SIDLEY AUSTIN LLP
SIDLEY

SIDLEY AUSTIN LLP
1501 K STREET, N.W.
WASHINGTON, D.C. 20005
(202) 736 8000
(202) 736 8711 FAX

ratkins@sidley.com
(202) 736 8889

BEIJING
BOSTON
BRUSSELS
CENTURY CITY
CHICAGO
DALLAS
GENEVA
HONG KONG
HOUSTON
LONDON
LOS ANGELES
NEW YORK
PALO ALTO
SAN FRANCISCO
SHANGHAI
SINGAPORE
SYDNEY
TOKYO
WASHINGTON, D.C.

FOUNDED 1866

238997

ENTERED
Office of Proceedings
August 6, 2015
Part of
Public Record

August 6, 2015

Daniel R. Elliott III, Chairman
Ann D. Begeman, Vice Chairman
Deb Miller, Member
Surface Transportation Board
395 E Street, S.W.
Washington, D.C. 20423-0001

Re: *Railroad Revenue Adequacy*, Docket No. Ex Parte 722

Dear Chairman Elliott, Vice-Chairman Begeman, and Member Miller:

Norfolk Southern Railway Company ("Norfolk Southern") is filing this letter in response to the Board's invitation for parties to supplement their testimony following the July 22-23, 2015 hearing in Ex Parte 722, *Railroad Revenue Adequacy*.

No party refuted the three main reasons for abandoning an independent revenue adequacy constraint. First, as Professor Sappington explained, implementation of a system-wide revenue adequacy constraint as a rate reasonableness standard would be a discredited form of regulation that is fraught with perils. Second, as Professor Cornell explained, the methodology used to determine the Board's annual revenue adequacy findings contains serious measurement errors that make it unsuitable for use as anything but a rough thermometer of directional changes in the general financial conditions in the railroad industry. Third, the Board already has targeted "revenue adequacy" tests in the form of its SAC and Simplified-SAC rate reasonableness standards.

Norfolk Southern's supplemental comments will not reiterate its written comments and oral testimony demonstrating that the Board should not adopt an independent revenue adequacy constraint. Instead, these supplemental comments will focus on three important issues raised at the hearing:

- First, Commissioner Miller asked whether the Board should use its annual revenue adequacy calculation as a trigger to alter the way in which it regulates rates. Norfolk Southern believes the answer to this question is "no" and that the achievement of revenue adequacy should not act as a trigger for a new regulatory regime. Even if it were a good idea to do so, the Board's existing rate remedies already incorporate revenue adequacy principles and thus make it easier for a shipper to prevail in a case against a railroad that is truly approaching revenue adequacy.

- Second, shipper groups claimed at the hearing that their proposals for a revenue adequacy constraint would not have substantial negative impacts on the rail transportation network. Those claims are incorrect. Despite its protests to the contrary, the National Industrial Transportation League's ("NITL's") proposals are plainly rate-of-return regulation that would skew railroad incentives in ways that would damage all shippers. And Western Coal Traffic League's ("WCTL's") proposed "rate freeze" would distort the transportation markets, deter both railroads and shippers from entering contracts, and affect a far wider segment of traffic than the "relatively small universe" that WCTL claims.

- Third, the Board expressed some concerns about its existing rate reasonableness remedies. The Board should address those concerns by continuing its work to improve those remedies. The Board has made significant progress in simplifying SAC cases, and it has worked assiduously to develop simplified methodologies for shippers concerned about the costs of SAC litigation. That work should be continued, not abandoned in favor of the discredited rate-of-return and rate freeze approaches proposed at the hearing. Any proposal must be grounded in sound railroad economics. Such economics include the concepts of economies of scale and density, and demand-based differential pricing of traffic.

I. The Board Should Not Use the Achievement of Revenue Adequacy as a Trigger for a New Regulatory Regime.

During the hearing, Board members asked whether railroad revenue adequacy provided a basis to adopt new regulatory measures such as forced access,[1] arbitration of rates, or rate-of-return or rate freeze regulation. Such an approach would be misguided as a policy matter and at odds with the statutory scheme.

