

BEFORE THE
SURFACE TRANSPORTATION BOARD

233398

ENTERED

M & G POLYMERS USA, LLC

Complainant,

v.

CSX TRANSPORTATION, INC.

Defendant.

Office of Proceeding
November 28, 2012
Part of Public
Record

Docket No. NOR 42123

COMMENTS OF M&G POLYMERS USA, LLC

Jeffrey O. Moreno
David E. Benz
Thompson Hine LLP
Suite 700
1919 M Street N.W.
Washington, D.C. 20036
Phone: (202) 331-8800
Fax: (202) 331-8330

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- The Board should use the R/VC_{>180} benchmark in lieu of the RSAM.

These Comments are supported by the Verified Statement of Thomas D. Crowley, President of L. E. Peabody & Associates, Inc. (“Crowley V.S.”).

I. **BACKGROUND AND OVERVIEW OF THE REFINED APPROACH.**

The Board adopted the refined approach because it perceived a need for an objective approach to determine whether alternative transportation options may be effective competitive constraints upon the challenged rates. The Board found this determination to be particularly challenging for issue movements where there were physically viable alternatives with rates that were similar to or below the challenged rail rates. Although the parties had presented extensive evidence and argument based upon traditional market dominance factors, the Board chose to rely primarily upon the refined approach.

The Board has long held that there is an absence of effective competition when the prices charged by alternative transportation providers are significantly higher than the challenged rates.¹ In fact, the Board previously has held that a 10% rate disparity after a substantial rate increase was sufficient to demonstrate the lack of effective competition. E.I. du Pont de Nemours and Company v. CSX Transp., Inc., STB Docket No. 42099, slip op. at 7 (served June 30, 2008) (“DuPont 42099”). Because, for 21 of the 43 issue movements where CSXT contested market dominance, the alternative rates presented by CSXT were at least 10% higher than the challenged rates even *after* CSXT had imposed double and triple digit rate increases, M&G argued that the Board had sufficient evidence, in accord with its precedent, to conclude that those

¹ See FMC Wyoming Corp. v. Union Pac. R.R., 4 S.T.B. 699, 719 (2000) (“Given the substantial rate disparity between the two modes, we are satisfied that trucking is not an effective alternative for those shipments that can be received by rail.”) (“FMC”); Ariz. Pub. Serv. Co. v. U.S., 742 F.2d 644, 650-51 (D.C. Cir. 1984) (holding that, because of the significant rate difference, complainant’s receipt of oil by both trucks and rail did not make trucks an effective competitive alternative) (“APS”); Atchison, Topeka & Santa Fe Ry. v. ICC, 580 F.2d 623, 636 (D.C. Cir. 1978) (“Shippers must be able to make the choice to use an alternative service without absorbing substantial economic loss.”).

alternatives were not effective competitive constraints. See Reb. Ev. at II-B-8. For those 21 movements, M&G does not believe the refined approach is necessary because the Board already has an easy-to-apply objective standard to determine the absence of effective competition. The Board, however, did not address M&G's argument. Nevertheless, the refined approach properly produced the same results for 19 of those 21 lanes.²

In this proceeding, there also are 22 contested issue movements that have transportation alternatives with rates that are similar to, or in some cases below, the challenged rates, for which the refined approach provides a valuable tool to objectively determine the absence of effective competition. While CSXT argued that the similarity of rates alone established the presence of effective competition, the Board correctly rejected CSXT's position, because a monopolist could raise its rates to the point where they would be constrained by a "patently ridiculous" higher cost alternative. Decision at 3, 12-13. However, the Board was not satisfied with M&G's evidence that, because the alternative transportation options available to it had much higher variable costs than CSXT, they could not be effective constraints. Decision at 13. The Board, therefore, proposed the refined approach as an objective means by which to determine if similar or lower-priced alternatives are effective competitive constraints.

Although M&G also had presented the Board with significant other evidence that the 22 issue movements with similar or lower priced transportation alternatives were not effective constraints, the Board either ignored or overlooked that evidence. Specifically, M&G presented evidence that trucks had a very small market share and that CSXT had successfully imposed double and triple digit rate increases over a brief, 2-year, period without losing any of the issue movements to lower-priced alternatives. Indeed, prior to CSXT's substantial rate increases, the

² The two exceptions are Lanes B-5 and B-50, which M&G believes is material error for the reasons stated above and in M&G's Petition for Reconsideration, filed October 17, 2012.

alternative transportation prices would have been substantially *higher* than the challenged rail rates, and are now lower only because CSXT priced up to these higher cost alternatives. These facts, M&G argued, were more than sufficient to demonstrate a lack of effective competition under a traditional market dominance analysis.³ See Op. Ev. at II-B-4, 20-21, 53, Op. Exs. II-B-4, 5, 6, 22; Reb. Ev. at II-B-14-15, 39-44; Reb. Ex. II-B-12. The Board did not mention this evidence or argument even though it would have supported the same conclusions as the refined approach.⁴

The Board instead developed the refined approach to serve as an objective means to reach a preliminary, but rebuttable, conclusion as to whether alternative transportation options are effective competitive constraints. The Board noted that the increasing use of regulatory remedies by non-coal shippers for dozens, if not hundreds, of lanes has complicated the market dominance inquiry and threatens to dwarf the SAC analysis in complexity. Decision at 3. The Board cited to this proceeding as a case in point, which required more time after the close of the record to decide market dominance than the 9 months that the statute provides for final decisions on rate reasonableness. Therefore, the Board offered the refined approach as a solution.

The refined approach first requires a party to determine the “Limit Price” of the alternative transportation. For single line movements, the Limit Price is the lowest rate available using alternative transportation. For joint line movements, the Limit Price also will be the lowest

³ See e.g., FMC, 4 STB at 718 (“the fact that [carrier] matches prices set by alternatives with significantly higher costs, while maintaining a dominant market share, is not enough to demonstrate effective competition”); Special Procedures, 353 ICC 875, 929 (1976). (“the absence of any diversion after a reasonable time following a rate increase” is strong evidence of market dominance); CF Industries, Inc. v. STB, 255, F.3d 816, 823-24 (D.C. Cir. 2001) (a rate increase of 20% has been considered “well above the standard usually employed to signal a substantial degree of market power”), and 826 (a price difference of just 5% or 10% is too significant to be an effective constraint).

⁴ Although the Board considered some of M&G’s market share evidence in the context of determining the practical feasibility of trucking, it made no mention of that evidence, or the rate history evidence, in its economic feasibility analysis.

alternative rate, if the alternative route is between the same end points as the issue movement; otherwise, if the alternative rate is for transportation that originates or terminates at a different point, the Board has proposed a formula to back out the price attributable just to the portion of the alternative that is parallel or otherwise comparable to the issue movement.⁵ Although not an issue in this proceeding, the Limit Price will need to reflect the cost of capital investments and extra operating expenses that a shipper or receiver may need to incur in order to make use of the alternative transportation.⁶ This requirement may complicate the ease and simplicity of the refined approach in future cases.

Second, the refined approach calculates a Limit Price Revenue to Variable Cost (“LP R/VC”) ratio. The LP R/VC ratio is the R/VC ratio that CSXT would earn on the issue movements if it matched the price of the alternative transportation.

Third, the Board compares the LP R/VC ratio to the most recent 4-year average RSAM ratio for the defendant, which in this case was 293% for CSXT. Decision at 14. This RSAM ratio measures the average R/VC ratio that CSXT would need to earn on all of its potentially captive (*i.e.*, above 180% R/VC) traffic to be considered “revenue adequate,” as defined by the Board. If the LP R/VC ratio is greater than the RSAM ratio, the Board preliminarily concludes that the alternative is not an effective constraint. If the LP R/VC ratio is less than the RSAM ratio, the Board preliminarily concludes that the alternative is an effective constraint.

⁵ The need to calculate a Limit Price for a joint movement that originates or terminates at a different point from the issue movement may be moot in future cases. In this case, the Board granted CSXT’s Motion to Strike M&G’s evidence and argument that alternative transportation options lawfully can only be between the same origin and destination as the issue movement. Decision at 9-10. Therefore, the Board did not address M&G’s argument. In future cases, the Board will need to address this issue. Unless the Board reverses its precedent in future cases, it will not consider alternatives that do not originate and terminate at the same points as the issue movements.

⁶ M&G presented evidence of additional infrastructure and operating costs that would be required to substantially increase the use of trucks from its Apple Grove, WV facility. Because the refined approach concluded that so few issue movements from Apple Grove had effective alternative transportation options even when considering just the alternative rate, the Board found it unnecessary to address M&G’s evidence. Decision at 36-37.

