the four-year average the Board uses in the 3B test.

The 3B methodology already includes an element designed to reflect revenue adequacy – the adjustment by the ratio of RSAM ÷ $R/VC_{>180}$ that is applied to the R/VC ratios of traffic in the comparison group. As the Board has explained, the adjustment is designed to "reduce R/VC ratios of the comparison group where the carrier is earning greater than adequate revenues from its captive traffic." *Waybill Data Released in Three-Benchmark Rail Rate Proceedings*, EP 646 (Sub-No. 3), slip op. at 6 n.14 (STB served Mar. 12, 2012) ("*Waybill Data*").[16]

NGFA's attempt to justify a commodity-specific revenue adequacy adjustment falls flat. Mr. Crowley says the RAAF appropriately takes into consideration the amount of commodity traffic "ostensibly captive" to the railroad and "allocates the burden of helping achieve revenue adequacy to those commodities that provide the most revenue." NGFA Comments, Crowley VS at 12. The RAAF reflects the percentage by which *total* commodity-specific revenue must fall to eliminate a portion of a carrier's "tax-adjusted surplus" that is calculated as if the total surplus

[16] USDA is therefore incorrect when it states that the 3B test does not attempt to account for revenue adequacy. *See* USDA Comments at 5.

The Board's current revenue adequacy adjustment is problematic because the Board calculates RSAM using a railroad's depreciated historical book values of assets, rather than replacement costs, to determine the railroad's required return on investment. However, NGFA's proposed RAAF shares the same flaw. Moreover, under NGFA's proposal this flaw would be magnified because, as discussed below, NGFA proposes to remove all limits on relief for the proposed methodology, which means that even more rates would be affected by this flawed adjustment.

were assigned to commodities based on the share of each commodity's traffic moving at R/VC ratios above 180 percent.[17] But Mr. Crowley does not explain why it makes any sense to calculate a commodity-specific "share" of any surplus, given the network nature of the railroad industry and the existence of high joint and common costs. Nor does Mr. Crowley explain why traffic moving at R/VC ratios below 180 percent should play any role in the allocation of a "share" of surplus that was assigned to specific commodities in the first place based on the commodities' share of traffic with R/VC ratios above 180 percent.

NGFA's proposed commodity-specific adjustment, with its long formula, appears designed to help distract from NGFA's primary objective: basing the revenue adequacy adjustment on one year of revenue adequacy data. However, the Board recognized in *Simplified Standards* that it would be wrong to rely on revenue adequacy calculations from a single year in the 3B test's revenue adequacy adjustment. *See Simplified Standards* at 20. A one-year snapshot is unlikely to reflect the variation in market conditions that are relevant to the long-run revenue needs of a railroad. Even the four-year period over which the revenue adequacy adjustment is calculated under the 3B test can result in a misleading view of a railroad's progress towards achieving revenue adequacy – four years is less than a full business cycle and much less than the average life of the assets on which railroads must earn a return.

In addition, use of a single year of data for any revenue adequacy adjustment could easily be exploited by grain shippers. They would avoid challenging rates in lean years, waiting until the railroad has a strong year to reach back for damages and establish prescribed rates for the

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[17] Mr. Crowley calculates a carrier's "tax-adjusted surplus" in the same way the Board calculates a carrier's surplus (or shortage) as part of its Revenue Shortfall Allocation Method ("RSAM").

future. Rate prescriptions obtained based on a strong year would remain in place if the lean years returned, leaving railroads holding the bag.

Notably, in *Waybill Data* shippers generally supported use of four years of railroad rate data in 3B cases on the ground that it would smooth out short term variations in prices and costs that make up the data. *Waybill Data* at 4. The Board agreed. It said the purpose of the 3B test "*is not to reflect a snapshot* of current market conditions; it is to use the three benchmarks to decide the reasonable maximum contribution to joint and common costs for the issue movement where no cost-based approach is feasible." *Id.* at 7 (emphasis added). For the same reason, NGFA's proposal to use a single year of data for a revenue adequacy adjustment should be rejected here.

4. NGFA's mechanical selection process for comparison groups is inappropriate.

NGFA proposes using a limited number of mechanical criteria for the selection of movements for the comparison group, with no further consideration of whether the movements are actually comparable. *See* NGFA Comments, Crowley VS at 6-7. UP believes use of a mechanical selection process would be inappropriate. For an R/VC comparison test to work as intended, parties must submit comparison traffic with market and cost characteristics as similar to the issue traffic as possible. The 3B test's current "baseball arbitration" process strikes a reasonable balance between speed and accuracy by simplifying the Board's selection process while recognizing that the relevant criteria might change depending on the specific characteristics of issue traffic.