Revenue adequacy should not be a "trigger" that alters the sound economic regulatory framework under which the Board currently operates. The Board's economic regulations already consider revenue adequacy on a targeted basis in both SAC and Simplified-SAC cases, and as the D.C. Circuit has held, measurements of a railroad's system-wide revenue needs can provide "no guidance" on whether an individual rate is reasonable. The Board's existing remedies provide effective constraints targeted at the specific rate at issue both for a railroad

[1] It is worth noting that NITL opposes the idea that revenue adequacy could be a basis to adopt forced access measures. *See* NITL Testimony, July 22, 2015 Hearing Video 1 at 50:30.

that is revenue inadequate and for a railroad that is revenue adequate. The Board should not apply different sets of rules to different railroads.

While revenue adequacy should not be a "trigger" for a different rate reasonableness regime, this does not mean that a railroad's improving financial health is not recognized in the Board's existing rate reasonableness remedies. If a railroad improves its financial performance through increasing its revenues, those higher revenues will increase the revenues that SAC and Simplified-SAC complainants can assign to their traffic groups. And if a railroad improves its financial performance through reducing costs, those cost savings will be reflected in the URCS costs used by a Simplified-SAC complainant and could be used to posit similarly reduced costs for a SAC complainant's Stand-Alone Railroad. Therefore the maximum reasonable rates produced by the SAC, Simplified-SAC, or even the Three Benchmark approach will be lower as a railroad approaches revenue adequacy. The Board does not therefore need revenue adequacy to be a "trigger" for a different regulatory scheme when its existing scheme already provides for tighter constraints on rates as a railroad improves its financial health.

II. The Revenue Adequacy Constraints Proposed by Shippers are Deeply Flawed.

Two very different revenue adequacy constraint proposals were explicated at the hearing: (i) the National Industrial Transportation League's Rebate and Benchmark proposals and (ii) the Western Coal Traffic League's Rate Freeze proposal. Each party's proposals contain serious flaws and it would be dangerous for the Board to adopt any of them.

A. NITL's Rebate and Benchmark Proposal Is Unvarnished Rate-of-Return Regulation.

Despite NITL's protests to the contrary, the Rebate and Benchmark proposals are precisely the kind of rate-of-return regulation that stifles innovation, removes incentives to improve service, and has been thoroughly discredited. The key feature of rate-of-return regulation is the imposition by a regulator of maximum lawful rates or a requirement of rebates as a function of the overall profits of the regulated company. Experience has shown that a regulatory policy of capping overall earnings at a level the regulator deems to be sufficient results in poor incentives, and as a result it is largely out of favor with regulators. Op. Comments of Norfolk Southern Ry. Co., Verified Statement of Prof. David Sappington, *Railroad Revenue Adequacy*, STB Docket No. Ex Parte 722, at 2-4, 11 (Sept. 5, 2014) ("V.S. Sappington"). As numerous economists testified in this proceeding, rate-of-return regulation has significant drawbacks, including stifling innovation and service improvement.[2] Once a company hits a

[2] *See* V.S. Sappington at 4 ("[S]tringent earnings regulation provides no incentive for the regulated firm to engage in the challenging, costly processes of discovering more efficient means of operation and identifying and fulfilling the needs and desires of consumers."); Op. Comments of Norfolk Southern Ry.

system-wide revenue constraint, it loses the profit motive to innovate, to improve productivity, or to compete for new lines of service because it knows that any increased earnings could be returned to the customer through rate-of-return regulation.

A simple example illustrates how NITL's Rebate or Benchmarking proposal would essentially transfer money received from shippers moving competitive traffic to "captive" shippers. Assume that in Year 1, a railroad received $7 million in revenue from competitive traffic and $3 million in revenue from captive traffic, for a total of $10 million in revenue. Assume further that the Board determined that $10 million is the precise revenue adequacy level for that railroad for that year. In Year 1, no shippers would receive a rebate. In the subsequent year, Year 2, the railroad receives $8 million in revenue from the exact same competitive traffic (as a result of increased rates) and receives the same $3 million in revenue from the same set of captive traffic (holding its rates constant), for a total of $11 million in revenue. Assume that the Board again determines that $10 million is the revenue adequacy mark for Year 2. The result is that the additional $1 million earned by the railroad from its competitive traffic would be transferred from the railroad to the captive shippers under either the Rebate or Benchmarking proposal—even though the captive shippers' rates have not changed at all. What rational railroad would compete for new traffic or reinvest to improve service and safety under such a regime where the railroad is deprived of the fruits of its labors?

At the oral hearing, I offered a different example to illustrate the perverse incentives generated by NITL's "Rebate" proposal. What if a revenue-adequate railroad competed for a new line of competitive business and earned $100 million on that new business? NITL's rebate proposal would seemingly deprive the railroad of the benefits and profits from this competitive business. Instead, NITL would have the railroad rebate those profits back to a subset of customers paying differentially higher rates and thus remove incentive to compete for new lines of business.