Fourth, and last, either party may attempt to rebut the preliminary conclusions rendered by the foregoing analysis with evidence of “intangible” features, such as unquantifiable benefits or costs associated with the alternative transportation or rail transportation. Decision at 14. The greater the difference between the LP R/VC and the RSAM, in either direction, the greater the Board would require the evidence of intangible features to be in order to overcome the preliminary conclusion.

The refined approach is applied only *after* an alternative transportation option is determined to be practically feasible. Decision at 12. The Decision distinguishes between practical and economic feasibility. *Id.* at 3, n. 5. The refined approach is used only to assist with the latter determination. All of the factors that are relevant to a traditional market dominance analysis will continue to be considered in the practical feasibility determination. Moreover, those factors also would be relevant to the consideration of intangible features that could be presented to rebut the preliminary conclusions of the refined approach as to economic feasibility.⁷ Therefore, the refined approach is most accurately viewed as a supplement to, not a replacement for, a traditional market dominance analysis.

II. THE REFINED APPROACH IS SUBSTANTIVELY SOUND FOR EVALUATING THE ABSENCE OF EFFECTIVE COMPETITION, THOUGH IT SHOULD BE MODIFIED. THE REFINED APPROACH SHOULD NOT BE USED FOR EVALUATING THE EXISTENCE OF EFFECTIVE COMPETITION.

The Board’s adoption of the refined approach is reasonable, but only as an indicator that a transportation alternative is *not* an effective constraint. Although it is appropriate for the Board

⁷ Although this is implied by the Decision, the Board’s choice of the term “intangible” leaves room for doubt. “Intangible” means “not definite or clear to the mind; vague; elusive.” Random House Webster’s College Dictionary (1991). In contrast, the Decision describes “intangible features” as “unquantifiable benefits” or “unquantifiable costs.” Decision at 14. Such benefits or costs are not indefinite, unclear, vague or elusive; they simply are not easily quantified. Indeed, M&G has discussed such “intangible features” with great specificity in its evidence (*e.g.*, industry dependence upon rail cars for storage, product integrity). Therefore, M&G urges the Board to clearly define “intangible features” by reference to the types of traditional qualitative market dominance evidence that the Board has considered in the past to evaluate the existence or absence of effective competition.

to conclude that an alternative transportation option is *not* an effective competitive constraint if the LP R/VC ratio is above the RSAM ratio, the opposite conclusion is unlawful and unsupported, and thus would be arbitrary and capricious. If the LP R/VC ratio is below the RSAM ratio, the Board should conduct its traditional qualitative market dominance assessment, rather than presume that there is effective competition. M&G also contends that, for determining the absence of effective competition, the R/VC _{>180} ratio is superior to the RSAM ratio in the refined approach where the defendant railroad is revenue inadequate.

In short, in this case, M&G believes that the Board has properly used the refined approach as a starting point to determine the *absence* of effective competition. However, M&G believes that the Board has not lawfully used, and should not use, the refined approach to determine the *existence* of effective competition. Furthermore, greater reference to additional supporting factors in the Decision would demonstrate that the refined approach rests upon solid ground when used to determine the absence of effective competition.

A. The Refined Approach Should Be Used Only To Determine The *Absence* Of Effective Competition.

The logic underlying the refined approach strongly supports a conclusion that alternative transportation options are *not* effective competitive constraints when the LP R/VC ratio exceeds the RSAM ratio. In contrast, the logic does not support a conclusion that effective competition exists when the LP R/VC ratio is less than the RSAM ratio. Therefore, the Board should apply the refined approach only to determine the *absence* of effective competition.

The refined approach is predicated upon the following logic:

1. The Limit Price is the point up to which the railroad will retain the issue traffic, based on a presumption that the traffic is demand elastic and a shipper would switch to the alternative provider based solely on the relative rate levels.
2. If the Limit Price R/VC is greater than the RSAM ratio, the Board presumes the railroad is exercising market dominance at that price because the Limit Price would

be above the rate level that the railroad would need to impose on captive shippers in order to achieve revenue adequacy.

3. If the Limit Price R/VC is less than the RSAM ratio, the Board presumes the railroad is not exercising market dominance at the Limit Price because it would be below the rate level that the railroad would need to impose on captive shippers in order to achieve revenue adequacy.

As discussed in more detail below, although Point #1 is subject to significant exceptions, M&G believes that is accounted for by the opportunity to present evidence of intangible factors. Point #2 makes economic sense because RSAM (or more accurately $R/VC_{>180}$) represents the theoretical tipping point where market power is exerted to the extent that it is reasonable to presume that an alternative transportation option is not an effective constraint. In contrast to Point #2, because the logic underlying Point #3 is fundamentally flawed, that presumption should be discarded as unlawful, arbitrary and capricious.

As to Point #1, a railroad may still retain traffic even when rail rates exceed the Limit Price if rail offers inherent advantages over trucks. For example, M&G presented evidence that both it and the entire polymer industry are intrinsically tied to rail transportation, such that lower-priced truck transportation is used primarily to serve customers only at close distances, for small volume shipments, and in emergencies (even higher-priced trucks would be used in emergencies). Reb. Ev. at II-B-67-70. As a result, rail rates above the Limit Price may not cause a traffic shift to alternative transportation, unless these conditions exist. M&G believes that the Board intended to account for such factors through its consideration of intangible features.⁸ Decision at 14. However, as discussed in M&G's Petition for Reconsideration of the Decision, the Board committed material error in this case by not considering the relative *advantages* of rail transportation for lanes where the LP R/VC ratio was below the RSAM ratio.

⁸ See note 7, above.

M&G believes that there is a sound economic basis for Point #2, that an LP R/VC ratio above the RSAM ratio strongly indicates the absence of effective competition. See Crowley V.S. at 9-12 (showing that the refined approach has economic support in the Lerner Index). The RSAM ratio represents the average R/VC ratio that a railroad must charge its potentially captive traffic to achieve revenue adequacy (as defined by the STB). A railroad clearly possesses market dominance over a movement with no competitive alternatives priced below that level. Id. at 5-8 (RSAM is a conservatively high threshold above which market dominance clearly is being exerted). It would be illogical to conclude that alternative transportation rates above what a railroad would need to charge its captive traffic to achieve revenue adequacy are effective competitive constraints. Therefore, it is eminently reasonable to presume that an alternative transportation option is not an effective constraint if its LP R/VC ratio is above the RSAM ratio. Indeed, the RSAM ratio is a conservatively high threshold, because a higher LP R/VC ratio would mean that the railroad is pricing above what it needs to achieve revenue adequacy from its captive traffic. Id. at 7 (concluding that $R/VC_{>180}$ is superior to RSAM). Furthermore, it is reasonable to find that this already quite strong preliminary conclusion of no effective competition grows even stronger as the difference between the RSAM and the LP R/VC increases.⁹

In contrast, the foregoing logic fails in the opposite situation covered by Point #3. Although the RSAM ratio is a useful threshold for demonstrating an absence of effective competition when the LP R/VC ratio is greater, its utility is based upon the fact that it is such a high number. In other words, a Limit Price that permits a railroad to charge in excess of what it needs to recover from its captive traffic to achieve revenue adequacy is a very strong, if not

⁹ Indeed, Mr. Crowley concludes that the RSAM is such a conservatively high figure that the Board could justify a non-rebuttable presumption of no effective competition when the LP R/VC ratio exceeds the RSAM. Id. at 7-8.

definitive, indicator that it is not an effective competitive constraint. Since the RSAM ratio is such a high benchmark, there necessarily will be significant amounts of captive traffic with alternative LP R/VC ratios below the RSAM ratio that are not effectively constrained by the alternative transportation rates. Thus, it is not rational to conclude that an LP R/VC ratio below the RSAM ratio indicates the existence of effective competition.

Furthermore, because the RSAM ratio is the average R/VC ratio that the railroad would need to charge its potentially captive traffic to achieve revenue adequacy, by definition there still is a substantial amount of captive traffic that is priced below the RSAM level. See, Crowley V.S. at 8-9. The Board itself notes this fact in the Decision, at 15, when it quotes from the D.C. Circuit's decision in BNSF Ry v. STB, 453 F.3d 473, 481 (D.C. Cir. 2006), in which the Court observed that "because the average derived by the RSAM is the average for captive shippers only...the ratios for some captive shippers must be above and some below that figure." The Court explicitly noted that "even a shipper with inelastic demand may be charged less than the average derived by the RSAM," and that this would "inevitably" occur because the average derived by the RSAM is based upon evaluation of captive shippers only, which means that some captive shippers must have rates below the RSAM level. Id. Therefore, because the RSAM ratio represents an average R/VC based upon theoretical contribution levels from all captive shippers, it would be inaccurate and arbitrary to presume the *existence* of effective competition, even preliminarily, merely based upon an LP R/VC ratio that is below the RSAM ratio.