UP also disagrees with the criteria proposed by NGFA for identifying comparable traffic. In particular, Mr. Crowley combines single-line and interline movements in comparison groups used to test single-line rates. Even apart from the problems associated with using movements that occur in part on non-defendant carriers, it is inappropriate to use interline movements, which, all other factors being equal, have higher costs than single-line movements, and thus lower R/VC ratios, to reduce the average R/VC ratios for comparison groups used to test single-line rates. *Cf. US Magnesium, L.L.C. v. Union Pacific R.R.*, NOR 42114, slip op. at 8-9 (STB served Jan. 28, 2010) (selecting comparison groups that included movements of different commodities rather than comparison groups that included single-line and interline traffic), *aff'd sub nom. Union Pacific R.R. v. STB*, 628 F.3d 597 (D.C. Cir. 2010).

In addition, UP disagrees with NGFA's proposal to consider a movement comparable "if its total distance is within plus or minus 20 percent of the issue movement's standard routing." NGFA Comments, Crowley VS at 6. Mr. Crowley provides no support for this proposal. UP believes that the 20-percent figure would capture too much dissimilar traffic when evaluating relatively long movements and might ignore too much similar traffic when evaluating shorter issue movements.[18] Moreover, UP believes flexibility is important: it may be possible to use a narrower range when there is a great deal of potentially comparable traffic, and it may be appropriate to use a broader range when there is little potentially comparable traffic.[19]

Finally, UP believes comparable movements should not include movements of the issue traffic. *See US Magnesium* at 7. NGFA does not address this point directly, but it appears that movements of the issue traffic might be included in the sample comparison groups presented in Mr. Crowley's Exhibit 6.

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[18] For example, using a 20% plus or minus bracket (as Mr. Crowley proposes) would yield a range of 600 miles for a 1500-mile movement, but a range of just 200 miles for a 500-mile movement.

[19] In addition, a narrower range is preferable, when possible, to avoid the "feedback effect" the Board has described. *See Simplified Standards* at 73.

5. NGFA's Elimination of a confidence interval is improper.

NGFA argues that maximum rates for grain should not be set at the upper end of a confidence interval surrounding the mean R/VC ratio for the comparison group because this might result in a rate prescription that is too high. *See* NGFA Comments, Crowley VS at 14. The Board included a confidence interval as part of its 3B test for an important reason: because of the imprecision that results from estimates based on a sample of waybills, there is a substantial possibility that the point estimate of the R/VC mean in fact will be lower than the mean for the entire population of waybills. *See Simplified Standards* at 21-22 & 21 n.30. Adding this risk of sampling error to the inherent imprecision of a crude comparison group approach, there is a significant prospect that the point estimate will be too low, and that a rate will incorrectly be presumed to be unlawful. In these circumstances, railroads should get the benefit of the doubt. Otherwise, there is too great a risk that railroads will be deprived of revenue needed for investment due to an incorrect R/VC estimate.

NGFA's further argument that elimination of the confidence interval would simplify the process is frivolous. *See* NGFA Comments at 30. Development of a confidence interval and the upper bound of that interval involves a mechanical calculation, no more difficult to apply than NGFA's proposed RAAF. Again, NGFA's argument is a thinly veiled attempt to achieve lower rates, not a good faith effort to simplify the process of determining a reasonable rate.

6. Consideration of "other relevant factors" should not be eliminated.

Under the 3B test, the Board may consider "other relevant factors" to demonstrate that the maximum lawful rate should be higher or lower than the rate produced from the benchmark calculations. NGFA would eliminate any consideration of "other relevant factors" from the analysis under its proposed grain rate rules. *See* NGFA Comments at 31 & Crowley VS at 15. NGFA contends that eliminating consideration of "other relevant factors" would help streamline cases, but the Board has already streamlined the process by requiring parties "to quantify the impact of these 'other relevant factors' on the presumed maximum lawful rate." *Simplified Standards* at 22. Moreover, the Board prohibits parties from submitting evidence of product and geographic competition or movement-specific adjustments to URCS. *See id.* The Board has also expressly "reserve[d] the right to prohibit other categories of evidence if experience demonstrates that the introduction of such evidence would or does unduly complicate this process." *Id.*

Leaving a door open to consideration of "other relevant factors" is critical to ensuring that a crude comparison group test does not overlook significant information. Indeed, the Board has already recognized one appropriate adjustment in 3B cases: an adjustment to account for the use of contract rates in comparison groups. *See US Magnesium* at 18-19. Eliminating consideration of "other relevant factors" could preclude the Board from making important refinements to what would otherwise be an almost entirely mechanical process. Consideration of such factors would be even more important, given NGFA's inclusion of other railroads' traffic in the comparison group.