Co., Verified Statement of Prof. Bradford Cornell, *Railroad Revenue Adequacy*, STB Docket No. Ex Parte 722, at 35 (Sept. 5, 2014) (explaining that a system-wide rate-of-return cap "would dampen the incentive for railroads to take these kinds of innovative risks to improve service"); Op. Comments of the Ass'n for Am. R.R.'s, Verified Statement of Prof. Joseph Kalt, *Railroad Revenue Adequacy*, STB Docket No. Ex Parte 722 at 33-34 (Sept. 5, 2014) ("[C]ompetitive revenue adequacy is necessary to provide incentives for railroads to invest in efficient capacity expansion and system replenishment, to pursue cost saving innovations, and to respond to the opportunities presented by emerging market developments. It is sound economic policy to maintain incentives for railroads to try to earn returns in excess of their cost of capital."); Op. Comments of Union Pac. R.R. Co., Verified Statement of Prof. Kevin Murphy, *Railroad Revenue Adequacy*, STB Docket No. Ex Parte 722, at 6 (Sept. 5, 2014) (explaining that a revenue adequacy constraint would "harm competition and shippers" by bringing "into play the classic problems of rate of return regulation").

As I predicted, at the hearing NITL asserted that its Rebate approach was not rate-of-return regulation because it allows railroads to keep revenue from competitive traffic. That claim does not withstand scrutiny.

To illustrate, consider how NITL's "Rebate Reduction Approach" Attachment No. 2 changes if the railroad in that example earned an additional $100 million from new competitive traffic.

	Attachment #2 Example	Add $100 million from new competitive traffic
Railroad 2014 Revenues	$23,876,553	$23,976,553
Average Surplus	$1,273,053	$1,373,053
Potentially Captive Excess Return Share	90%	90%
Surplus Available to Potentially Captive Shippers	$1,145,748	**1,235,748**

* all dollar values expressed in thousands

NITL's original exhibit assumed that the railroad's revenues for 2014 were $23.9 billion and that the "average surplus" amounted to $1.27 billion. NITL then assumes that 90% of that "average surplus" ($1.1 billion) would be "surplus" available to potentially captive shippers. What happens if the railroad earned an additional $100 million from new competitive traffic (or from increased productivity)? The 2014 revenues would increase by $100 million, and under NITL's rebate proposal the railroad could keep only $0.10 of every additional dollar it earned. The total "surplus" available to be rebated back to potentially captive shippers would increase by $90 million, even if those additional dollars were earned entirely through improving efficiency or improving margins on competitive traffic. (The same result would hold true from any gains attributed to improved productivity. The railroad would only keep a tiny fraction of the gains it received as a result of its improved productivity, thereby diminishing exponentially the incentive to innovate.) This is textbook rate-of-return regulation, and it would carry all the negative consequences of such an approach.

How can NITL argue that railroads will keep additional revenue from competitive traffic under its proposal? They never quite say that on paper. Instead, NITL says the rebate approach "explicitly allows railroads to retain surplus revenue attributable to competitive traffic." Consol. Hearing Testimony of Concerned Shippers Ass'ns, *Railroad Revenue Adequacy*, STB Docket No. Ex Parte 722, at 28 (filed July 22, 2015).

The key caveat is the careful use of the word "surplus." The Rebate proposal only permits a railroad to keep the "excess" revenue contribution from competitive traffic, defined as revenues in excess of "fully-allocated cost." But this is an empty promise. Fundamental railroad economics teaches that railroads must engage in differential pricing precisely because competitive traffic will **not** cover fully-allocated costs. Congress itself understood and endorsed this fundamental economic principle when it adopted Staggers.[3]

Thus, if a railroad subject to NITL's rebate proposal achieved $100 million in new earnings from highly competitive new traffic with rates that fell below fully allocated costs, then there is **no** so-called "excess" revenue from that competitive traffic at all. And therefore under NITL's proposal, **all** of the additional $100 million that the railroad gained from its competitive endeavor would simply be rebated back to the "captive" traffic.

NITL's proposal is precisely the kind of discredited rate-of-return style regulation that discourages innovation and competition, but one with a convoluted way of rebating total system-wide "surplus" revenue back to a subset of shippers. Norfolk Southern strongly urges the Board to summarily reject these kinds of proposals.