The foregoing is illustrated by the 4-year average R/VC_{>180} ratio, which is below the RSAM ratio for every railroad except NS, because NS has been determined to be revenue adequate based on the STB's revenue adequacy standard over most of the four-year period covered by the average ratios. See Simplified Standards for Rail Rate Cases—2010 RSAM and

R/VC_{>180} Calculations, Ex Parte No. 689 (Sub. No. 3) (served Feb. 27, 2012). Whereas the RSAM ratio reflects what a railroad would need to earn on average from its potentially captive traffic to achieve revenue adequacy as defined by the STB, the R/VC_{>180} ratio reflects what a railroad actually is earning on average from its potentially captive traffic (an amount that apparently is satisfactory to the railroads' shareholders). Because all but one railroad has a four year average R/VC_{>180} ratio that is below its RSAM ratio, there clearly is a substantial amount of captive traffic moving below the RSAM ratio. See Crowley V.S. at 7 (An RSAM greater than R/VC_{>180} indicates a railroad would lose business if it charged rates at the RSAM level.). Thus, an LP R/VC ratio *below* the RSAM ratio does not indicate the existence of effective competition.

A fundamental flaw in the Board's reasoning for using the RSAM ratio to presume the *existence* of effective competition is graphically demonstrated by the very precedent upon which the Board relies. In note 42 on page 15 of the Decision, the Board quotes a sentence fragment from page 81 of its September 5, 2007 decision in Simplified Standards for Rail Rate Cases, EP 646 (Sub-No. 1) ("Simplified Standards"), to suggest that a rate that falls below the RSAM is "being constrained by...market forces." But the Board was not referring to an "effective" competitive constraint. Indeed, that discussion was not in the context of market dominance at all, but rather for the purpose of determining a reasonable rate level under the Three-Benchmark rate reasonableness approach, *after* a separate market dominance determination already has been made. Moreover, the Board was talking about the "comparison rates" used to determine a maximum reasonable rate in the Three-Benchmark approach, which the Board itself has described as a "cruder methodology." Id., slip op. at 28. As the Board well knows, the RSAM ratio is used as the numerator in a fraction (R/VC_{>180} is the denominator) applied to adjust the average R/VC ratio of "comparable" potentially captive rail movements upward or downward

based upon the defendant carrier's revenue adequacy or inadequacy. Id., slip op at 20-21. The Board's out of context citation, to support a presumption of effective competition when the LP R/VC ratio is below the RSAM ratio, leads to the erroneous conclusion that any rail rate below the RSAM ratio must be reasonable, which clearly is not accurate.

Similarly, it would be unlawful as contrary to the Board's governing statute to apply the refined approach to presume the existence of effective competition based upon an LP R/VC ratio below the RSAM, because that effectively would replace the quantitative market dominance jurisdictional threshold of 180% R/VC with the RSAM ratio for many rail movements. Anytime that there is a transportation alternative with an LP R/VC ratio below the RSAM ratio, a railroad could confidently set rates at the RSAM ratio and be immunized from a regulatory challenge. This would be true even if the railroad would have to raise its rates by 20%, 50%, or even 100% or more to equal its RSAM ratio. In that situation, the Board's refined approach would *sub silentio* overturn the holding in DuPont 42099, slip op. at 7, that a 10% rate disparity after a substantial rate increase is sufficient to demonstrate the lack of effective competition. The practical effect would be to set a rail rate floor at the RSAM ratio whenever there is a transportation alternative with an LP R/VC ratio below the RSAM ratio. Thus, the jurisdictional threshold effectively would increase from 180% R/VC to the RSAM ratio, which is contrary to the statute. See 49 U.S.C. 10707(d)(1)(A).

The arbitrary and distorting effects of the downside presumption based on Point #3 above is perfectly illustrated by the facts in this case. The Board concluded that nine issue movements had effective competitive alternatives because the LP R/VC ratio was below CSXT's RSAM

ratio or CSXT had rebutted the presumption of market dominance.¹⁰ M&G's evidence, however, demonstrated that CSXT had imposed rate increases up to 271% over a 2 year period, including triple digit rate increases on 5 of those 9 movements, and substantial double digit increases on 3 of the other lanes.¹¹ See Op. Ex. II-B-22. Because the Limit Price still allowed those enormous rate increases, it defies credulity to hold that the Limit Price indicates that there is an effective competitive constraint. The fact that the Board nevertheless reached that conclusion based on Point #3 of the refined approach illustrates the substantial arbitrariness of the refined approach as a tool for concluding, even on a preliminary basis, that there is an effective competitive alternative when the LP R/VC ratio is below the RSAM ratio.¹²

The Board should not be concerned that the refined approach works only to determine that effective competition does not exist. The Board's previous use of rebuttable presumptions in the market dominance analysis also worked the same way. The "cost test," the "market share test," the "substantial investment test," and the "rate bureau test" all established rebuttable presumptions that market dominance existed, without any inverse presumption that market dominance did not exist on the other side of the threshold benchmark. See Market Dominance Determinations, 365 I.C.C. 118, 121-27 (1981).

The Board is improperly trying to use the RSAM ratio as a fulcrum to establish a presumption that effective competition exists above the ratio and is absent below the ratio. As demonstrated above, there can be no single point that serves both objectives, and the Board's attempt to shoehorn the RSAM ratio into that role is arbitrary. While the refined approach is

¹⁰ Those nine lanes are A-4; B-5, 6, 15, 20, 24, 35, 40 and 50. Although Lane A-4 had an LP R/VC ratio greater than the RSAM ratio, the Board irrationally concluded that CSXT had rebutted the presumption of market dominance, even though CSXT had increased its rate for this movement by a triple digit percentage.

¹¹ For one lane, which only had a one year rate history, there was a nearly 20% increase in just that one year.

¹² This would be true even if the Board were to substitute the $R/VC_{>180}$ ratio for the RSAM ratio, as M&G advocates in the next section of these comments.

suitable for presuming the *absence* of effective competition when the LP R/VC ratio exceeds the RSAM ratio, it is not suitable for presuming the *existence* of effective competition when the LP R/VC ratio is below the RSAM ratio. Therefore, the Board should abandon the latter presumption.

B. The Board Should Substitute $R/VC_{>180}$ For RSAM If The Defendant Is Not Revenue Adequate.

Although the RSAM ratio is a workable threshold for the refined approach when used to determine that effective competition does *not* exist, it is in fact exceedingly and unnecessarily high. The Board has not clearly explained why it chose the RSAM over other possible threshold measures. In particular, how does a measure related to a carrier's revenue adequacy indicate effective competition? A much more appropriate refined approach benchmark for CSXT, and any other revenue inadequate railroad, is the $R/VC_{>180}$ ratio.

The RSAM ratio is a technical benchmark that represents the average R/VC that must be earned from potentially captive traffic to achieve revenue adequacy, as determined by the Board. The RSAM ratio has nothing to do with actual railroad pricing of captive traffic. Nor does revenue adequacy have any role to play in the market dominance determination. Rather, the RSAM ratio is a workable threshold for the refined approach because it is a conservatively high figure above which it is appropriate to presume the *absence* of effective competition. As discussed in Part II.A., above, it would be arbitrary to presume that alternative transportation rates in the upper range of where a railroad would be expected to price its captive traffic are effective competitive constraints. *Crowley V.S.* at 5-8 (explaining why RSAM represents a clear exercise of market power). Also as discussed in Part II.A, because the RSAM ratio is an exceedingly high threshold, it is arbitrary to establish a presumption of effective competition when the LP R/VC ratio is below the RSAM ratio of a revenue inadequate railroad.

The $R/VC_{>180}$ ratio is the true measure of a railroad's constrained rate level on potentially captive traffic, because it reflects the average price the railroad is actually charging such traffic. Id. at 7. In other words, the $R/VC_{>180}$ ratio reflects a railroad's observed average monopoly rate level. An LP R/VC ratio above that level, between the $R/VC_{>180}$ ratio and the RSAM ratio, still would be a strong indicator of market dominance, because it would be above the average rate for all of the railroad's captive traffic. This would be an eminently reasonable rebuttable presumption for market dominance because it reflects actual pricing over captive traffic.

A revenue inadequate railroad, by definition, will have an $R/VC_{>180}$ ratio that is lower than its RSAM ratio. In that scenario, the higher RSAM ratio indicates that the railroad would lose business if it imposed rates at the RSAM level. Id. at 7. This further confirms that the RSAM ratio is an exceedingly high threshold at which to establish a presumption of market dominance when the LP R/VC ratio exceeds the RSAM ratio of a revenue inadequate railroad. In that scenario, the $R/VC_{>180}$ ratio is superior.