7. A limit on relief would be essential for any special grain rule.

NGFA argues that there should be no limit on relief for the grain rate rules it proposes. *See* NGFA Comments at 31. This is clearly unacceptable. In view of the rough nature of the 3B test, the Board has imposed limits on the relief shippers may obtain when that test is applied. Because the 3B methodology employs departs significantly from the SAC methodology, the Board correctly concluded that it should be used only when relatively small amounts of revenue are at stake. NGFA's methodology is even further removed from the SAC test, and NGFA would apply it mechanically to reduce rates across a broad swath of rail traffic. If adopted by the Board without a limit on relief, the NGFA methodology would be available to all grain shippers, including high-volume agribusinesses and trading companies. The maximum revenue loss Mr. Crowley calculates would be virtually guaranteed to occur. In fact, the revenue loss would be even higher, because without any limit on the cases that could be brought, rates would quickly be ratcheted down to the jurisdictional threshold. This would not even require shippers to file an avalanche of cases, because, under NGFA's proposal, just a small number of interested parties could bring cases challenging all grain rates. Adoption of NGFA's proposal without limits on relief would mean railroads would end up writing a series of reparations checks to shippers who had paid the rates and reducing all grain rates to the 180 percent R/VC jurisdictional threshold.

B. The Board should reject ARC's proposals, which would artificially limit rates and discourage investment in rail capacity and better service.

ARC proposes several changes to the Board's rate rules for grain, but none has any merit. ARC's primary argument is that the Board should permit grain shippers to use a two-benchmark test, effectively capping rates at the RSAM level. *See* ARC Comments at 17-20 & Fauth VS at 26. Mr. Fauth acknowledges that this approach disregards the railroads' need for differential pricing to recover their joint and common costs. *See id.*, Fauth VS at 25. ARC's proposal is thus inconsistent with the competitive market principles embodied in the Board's governing statute and with basic railroad economics.[20]

[20] ARC complains that an R/VC comparison approach is "ineffective" for grain shippers because railroads often charge "similar rates to similarly situated shippers." ARC Comments at 23. But a railroad applying demand-based differential pricing principles should be charging similar rates to similarly situated shippers. The fact that a railroad does so indicates the railroad is basing rates on competitive market principles. In other words, the only reason ARC considers the R/VC approach "ineffective" is that shippers want to pay rates lower than those determined by competitive market principles.

Ironically, while ARC complains about rates that are similar, NGFA, as noted above, appears to be seeking equalization of rates. However, NGFA's proposed methodology would not achieve uniform rates. Both ARC and NGFA propose methodologies that instead would drive R/VC ratios down to the jurisdictional limit.

Moreover, ARC's view that RSAM establishes the rate a railroad needs to charge to be revenue adequate is simply wrong. The Board calculates RSAM using a railroad's depreciated historical book values of assets, rather than current costs, to determine the railroad's required return on investment. As UP will explain in more detail in Ex Parte No. 722, use of historical book value significantly understates its required return, and four years is too short a period to provide a reliable assessment of whether a railroad has achieved "revenue adequacy." Moreover, RSAM is essentially an average mark-up, not a maximum mark-up. To the extent a railroad has movements with R/VC above 180 percent but below its RSAM, it needs traffic with margins above the RSAM if it is to be revenue adequate.

Even if the Board's calculation of RSAM did reflect railroads' required return on investment, capping grain rates at that minimal level would drive investment away from grain traffic. Again, as UP will explain in Ex Parte No. 722, unless a railroad can charge rates that produce returns exceeding its cost of capital, it will never invest to expand capacity, because it has no possible up-side benefit and will suffer all the down-side consequences if the investment fails to pan out – that is, if the expected traffic levels fail to materialize. All companies need the potential to earn more than their cost of capital from their investments in order to spur them to undertake risky investments.