B. WCTL's proposal creates different but equally problematic incentive problems.

While WCTL's proposed rate freeze is a different proposal from NITL's, it is similarly flawed. WCTL proposes a system-wide rate freeze on all captive traffic once a railroad becomes revenue adequate. While WCTL's proposal is not rate-of-return regulation, its proposed rate freeze has its own significant pitfalls reminiscent of the failed price control policies of the Nixon and Ford eras. The major problems with this approach include the following:

- **Measurement Trigger**. WCTL's proposal asks the Board to presume that any rate increase on regulated traffic by a revenue adequate railroad is an inappropriate exercise of market power. As Norfolk Southern described in its reply comments, such a presumption is simply not true. A railroad could increase a particular rate because increasing demand has tightened capacity in the transportation marketplace. Such a reaction is consistent with the basic theory of differential pricing: that prices should be responsive to demand for that particular service. A rate freeze would prevent responsive pricing adjustments based upon market demand and thus would prevent the marketplace from functioning as it should.

---

[3] H.R. REP. NO. 96-1035, at 39-40 (1980), *reprinted in* 1980 U.S.C.C.A.N. 3978, 3984-85 ("Because of the existence of competition, all rates cannot pay an equal percentage of 'fixed costs.' As in other industries, some rates will contribute more to fixed costs than others. The Committee understands the necessity of such differential pricing, and has designed a regulatory system which allows for such pricing decisions. In the absence of the regulatory flexibility which permits differential pricing, all shippers would be harmed.").

- **Legality.** WCTL's proposal creates a presumption that a rate increase imposed by a revenue adequate railroad on regulated traffic is unreasonable. This presumption would shift the burden of proof in rate reasonableness cases from complaining shippers to defendant railroads and would violate both the Interstate Commerce Act and the Administrative Procedure Act. *See* 49 U.S.C. § 11701(a); 5 U.S.C. § 556(d). Indeed, WCTL's proposal would violate the statute by having the Board place a cap on railroad rates without any factual finding that the particular challenged rate is unreasonable. It would be irrational, illogical, and illegal for the Board to presume that all rate increases—regardless of the level of the challenged rate—are unreasonable.

- **A Rate Freeze Would Deter Transportation Contracting.** WCTL's rate cap proposal would create a powerful disincentive for shippers and railroads to enter into transportation contracts. The disincentives would exist on both sides. No railroad would agree to lower a contract rate in exchange for consideration from the shipper (e.g., capital investments or volume commitments) when it knows that at the expiration of the contract, the shipper could simply seek an order from the Board capping the rate indefinitely at that historic contract level. And shippers would be reluctant to enter into contracts that could relinquish rate freeze protections.[4]

  Consider the following simple example. Assume a railroad has been deemed revenue adequate and subject to WCTL's rate cap proposal. One of its customers, a captive coal fired power plant, is significantly impacted when the price of natural gas drops suddenly and as a result that coal plant will no longer dispatch at the current delivered price of coal. The shipper requests a short term rate reduction to allow the coal power plant to continue to dispatch until the price of natural gas rises to normal levels. In this instance, the railroad would like to lower its rate to help its customer to ride out the short term dip in natural gas prices, but knows that if it did so, its rates would be frozen at those levels. Thus, a rational railroad would decline to quote a short term rate to the power plant, and the shipper would either stop dispatching the plant in the short term or pay more than it would under a regime that did not lock in place the short-term transportation rate.

---

[4] The Board has recognized that contract rates often differ from tariff rates as a result of market conditions. *E.I. du Pont de Nemours & Co. v. Norfolk Southern Ry. Co..*, STB Docket No. NOR 42125, at 57 n.3 (served Mar. 21, 2014) ("In my view, it is difficult to treat contract rates and tariff rates as apples-to-apples comparisons because contract rates are often lower for a variety of reasons, including volume commitments.") (Chairman Elliott, concurring); *see also U.S. Magnesium, L.L.C. v. Union Pac. R.R. Co.*, STB Docket No. 42114, at 18 (served Jan. 28, 2010) ("UP observed, and the Board agrees, that contract rates can in some instances be lower than tariff rates for a number of reasons (for instance, shippers in certain settings could negotiate indemnity or volume assurances with the carrier in exchange for a better rate).").