The RSAM ratio is a superior measure *only* when a railroad already has achieved revenue adequacy. In that scenario, because the railroad is earning more on its potentially captive traffic than is necessary to achieve revenue adequacy, a higher $R/VC_{>180}$ ratio would indicate that the railroad is abusing its market power on a system-wide basis. Id. at 7, n. 13. Therefore, when a railroad has achieved revenue adequacy, it would be reasonable to presume the absence of effective competition when the LP R/VC ratio is above the RSAM.

The Board's adoption of the RSAM ratio as the fulcrum for determining the absence or existence of market dominance lacks a clear justification in the Decision. M&G has demonstrated that the $R/VC_{>180}$ ratio is far more rational when the defendant rail carrier has not yet achieved revenue adequacy, but that the RSAM ratio would be the superior measure when

the defendant rail carrier is revenue adequate. Regardless which ratio is used, however, it is only rational to presume the *absence* of effective competition when the LP R/VC ratio is higher; the opposite presumption when the LP R/VC ratio is lower is neither rational nor supportable.

C. The Refined Approach, As Modified by M&G In These Comments, Reasonably Balances Conflicting Rail Transportation Policies.

The refined approach, as modified by M&G herein, would be a reasonable exercise of the Board's discretion to implement often-competing principles found within the National Rail Transportation Policy ("RTP") set forth at 49 U.S.C. 10101. Association of American Railroads v. Surface Transportation Board, 306 F.3d 1008, 1111 (D.C. Cir. 2002) ("it is up to the Board to arrive at a reasonable accommodation of the conflicting policies set out in the Staggers Act"). The RTP requires the Board, among other things, to provide reasonable rates where rail revenues exceed the amount necessary to maintain the system and attract capital (RTP #6), expeditiously handle its proceedings (RTP #2 and 15), and allow rail carriers to earn adequate revenues (RTP #3). These policies inevitably conflict at times, but the Board's use of the refined approach is a reasonable compromise.

Here, the Board sought an efficient and effective means to evaluate the effectiveness of alternative transportation for over 43 contested movements. This determination was more difficult in this case than in most prior proceedings due to the large number of individual movements at issue and the fact that trucks can physically transport the issue commodity. Yet, the Board also faced a statutory mandate to handle proceedings such as this expeditiously. Its ability to do so already was hindered by the complexity of the rate reasonableness analysis, and here it faced a market dominance analysis of similar scope and complexity.

Therefore, the Board sought to develop a reasonable refinement to its market dominance analysis that would enable it to easily screen those movements where alternative transportation

could not reasonably provide even a modicum of effective competition. Although the Board also attempted to screen for movements where alternative transportation could provide effective competition, that portion of the refined approach is not sound, and thus would be unlawful and arbitrary, for the reasons presented in Part II.A, above. Nevertheless, even with just the former screen, the Board's analysis will be faster and more efficient.

III. **THE REFINED APPROACH IS PROCEDURALLY SOUND.**

The Board was within its authority to adopt the refined approach in this proceeding. Three rail carriers, BNSF Railway Company ("BNSF"), Norfolk Southern Railway Company ("NS"), and Union Pacific Railroad Company ("UP"), have filed letters with the Board suggesting that the Board's adoption of the refined approach was procedurally flawed.¹³ NS presented the most vocal and detailed letter. Presumably CSXT will raise similar arguments in its comments.

A. **The Board Is Not Required To Engage In Notice And Comment Rulemaking.**

NS describes the refined approach as "a sharp break from the Board's existing and longstanding rules on qualitative market dominance, which were adopted through notice and comment rulemaking by the Interstate Commerce Commission ("ICC") in Market Dominance Determinations, 365 I.C.C. 118 (1981), and can only be pursued through notice and comment rulemaking." NS Letter, p. 2. That simply is not accurate. The Board is not required to engage in notice and comment rulemaking for the following reasons.

First, the refined approach is not a "sharp break" from Market Dominance Determinations. In that decision, the ICC stressed that it was adopting non-exhaustive guidelines for the types of evidence that it would consider in a qualitative market dominance analysis.

¹³ See UP and NS letters filed October 9 2012, and BNSF letter filed October 16, 2012.

Notably, the ICC specifically stated that other types of evidence would be permitted and could be considered. *Id.* at 133 (“Other types of evidence on the feasibility or nonfeasibility of motor carriage as an alternative to rail will also be considered.”). While the Board may not ignore or otherwise disregard the factors that it has stated it will consider,¹⁴ it is not precluded from considering other factors in individual adjudications. Nor has the Board repealed or deviated from any of the explicitly enumerated market dominance factors. They continue to play significant roles in determining the practical feasibility of alternative transportation options and in rebutting the preliminary conclusions of the refined approach. The refined approach is merely a lens through which the Board will evaluate the various market dominance factors.

Second, the refined approach does not reverse Market Dominance Determinations on the use of rebuttable presumptions. The contrary claim by NS rests on the theory that, since the ICC repealed four specific types of rebuttable presumptions from market dominance consideration in a rulemaking, then any future use of a rebuttable presumption is an “amendment” of the prior ICC decision and similarly requires adoption in a rulemaking proceeding. But, the refined approach is distinct from the rebuttable presumptions adopted in Special Procedures, 353 I.C.C. 875 (1976), and repealed in Market Dominance Determinations. The ICC never stated that it was deciding never to use any rebuttable presumption ever again in a market dominance decision. Instead, the ICC merely repealed the four rebuttable presumptions that it had adopted in Special Procedures. Because those presumptions had been adopted via notice and comment rulemaking, the ICC could only repeal them via the same process. That did not preclude the agency from ever adopting new and different presumptions through an adjudicatory proceeding.

¹⁴ APS, 742 F.2d at 650.

NS also has suggested that the refined approach requires a notice and comment rulemaking because it is sufficiently similar to a rebuttable presumption based upon R/VC ratios that the ICC repealed in Market Dominance Determinations. That presumption, which was based *solely* upon the R/VC ratio of the challenged rate, was repealed because it was inconsistent with the statute after the Staggers Act. Market Dominance Determinations at 121-22 (the statutory 180% threshold was above the 160% rebuttable presumption). The ICC acknowledged, however, that it could have chosen to just raise the level of the rebuttable presumption, but chose not to do so for other reasons. *Id.* at 122. Furthermore, the ICC stated that its new market dominance guidelines “will encourage submission of more accurate costing information which may include *price-cost ratios* and lead to more appropriate market dominance determinations.” *Id.* [italics added] The refined approach is not a pure R/VC presumption. Rather, it compares the R/VC ratio that the alternative transportation rate would yield on the issue movement if priced similarly and then compares that LP R/VC ratio to the RSAM ratio. Because the refined approach is not the same measure as a presumption based solely upon the R/VC ratio of the issue movement, it is not inconsistent with, or a reversal of, Market Dominance Determinations.

Third, because the refined approach is not a legislative rule, notice and comment rulemaking is not required. Under well-established precedent, a rebuttable presumption is not a legislative rule because it leaves an agency with discretion. Catawba County v. EPA, 571 F.3d 20, 34 (D.C. Cir. 2009); Alliance for Bio-Integrity v. Shalala, 116 F.Supp.2d 166, 172-173 (D.C. Cir. 2000); National Association of Broadcasters v. FCC, 569 F.3d 416, 425 (D.C. Cir. 2009). “An agency pronouncement is not deemed a binding regulation merely because it may have some substantive impact, as long as it leaves the administrator free to exercise his informed discretion....Presumptions, so long as rebuttable, leave such freedom.” Panhandle Producers and

Royalty Owners Association v. Economic Regulatory Administration, 822 F.2d 1105, 1110 (D.C. Cir. 1987) (internal citation and quotation omitted). Cf. Stanley v. Illinois, 405 U.S. 645, 657-658 (1972) (due process prevents state from using an un rebuttable presumption).

Moreover, an agency may develop and rely upon a rebuttable presumption in the course of an adjudication. American Forest and Paper Association v. FERC, 550 F.3d 1179, 1183 (D.C. Cir. 2008) (indicating that FERC could have adopted rebuttable presumption either in adjudication or rulemaking); NLRB v. Baptist Hospital, Inc., 442 U.S. 773, 788-789 (1979) (describing case where rebuttable presumption first used); Rice v. NTSB, 745 F.2d 1037, 1039 (6th Cir. 1984) (describing custom by which NTSB views FAA's recommended punishment as a rebuttable presumption); Republic Aviation Corporation v. NLRB, 324 U.S. 793, 803-805 (1945) (describing an adjudicatory proceeding where a rebuttable presumption was first adopted).

The only potentially valid point raised by NS and the other railroad letters pertains to application of the refined approach to future proceedings. "Agencies may establish rules of general application in a statutory rulemaking or an individual adjudication." Shell Oil Company v. FERC, 707 F.2d 230, 235 (5th Cir., 1983).¹⁵ However, the Board may be required to allow future litigants to challenge the rule if it is applied in future cases, because those litigants are not parties to this adjudication.¹⁶ Id. at 235-236.