Mr. Fauth also refers to an "export grain rate adjustment." *See* ARC Comments, Fauth VS at 30-32. He appears to be suggesting that the Board interfere with the market to promote export over other uses of grain. This is both inappropriate and unwise. To the extent grain exports are artificially expanded, this will tend to increase the prices that domestic consumers (such as poultry farmers and flour mills) pay for grain. The Board should limit its actions to those consistent with its role assigned by Congress, not engage in policymaking to advance special interests.

In any event, Mr. Fauth's evidence regarding the connection between U.S. grain exports and grain prices appears to have nothing to do with railroad pricing and everything to do with U.S. and global markets for grain. Moreover, if Mr. Fauth believes that "when exports go up, crop prices go down, and farmers and producers get squeezed," *id.* at 32, it is not clear why he is advocating lower rail rates to promote exports. (In reality, it appears that Mr. Fauth may be confusing the causal relationship between U.S. grain prices and exports.)

ARC appears to ignore the impact that its proposals would have on rail investment. UP has spent billions of dollars to expand its capacity and improve its service in various respects in recent years, largely because it has been able to obtain revenue from rates subject to competitive market principles. It is remarkable that ARC and Mr. Fauth argue that rail rates are too high when they talk in the next breath about the need for additional investment by railroads to address capacity limitations. *See* ARC Comments at 24 & Fauth VS at 30. As UP will discuss at greater length in Ex Parte No. 722, artificial constraints on railroad earnings will lead to less investment, not more. As noted above (at page 22 note 10), in the hearing held in April in Ex Parte No. 724, grain shippers pressed for railroads to invest more in order to provide more capacity and better service. But the rate methodology ARC argues for in this proceeding will remove incentives for carriers to invest in their networks and improve service.

V. Any Modifications to the Board's Rate Rules Should Be Limited to Measures Consistent With Competitive Market Principles.

UP is willing to consider seriously proposals that would remove uncertainty and reduce the costs of litigating rate cases, so long as any new measures are consistent with Congress's mandate that rates be determined based on competitive market principles. As discussed above, the proposals put forward by NGFA and ARC are inconsistent with those principles and should be rejected. There nevertheless may be steps the Board could explore consistent with the statute.

If the Board concludes that it would be useful, it could clarify that a party need not sustain damages to file a rate complaint, so long as the party would otherwise have standing (which requires a fact-specific determination). If it does provide such clarification, the Board should also clarify that, if the party did not itself pay the rate (because, *e.g.*, a grain elevator owner, processor, or trading company paid the railroad), the party is not entitled to recover reparations.

The Board could also consider adopting rules that identify circumstances in which shippers could band together to bring a joint complaint. Such rules might allow shippers at the same origin point to pool their resources to cover litigation costs. However, the Board would need to place limits on how such cases could be litigated. For example, complainants would need to prove market dominance and the right to rate relief with respect to each individual movement. In addition, shippers could receive only one reparations recovery for particular traffic. *Cf.* 49 C.F.R. § 1133.2.

We believe it would be difficult to simplify the 3B methodology beyond its current form and still remain consistent with the statutory mandate for demand-based pricing.[21] However, if the Board pursues efforts at further simplification, the objective of such changes must not be to develop a rule that provides lower rates to grain shippers. There is no evidence that grain shippers are paying unreasonably high rates, and every reason to think rail rates for grain are

[21] In fact, one could fairly conclude that shipper complaints about the 3B test are not motivated by that test's complexity or cost – it is not especially complex or costly – but by the results it produces.

subject to effective competition. The objective must be a less costly rule that remains faithful to competitive market principles.

CONCLUSION

The Board should reject the special rate rules for grain proposed in the opening comments of NGFA and ARC, because there has been no showing that rail rates for grain transportation are unreasonable and because the NGFA and ARC proposals are inconsistent with the statute. If the Board considers any steps beyond clarifying who has standing to seek rate prescriptions only and who can recover reparations, then any new measures must be consistent with Congress's mandate to base rate regulation on competitive market principles.

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August 25, 2014

VERIFICATION

I, Jason M. Hess, Vice President and General Manager – Agricultural Products for Union Pacific Railroad Company ("UP"), declare under penalty of perjury that I have read the foregoing Reply Comments of Union Pacific Railroad Company and that the facts and information regarding UP's agricultural products business that appear in Parts II and III of those comments are true and correct, to the best of my knowledge, information, and belief. Further, I certify that I am qualified and authorized to file this Verification.

Executed on August 25, 2014.

Jason M. Hess