¹⁵ See also, Qwest Services Corporation v. FCC, 509 F.3d 531, 536 (D.C. Cir. 2007) ("[m]ost norms that emerge from a rulemaking are equally capable of emerging (legitimately) from an adjudication"); Brotherhood of Locomotive Engineers v. Union Pacific Railroad Company, 537 F.3d 789, 790 (7th Cir. 2008) ("Administrative agencies no less than courts may adopt new rules by adjudication."); American Council of Life Insurance v. Ludwig, 1 F.Supp.2d 24, 31 (D. D.C. 1998) ("[t]he Supreme Court has determined that an agency is not prohibited from advancing new principles through adjudication"); Mobil Exploration and Producing North America, Inc. v. FERC, 881 F.2d 193, 198 (5th Cir. 1989) ("Adjudication can be used to announce new principles even if the principles involve a change from past policies.").

¹⁶ The Board's October 25 decision permitting third parties to comment upon the refined approach as *amici curiae* does not alter this conclusion because that decision did not comply with the Administrative Procedure Act by providing notice in the Federal Register and because *amici* do not have standing to appeal a final Board decision.

Thus, there clearly is no procedural barrier to the Board's application of the refined approach to this case, because the Board is affording both parties the opportunity to comment upon it. Nor is the Board precluded from applying the refined approach in other pending and future cases so long as it affords the parties in those cases a similar opportunity to comment upon and challenge the approach. Alternatively, the Board could conduct a notice and comment rulemaking for future cases, while still applying the refined approach in this case.

B. The Board Has Supplemented, Not Replaced, A Traditional Market Dominance Analysis.

UP erroneously suggests that the Board has replaced the qualitative market dominance test with a quantitative standard. The Board has not eliminated any of the qualitative market dominance guidelines. It still will consider all the same factors as it always has considered, both independent of the refined approach (when determining practical feasibility) and to rebut the presumptions of the refined approach (when determining economic feasibility). Decision at 14-15.

The Board has identified three steps in the qualitative market dominance analysis, only one of which contains a quantitative assessment. *Id.* at 14 (“a threshold feasibility analysis, a comparison of the limit price to the defendant's variable costs of providing the service at issue, and a consideration of intangible factors”).

The first step is to determine whether modal alternatives are feasible as a practical matter. Decision at 12 (“The preliminary step is to determine the feasibility of any theoretical transportation alternatives that could be used for the issue traffic (considering both intramodal and intermodal alternatives).”). This first step requires consideration of all the traditional qualitative market dominance factors described in Market Dominance Determinations. If there are no practical feasible alternatives, the Board can definitively conclude that market dominance

exists without resort to the second and third steps. If practical alternatives exist, however, the Board will proceed to the next step.

The second step is to determine whether modal alternatives are economically feasible. Id. (“whether feasible alternatives exert effective competitive pressure on [railroad’s] pricing...”). This is where the Board will apply the quantitative element of the refined approach announced in the Decision. Id. at 13-14. By comparing the LP R/VC ratio with the defendant’s 4-year average RSAM ratio, the Board will reach a preliminary conclusion as to whether a practical feasible modal alternative also is an economically feasible effective competitive constraint. As discussed in Part II.A., above, the Board should only use this quantitative element of the refined approach to conclude that a transportation alternative is *not* an effective constraint when the LP R/VC ratio is greater than the RSAM ratio, because the opposite conclusion when the LP R/VC ratio is below the RSAM is unlawful, arbitrary and capricious. The preliminary conclusion generated by this second step is then subject to rebuttal in the third step.

The third step is to consider whether any intangible features of the alternative transportation are sufficient to overcome the preliminary conclusion reached in the second step. Id. at 14 (“Finally, when appropriate, we will consider whether the alternative has any intangible features sufficient to overcome the applicable preliminary conclusion.”). This step appears to require consideration of the traditional qualitative market dominance factors described in Market Dominance Determinations.¹⁷ M&G believes, however, that the Board has described this third step too narrowly by reference only to intangible features of the alternative transportation. There also may be significant intangible features of rail transportation that outweigh those of any alternative transportation, and to ignore those would be arbitrary, capricious, and inconsistent

¹⁷ As also discussed in footnote 7, M&G believes that the Board should make clear that its review of “intangible” factors includes a review of all of the factors associated with a traditional market dominance determination.

with Market Dominance Determinations. Therefore, the Board should clarify that this third step will consider and balance the intangible features of both the alternative transportation and rail transportation.

Despite UP's contrary suggestion, there is nothing inappropriate in the Board's decision to use a quantitative analysis to inform its qualitative market dominance determination. In CF Industries, Inc. v. Surface Transportation Board, 255 F.3d 816, 822 (D.C. Cir. 2001), the DC Circuit affirmed the Board's use of a quantitative analysis in conjunction with qualitative market dominance considerations:

While the Board's market dominance guidelines contemplate the use of...qualitative considerations, they do not exclude the application of quantitative analysis as well.

In that case, the Court also noted that the Board's quantitative methodology was merely a part of its overall market dominance evaluation, which entailed many non-quantitative factors. Id. at 822 (n. 8). This is similar to the instant case, which involved evaluation of feasibility (Decision at 12) and "intangible features" (Decision at 14) in addition to the quantitative element of the refined approach.

As noted in the foregoing description of the qualitative market dominance analysis under the refined approach, the Board has not supplanted a traditional market dominance analysis with a purely quantitative approach. Rather the quantitative element of the refined approach supplements the traditional factors and the rebuttal element of the refined approach also incorporates those factors. There is nothing unlawful with this approach.

IV. CONCLUSION.

M&G supports the Board's adoption and application of the refined approach to market dominance determinations, subject to certain modifications to correct a fundamental flaw and to use a more appropriate threshold for the rebuttable presumption. First, the Board should apply

the refined approach only to preliminarily conclude that alternative transportation is *not* an effective competitive constraint when the LP R/VC ratio is above the threshold. Because it is illogical to preliminarily conclude that alternative transportation is an effective competitive constraint when the LP R/VC ratio is below the threshold, the Board should abandon that proposal. Second, the Board should substitute the $R/VC_{>180}$ ratio for the RSAM ratio in the refined approach because it is superior to the exceedingly and unnecessarily high RSAM threshold for railroads that have not achieved revenue adequacy.

The Board was within its authority to adopt the refined approach in this case and without a notice and comment rulemaking. The refined approach is not a departure from precedent, but merely supplements the existing qualitative market dominance standards. Furthermore, a rebuttable presumption is not a legislative rule that would require notice and comment rulemaking, because it leaves the agency with discretion.

For the foregoing reasons, the Board should confirm its use of the refined approach in the Decision to the extent that the refined approach has resulted in determinations that alternative transportation is *not* an effective competitive constraint. But the Board should reconsider its determinations in the Decision that alternative transportation is an effective constraint for those issue movements where the LP R/VC ratio is below the RSAM ratio. The Board first should substitute the $R/VC_{>180}$ ratio for the RSAM ratio, apply the preliminary conclusions to those movements where the LP R/VC ratio is above the $R/VC_{>180}$ ratio, and apply a traditional market dominance analysis to those movements where the LP R/VC ratio is below the $R/VC_{>180}$ ratio.¹⁸

¹⁸ As part of this reassessment of the Decision, the Board should reverse its determination that Lane A-4 is subject to effective competition, despite an LP R/VC ratio above the RSAM. As discussed herein, the RSAM is a conservatively high threshold that should require a very high degree of evidence to rebut a presumption of market dominance. Furthermore, Lane A-4 would no longer be a borderline movement if the Board substitutes the $R/VC_{>180}$ ratio for the RSAM ratio, as M&G has proposed. Finally, a triple digit CSXT rate increase for this lane over just two years exemplifies the absence of an effective competitive constraint despite an LP R/VC ratio below the RSAM ratio.

For the reasons presented in M&G's Petition for Reconsideration, the Board also should conduct a traditional market dominance analyses in this case to show that the refined approach is a good indicator of when alternative transportation does not provide effective competition.

Respectfully submitted,

A handwritten signature in blue ink, appearing to read "Jeffrey O. Moreno", is written over a horizontal line.

Jeffrey O. Moreno
David E. Benz
Thompson Hine LLP
1919 N Street, N.W., Suite 700
Washington, D.C. 20036
(202) 331-8800

November 28, 2012

CERTIFICATE OF SERVICE

I hereby certify that this 28th day of November 2012, I served a copy of the foregoing upon counsel for defendant CSXT via electronic mail and first class mail at the address below:

G. Paul Moates
Paul Hemmersbaugh
Sidley Austin LLP
1501 K Street, NW
Washington, DC 20005

Counsel for CSX Transportation, Inc.



Jeffrey O. Moreno

TABLE OF CONTENTS

PAGE

I. INTRODUCTION1

II. THE STB’s APPROACH IS OBJECTIVE.....2

III. THE STB’s APPROACH IS ECONOMICALLY RATIONAL WITH CERTAIN
MODIFICATIONS5

 A. THE STB’s THRESHOLD REPRESENTS A RATE LEVEL ABOVE WHICH
 MARKET DOMINANCE IS CLEARLY BEING EXERTED.....5

 B. THE STB’s APPROACH IS ECONOMICALLY RATIONAL.....9

IV. THE STB’s METHOD ALLOWS FOR ADDITIONAL QUALITATIVE
ASSESSMENT OF MOVEMENT FACTORS.....13

V. THE STB’s METHOD IS CONSERVATIVE15

I. INTRODUCTION

I am Thomas D. Crowley, an economist and the President of L. E. Peabody & Associates, Inc., an economic consulting firm that specializes in solving economic, transportation, marketing, financial, accounting and fuel supply problems. I am the same Thomas D. Crowley who filed opening market dominance evidence in this proceeding on behalf of M&G Polymers USA, LLC (“M&G”) on June 6, 2011. My qualifications and experiences are included in Part IV of that opening market dominance evidence.

I have been requested by Counsel for M&G to comment on the procedures used by the Surface Transportation Board (“STB” or “Board”) in its September 27, 2012 decision¹ in this proceeding regarding the STB’s determination of qualitative market dominance.

In response to the STB’s request,² Counsel asked that I comment on the STB’s procedures for determining qualitative market dominance in a maximum reasonable rate proceeding. Specifically, the Board requested that the parties submit comments on the STB’s refined approach to determining whether or not effective competition exists to constrain CSX Transportation, Inc.’s (“CSXT”) pricing power over the M&G issue traffic.

The remainder of my Verified Statement addresses the STB’s refinement and is organized under the following topical headings:

- II. The STB’s Approach is Objective
- III. The STB’s Approach Is Economically Rational with Certain Modifications
- IV. The STB’s Method Allows for Additional Qualitative Assessment of Movement Factors
- V. The STB’s Method is Conservative

¹ Docket No. 42123, *M&G Polymers USA, LLC v. CSX Transportation, Inc.*, served September 27, 2012 (“September Decision”).

² *Id.*, pp. 3-4.

II. THE STB'S APPROACH IS OBJECTIVE

As established in 49 U.S.C. § 10707(a), the Board must determine whether CSXT possesses market dominance over the issue movements, which means that there is “an absence of effective competition from other rail carriers or modes of transportation for the transportation to which a rate applies.” To make the required determination, the Board conducts both a quantitative and qualitative review. Under the quantitative determination, a railroad “does not have market dominance over the transportation to which the rate applies if such rail carrier proves that the rate charged results in a revenue-variable cost percentage for such transportation that is less than 180 percent.”³

If the quantitative analysis determines that a rate charged by the rail carrier produces a revenue-variable cost percentage equal to or greater than 180 percent, a qualitative analysis is undertaken by the Board to determine if there are any feasible transportation alternatives that provide effective competition. A competitive alternative is considered “effective” if it can place pressures on the rail carrier “to perform up to standards and at reasonable prices, or lose desirable business.”⁴ The STB performs an ad hoc analysis of the competitive alternatives available to constrain a railroad’s rates in each issue lane. Depending upon the evidence presented and the STB’s assessment of an alternative’s ability to constrain the railroad’s rates, the STB determines if the railroad is market dominant within the issue lane.

Because of the ad hoc nature of qualitative market dominance determinations and the escalating complexity of market dominance inquiries, the STB’s *September Decision* refined its current approach to include an objective methodology for framing market dominance issues.

³ See, 49 U.S.C. § 1070(d)(1)(A).

⁴ See, *Market Dominance Determinations & Consideration of Product Competition*, 365 I.C.C. 118, 129 (1981).

The STB's refinement involves a simplifying step in the existing process that the STB may use to help focus its qualitative market dominance analysis.

The Board's refined approach incorporates a threshold screening analysis, which relies on a three-step process to determine the rate representing the theoretical tipping point where market dominance is exerted for each issue movement. In the first step, the price of the potential next best competitive option to the traffic lane at issue is determined based on evidence submitted by the parties.⁵ This price is termed the "Limit Price" ("LP") and reflects the rate up to which the railroad theoretically could charge before potentially losing significant traffic to the competitive alternative. In the second step, the "LP" is divided by the issue movement's Uniform Railroad Costing System ("URCS") Phase III variable cost ("VC") to determine the "LP R/VC ratio." In the third step, the LP R/VC ratio is compared to the defendant railroad's most recently calculated 4-year average RSAM⁶ ratio. The Board proposes to review each lane where the LP R/VC ratio falls slightly below or slightly above the RSAM percentage, for "intangible qualities that bear on the alternative's ability to effectively constrain the rate at issue."⁷ Thus, the final step of the

⁵ The Board's model relies completely on the use of valid estimates of competitive option prices, and is therefore open to gaming. In the instant case, the Board accepted the lowest rate submitted by either party as a valid rate for a competitive option. If the parties are allowed to freely submit supposedly valid rates, there is a possibility that gaming of the model could occur by submitting artificially low rates for the competitive option being proposed. This is particularly troublesome given the trucking industry's market structure. Specifically, the trucking industry – and in particular the truckload ("TL") segment of the trucking market – is made up largely of owner-operators and other independent drivers. The industry sees high turnover rates among its drivers (106% in 2012 according to the American Trucking Association. This means that a trucking company employing 100 drivers will hire 106 new drivers annually. See, <http://www.truckline.com/pages/article.aspx?id=1043/8e1c7279-ed27-4c03-b189-ceeee26bbb12>). In addition, the Federal Motor Carrier Safety Administration ("FMCSA") data shows that approximately 100,000 new trucking companies ("new entrants") enter the market every year (and a similar number of failing operators leave the market). Therefore, on any given day, there are thousands of new, inexperienced trucking companies entering the market. It would be exceedingly easy for the railroads to find a single "greenhorn" trucking company to provide a low-ball rate for services that it would never render. If this occurs and the STB accepts it as the "lowest limit price," the Board's refined model could potentially become meaningless as an evaluation tool (garbage in, garbage out).

⁶ Revenue Shortfall Allocation Methodology ("RSAM") – RSAM "measures the average markup that the railroad would need to charge all of its potentially captive traffic in order for the railroad to earn adequate revenues." Docket No. EP 689 (Sub – No. 3), *Simplified Standards for Rail Rate Cases – 2010 RSAM and R/VC Calculations*, decided February 24, 2012, page 1 ("*Simplified Standards*").

⁷ See, *September Decision*, p. 4.

refined process is the same as the current methodology. The Board's refined threshold screening analysis distinguishes those movements where the railroad is clearly market dominant from those that require a more in-depth analysis.

The Board's approach to determining market dominance via assessment of proposed competitive option prices is an objective and reasonable first step in the qualitative evaluation of market dominance. Comparison of a competitive option price to a rate threshold above which market dominance is clearly being applied is a logical and fair initial analysis to determine whether a transportation alternative potentially provides effective competition to the rail transportation in question. The Board may not need to use the test in all cases, though. For example, a coal shipper contesting a rail rate between a single origin/destination pair may not need to use the test to assist in determining whether the railroad holds qualitative market dominance on the movement. However, a shipper contesting rates between multiple origins and destinations can use the refined process to determine which lanes require additional scrutiny. Once the STB has applied its initial screening test it can then use the other tools at its disposal to determine whether the incumbent is truly market dominant.

III. THE STB's APPROACH IS ECONOMICALLY RATIONAL WITH CERTAIN MODIFICATIONS

The Board's threshold analysis in essence determines whether the issue rate reflects the exertion of market dominance, with the RSAM ratio representing the rate level above which market dominance clearly exists. The Board attempts to use the RSAM ratio as a fulcrum, such that an LP R/VC ratio above the RSAM ratio leads to a presumption of market dominance and an LP R/VC ratio below the RSAM ratio leads to a presumption of effective competition. However, only the former presumption – that market dominance exists where the LP R/VC ratio exceeds the RSAM ratio – is economically justified. Therefore, the Board should only use its threshold analysis to screen for movements where market dominance clearly exists. Furthermore, the $R/VC_{>180}$ ratio is clearly a much more accurate representation of the rate level for moves over which the railroad possesses market dominance than the RSAM ratio. Therefore, the Board should revise its threshold analysis to use the $R/VC_{>180}$ ratio instead of the RSAM ratio. With these modifications, the Board's refined approach to the qualitative market dominance determination is economically justified, and is a reasonable way to focus the scope of the analysis.

A. THE STB's THRESHOLD REPRESENTS A RATE LEVEL ABOVE WHICH MARKET DOMINANCE IS CLEARLY BEING EXERTED

Under the proposed methodology, if the threshold analysis reveals that the LP R/VC ratio is greater than the RSAM ratio, the defendant railroad is preliminarily presumed to possess market dominance over the issue move. In actuality, the defendant railroad must be presumed to definitively possess market dominance over the issue move in this scenario, for reasons discussed below.

Under the proposed methodology, if the LP R/VC ratio is less than the RSAM ratio, the movement is preliminarily presumed to be competitive with other transportation modes. In actuality, the Board's screening test based on either the RSAM ratio or the $R/VC_{>180}$ ratio should be used only as an upside measure of market dominance. For issue traffic with an LP R/VC ratio below either threshold, the STB should evaluate this traffic using the traditional qualitative market dominance evidence presented by the parties. This is because the railroads can and do exert their market dominance over traffic moving at rate levels far below either benchmark in the real world.

In *McCarty*,⁸ the Interstate Commerce Commission ("ICC") quoted a decision from the District of Columbia Court of Appeals, which states in pertinent part:

At the core of the "effective competition" standard is the idea that there are competitive, market pressures on the railroads deterring them from charging monopoly prices for transporting goods. Of course, any such effective competition will always be relative to the price that the railroads charge.⁹

The RSAM ratio represents the rate level the defendant railroad must charge its most price inelastic shippers to remain revenue adequate.¹⁰ The Board defines the RSAM ratio as "the measure of the average markup that CSXT would need to collect from all of its potentially captive traffic to earn a return on investment equal to the cost of capital."¹¹ The Board calculates

⁸ *McCarty Farms, et al v. Burlington Northern Inc.*, 3 ICC 2d at 822.

⁹ See, 3 ICC 2d at 822 (832).

¹⁰ For purposes of this discussion, revenue adequacy is defined as measured by the Board under 49 U.S.C. § 10704(a)(2). There is ample reason to believe that CSXT and all other Class I carriers are currently revenue adequate based on their present cost and revenue streams, as evidenced by the fact that the major ratings houses have been giving the railroads good ratings for years and Wall Street is investing heavily in them. Moreover, Berkshire Hathaway's 2010 acquisition of BNSF Railway Company for a substantial premium over its then current market value indicates the railroad's financial positions are better than indicated under the STB's current revenue adequacy procedures.

¹¹ See, *September Decision*, p. 4.

the RSAM ratio for all Class I carriers on an annual basis as part of its revenue adequacy determination.¹²

As part of the Board's annual RSAM determination, it also calculates each Class I carriers' $R/VC_{>180}$ benchmark. This benchmark measures the average markup over variable cost actually earned by the defendant railroad on its potentially captive traffic. Potentially captive (i.e., non-competitive) traffic is defined by the Board as all traffic with an R/VC ratio above 1.80 for purposes of this analysis. Therefore, it is the $R/VC_{>180}$ benchmark, not the RSAM ratio, that reflects the "price the railroad is charging" its most price inelastic shippers (i.e., its observed average rates for traffic over which it possesses market dominance).

Because the $R/VC_{>180}$ benchmark is the true measure of a railroad's constrained rate level on potentially captive traffic, it is superior to the RSAM ratio for identifying the rate level at which market dominance is clearly being exerted in the refined market dominance approach. This is particularly true when the RSAM ratio is greater than the $R/VC_{>180}$ ratio, because an RSAM ratio higher than the $R/VC_{>180}$ ratio indicates that the railroad would lose business if it implemented rates at the RSAM level (i.e., the product consumers would use a substitute good if the RSAM level rates were implemented).¹³

The Board's LP R/VC ratio is the manifestation of competition within one particular traffic lane. In its proposed model, the Board preliminarily concludes that, if the LP R/VC ratio is higher than the benchmark RSAM ratio,¹⁴ then the competition within that market is not

¹² See, *Simplified Standards*, p. 2.

¹³ It is also sometimes the case that the STB's RSAM determination reveals that a carrier is earning more on its potentially captive traffic than is required for the railroad to remain revenue adequate, even by the Board's very conservative revenue adequacy standards. If this should happen, the appropriate measure of a true monopoly rate level would be the RSAM ratio, because the railroad would have been shown to be abusing its market power on a system-wide basis.

¹⁴ The RSAM ratio is the Board's chosen proxy for the monopoly rate level. The $R/VC_{>180}$ ratio would be a better approximation of the railroad's true monopoly rate level.

restricting the rate relative to average price levels on non-competitive traffic across the railroad, and the railroad is preliminarily found to be market dominant in that lane. The Board's preliminary qualification is not required because, when the alternative rate exceeds the threshold rate level, there is by definition an absence of competition. As articulated by economist Wesley W. Wilson:¹⁵

When the railroad is the low-cost alternative, at least the possibility for market dominance exists. However, market dominance cannot be considered a discrete finding except in the case where [the constrained price is greater than or equal to the monopoly price]. Of course, a monopoly is, by definition, market dominant in the sense that at the monopoly price the railroad faces no actual or potential competition.¹⁶

Within the framework of the refined approach, the LP R/VC ratio represents the "constrained price" and the RSAM ratio represents the "monopoly price" in the foregoing quote. When the LP R/VC ratio exceeds the RSAM ratio, the Board must definitively conclude that the railroad possesses market dominance.

If the LP R/VC is below the RSAM benchmark, then the Board preliminarily concludes that there is a competitive option priced below the defendant railroad's average rate level for non-competitive traffic, so the railroad is not market dominant in that lane. This preliminary presumption is deeply flawed. Because the RSAM ratio (or the $R/VC_{>180}$ ratio) is an average for all potentially captive traffic, there are many captive movements that are priced below either benchmark. This conclusion is even stronger for the RSAM ratio than the $R/VC_{>180}$ ratio, when a railroad is deemed to be revenue inadequate by the STB, because the RSAM ratio would represent an average target rate level for potentially captive (i.e., non-competitive) traffic, with actual rates for potentially captive traffic (represented by the $R/VC_{>180}$ ratio) being less. The

¹⁵ See, Wilson, Wesley, W., "Legislated Market Dominance in Railroad Markets," *Research in Transportation Economics*, Volume 4 ("Wilson"), pp. 49- 67.

¹⁶ See, Wilson, p. 57.

only conclusion that can be drawn from a threshold test that reveals an LP R/VC below the average constrained market position¹⁷ is that the prices are above competitive levels.¹⁸ Thus, it would be irrational to presume, even preliminarily, the existence of effective competition based upon an LP R/VC ratio that is below the RSAM or the R/VC_{>180} ratio.

B. THE STB's APPROACH IS ECONOMICALLY RATIONAL

The STB's framework also comports with the economic theories of market power. In economics, market power is the ability of a firm to profitably raise its price of a good or service over its marginal cost. In perfectly competitive markets, market participants have no market power as any increase in price will lead to losing the customer to a competitor and a reduction in revenues and profits. On the other hand, a firm with market power can raise prices without losing its customers to competitors. Significant market power can therefore be equated to an ability to set prices well above marginal cost and long run average cost, so the firm makes increased economic profits.

The degree of market power exercised by a firm can be expressed using the Lerner Index,¹⁹ which is defined as follows in Equation 1 below:

$$L = (P - MC) \div P$$

Where:

L = Lerner Index

P = Market Price

MC = Marginal Cost

¹⁷ Either RSAM or R/VC_{>180}.

¹⁸ Because the threshold test is not applied until after the quantitative market dominance test is applied, the LP R/VC ratio for all moves with LP R/VC ratios below the threshold will be above 1.80.

¹⁹ The Lerner Index was first proposed by economist Abba P. Lerner. See, Lerner, A. P., "The Concept of Monopoly and the Measurement of Monopoly Power", *The Review of Economic Studies* 1 (3): 157-175 (1934). It can also be shown that the Lerner Index is equal to the negative inverse of the price elasticity of demand facing the firm. In other words, movements with the highest Lerner Index values are the most price inelastic.

The Lerner index ranges from a low of zero (0) to a high of one (1), with higher numbers implying greater market power. The end points of the Lerner Index range may be inferred by viewing the two extremes of market power conditions – a perfectly competitive market and a monopoly market. In a perfectly competitive market, firms must set prices equal to their marginal costs, or else risk losing customers to a competitor. Therefore, in a competitive market $P = MC$ and the term “(P – MC)” within the Lerner Index equation must equal zero leading to a Lerner index of 0. If the firm is in a monopoly position, it can set its price well above its marginal costs, whereby the “(P – MC)” term will eventually approach the firm’s Price. This will lead to an upper Lerner index value of 1. The main inferences that may be drawn from the Lerner Index is that the closer the index value is to one (1), the greater the firm’s market power over the product or service.

One of the limitations of using the Lerner Index in practice has been the difficulty in calculating marginal costs. However, previous studies have shown that a railroad’s variable cost of service can be used as a reasonable approximation of its marginal costs.²⁰ With this assumption, Equation 1 above can be rewritten to the form shown in Equation 2:

$$L = 1 - (1 \div R/VC)$$

Where:

L = Lerner Index

R = Rate

VC = URCS Phase III Variable Costs

Using Equation 2 above, railroad R/VC ratios can be used to estimate Lerner Indexes and provide an indication of a railroad’s market power over a movement.²¹

²⁰ See, Wilson, p. 59 and note 23.

²¹ Railroads sometimes set rates below a movement’s URCS variable cost of movement, which would mean an R/VC of less than 1.00 and a negative Lerner Index. As Wilson explains at page 65, note 23, using URCS Phase III variable costs as approximations for marginal costs can lead to an overstated Lerner Index value. This would

Railroads will tend to set rates for desirable traffic with competitive transportation options closer to the movement's variable costs of service than movements without competitive options. Therefore, movements with low R/VC ratios can be assumed to be more competitive than movements with high R/VC ratios, and will have lower Lerner Index values. Assuming a rail movement with high elasticity of demand has an R/VC ratio of 110 percent, a Lerner Index value of 0.09 is produced when inserted into Equation 2 above. In contrast, a movement with very inelastic demand and a high R/VC ratio of 350 percent will produce a Lerner Index value of 0.71.

As illustrated above, high R/VC movements are correlated with higher Lerner Index values indicating the influence of market power in rate-setting practices. The Lerner Index values do not, however, tell by themselves whether a particular movement is market dominant. Other factors, including the ability to switch to alternative modes of transportation, must be taken into consideration. Market dominance is dependent, in part, on the ability to switch between different alternatives. As indicated by Wilson:

If the railroad is the low cost mode, the associated rate is either strictly market dominant or constrained market dominant. If strictly market dominant, rates are monopoly rates. If constrained market dominant, monopoly and competitive rates bound the rates chosen by railroads. The bound depends critically on the potential for demanders switching between alternatives in mode...²²

The STB's revised screening test uses the RSAM ratio and alternative option prices to perform just such a comparison. As stated above, the RSAM percentage is simply a railroad's average R/VC ratio for potentially captive movements adjusted by a factor to account for

be a concern if one were using individual R/VC ratios in isolation, but because we are using the values as bases of relative comparisons, any overstatement would impact both sides of the comparison. Stated differently, it is the relative difference between the two implied Lerner Index values we are interested in and not the exact values themselves.

²² Id, p. 62.

revenue adequacy requirements. So, at its core, the RSAM percentage is simply an R/VC ratio, which from Equation 2 above, can be equated to a Lerner Index indicating significant market power.²³ However, as I discussed above, the $R/VC_{>180}$ ratio would provide a more accurate measure of the market power actually exercised by the incumbent railroad over its non-competitive traffic in the real world. In either case, a ratio that quantifies the railroad's exercise of market power over its most captive traffic is a logical cut-off for reviewing whether individual rates are effectively controlled by a next-best alternative. The comparison of the R/VC, or in effect Lerner Indexes, between the benchmark for the railroad as a whole and for an individual movement provides an indication of the relative market power a railroad exerts over an average captive movement and the market power that would be exerted if the incumbent priced its rates at the next best alternative rates. If the Lerner Index for the alternative movement is higher than that of the incumbent's non-competitive traffic Lerner Index, it infers that the railroad has market dominance in that lane. An index below the average might infer, but not verify, that the railroad may be market dominant within that lane. The only sure way to tell is by examining the specific competitive factors impacting the railroad's rate.

²³ Stated in a different way, the RSAM percentage for a railroad that is right at revenue adequacy is simply its average R/VC ratio for all shipments with R/VC ratios greater than or equal to 180%.

IV. THE STB's METHOD ALLOWS FOR ADDITIONAL QUALITATIVE ASSESSMENT OF MOVEMENT FACTORS

The Board clarified that its preliminary finding of market dominance resulting from its refined methodology could, “in certain circumstances be overcome by evidence demonstrating that the alternative upon which the limit price is based has certain intangible qualities that bear on the alternative’s ability to effectively constrain the rate at issue.”²⁴

The qualitative aspect of the market dominance determination has always been subjective. The subjective nature of the exercise results from the central question being asked. Specifically, do the proposed competitive options function as effective constraints on the incumbent’s pricing? As pointed out by the Board, “at some point even a monopolist could price its services so high that even patently ridiculous transportation alternatives would eventually serve to constrain rates.”²⁵

The STB proposes that its model’s preliminary finding of market dominance will be subject to further review based on individual movement parameters that may reveal other factors that have a bearing on the extent to which the alternative is truly a competitive option. As we discussed above, this preliminary finding needs no further exploration when it reveals a LP R/VC ratio at or above the average constrained market position. However, it is appropriate to conduct further qualitative review in the event that the preliminary finding reveals a LP R/VC ratio is below the average constrained market position. This is also consistent with Wilson’s findings. Specifically:

In the intermediate range, [where the constrained price is between the competitive price and the monopoly price], market dominance is a matter of degree. Competitive pressures constrain the market power of the

²⁴ See, *September Decision*, p. 4.

²⁵ *Id.*, p. 3.

railroad such that the observed price lies between the monopoly price and the competitive price.²⁶

In the Board's framework, the jurisdictional threshold ("JT") level where the R/VC ratio equals 180 percent represents the threshold between captive and competitive prices. Railroads by statute are not considered market dominant on movements with R/VC levels below the 180 percent JT. When the LP R/VC ratio lies below the RSAM ratio (or $R/VC_{>180}$) but above the JT level, the Board may still determine that the railroad possesses market dominance based on further qualitative analysis.

What is needed at the start of the inquiry, and what the Board's refined market dominance test provides, is a screening device to determine whether there are competitive options that could feasibly serve to constrain the challenged rate. Although the Board's refined model serves to provide an objective answer to the subjective inquiry, its application is merely the first step in the determination of market dominance for issue movements. After the Board applies its refined model and determines whether further investigation is warranted, it could then consider *any* other pertinent factors in determining market dominance.

²⁶ See, Wilson, pp. 57-58.

V. THE STB'S METHOD IS CONSERVATIVE

For the reasons outlined above, the Board's approach and model are objective and effectively serve its intended purpose (i.e., to objectively determine whether an intermodal transportation option provides effective competition to the rail transportation in question based on a comparison of the alternative rate to a quantifiable railroad price threshold above which the railroad clearly possesses market dominance.) However, the Board's model is overly conservative and may result in a finding that a lane is competitive when it is not.

The Board states, "a carrier's RSAM figure is a measure of the average mark-up that the carrier would need to collect from all of its potentially captive traffic in order to earn adequate revenues." And, "the RSAM methodology... provides for differential pricing... by directly linking its 'revenue need shortfall' to a benchmark mark-up for captive traffic."²⁷ By definition, rates at RSAM levels reflect the prices the railroad may extract from only its captive traffic – i.e., the shipments over which it has market dominance. As the Board also stated, "because the average derived by the RSAM is the average for captive shippers only, the ratios for some captive shippers must be above and some below that figure."²⁸ The Board has acknowledged that many captive shippers (shippers over which the railroad possesses market dominance) pay rates well below RSAM. However, the STB's model assumes that the railroad does not have market dominance over any shipper with an option below the RSAM level. As discussed above, a preliminary conclusion that market dominance does not exist for these moves is incorrect, and each such result should require a further examination of other pertinent factors before a conclusion is reached. Furthermore, the $R/VC_{>180}$ ratio would provide a more reasonable

²⁷ See, *September Decision*, p. 15.

²⁸ *Id.*

indication of rates for moves over which the railroad clearly exercises market dominance than the RSAM ratio.

The Board's model also preliminarily presumes that the competitive option price (expressed as the LP) is associated with a transportation mode viewed as a perfect substitute for rail transport by the shipper. This default position demands that careful consideration be given to all other relevant factors.

The bound depends critically on the potential for demanders switching between alternatives in mode, product, and location. These are the focal points of the regulatory rules pertaining to market dominance.²⁹

It is quite possible that the Board may lack the insight to perceive all of the shipper's requirements for transportation of issue traffic. Although the Board does reserve the right to overrule its preliminary market dominance findings, there may be a tendency to overlook a factor that makes rail the shipper's strongly preferred mode. For example, the risk of highway crashes may dissuade shippers from moving large quantities of toxic chemicals by truck.

²⁹ See, Wilson, p. 62.