- **Scope**. Despite WCTL's claim that the scope of its proposal is limited to a small subset of traffic, in fact, the proposal would reach a significant portion of the rail network. As explained above, WCTL's proposal would discourage parties from entering into contracts and alter the regulatory scheme for all regulated traffic. It is thus not correct to focus on the amount of regulated traffic that is currently moving under tariff rates, for potentially regulated traffic moving under contracts would be equally affected by the WCTL proposal (and would likely become tariff traffic as soon as the current contract expires). Approximately 22% (by carload) of Norfolk Southern's traffic is regulated traffic or potentially regulated traffic currently moving under contract.[5] The effect of a rate cap on 22% of Norfolk Southern's traffic volume hardly constitutes an impact upon a "relatively small universe" of traffic as WCTL claims.[6]

- **Market Distortions**. WCTL's proposal brings with it all of the traditional problems associated with a rate freeze. The rate freezes proposed by WCTL would distort market signals by preventing price adjustments based upon consumer demand. Such a regime would also create shortages in available transportation options by preventing the rail industry from anticipating changing market demands. Finally, if a railroad knows that it is subject to a rate freeze on a large amount of traffic on a particular route, the incentive to invest or make improvements to that route will be low because the railroad will have no ability to recoup those costs from the very shippers who use those services.

- **Control for Service**. A rate freeze is even more senseless if the level of service is not also frozen. For example, a $10 per ton rate for service in private cars cannot be compared to a $12 per ton rate for service in railroad cars. If the Board were to travel down the path proposed by WCTL, it would be drawn into a morass of complex disputes over whether the service levels between tariffs can be compared, and if not how that would affect the rate freeze. This is a well known problem with rate freezes learned from the failed Nixon and Ford era rate control policies.

- **Internal Cross-Subsidies**. WCTL asks the Board to ignore the well-established, sound principle that a customer should pay for the facilities that it uses and not shift those costs to another customer. The rate freeze proposal would allow long-term shipper customers of a particular railroad to benefit from "locked in" rates, without providing those same benefits to new shippers or shippers with shifting

---

[5] *See* NS Op. Comments, V.S. Baranowski at Figure 1, page 3. Because this 22% of traffic volume is regulated traffic with R/VC ratios above the jurisdictional threshold, it naturally comprises more than 22% of NS's traffic on a revenue basis.

[6] WCTL Testimony, July 22, 2015 Hearing Video 1 at 1:01:10.

> movement patterns resulting from a more fluid network of customers and suppliers. Unless the Board permits the railroad to show the rate is reasonable using a *PP&L/Otter Tail* cross subsidy analysis, a rate freeze would effectively result in a cross-subsidy of stable legacy shippers at the expense of newer shippers or shippers with more fluid network demands.

For all the reasons identified above, WCTL's proposal is riddled with flaws. The Board should not adopt a proposal that would embrace a rate freeze regime that has a long and unfortunate history of problematic implementation in other regulatory arenas.

III. The Board Should Improve Its Existing Rate Reasonableness Methodologies.

The Board has made no secret of its concerns about the SAC test. However, the Board's concerns should be addressed by continuing its efforts to improve that test, not by throwing out decades of sound economic policy in favor of a regime based upon discredited rate-of-return or rate freeze regulations. The SAC test has been continually improved over recent years. Board decisions in Ex Parte 657, Ex Parte 715, and rate cases have refined the approach and eliminated disputes over many items that were hotly contested in previous cases.[7] And the Board has devoted similar time and effort to developing simplified methodologies for smaller cases in Ex Parte No. 646. The Board should continue its work to improve those methodologies.

Some shippers complain that it is too difficult for shippers to develop SAC evidence. But shippers have prevailed in multiple SAC and Three Benchmark cases decided in the last decade. And shippers have access to consultants with the necessary expertise to develop and defend SAC presentations.[8]

Others complain that SAC litigation costs are too high. But that is why the governing statute calls for "a simplified and expedited method for determining the reasonableness of challenged rail rates in those cases in which a full stand-alone cost presentation is too costly, given the value of the case," 49 U.S.C. § 10701(d)(3). And it is also why the Board developed the

---

[7] Indeed, recent SAC complainants have recognized that the Board's decisions in prior cases have "produced a well-defined body set of precedent that can be relied upon by parties in SAC cases to design a specific SARR." Op. Evidence of SunBelt, *SunBelt*, STB Docket No. NOR 42130, at I-40 (Aug. 1, 2012); *see* Op. Evidence of E.I. du Pont de Nemours & Co., *DuPont*, STB Docket No. NOR 42125, at I-54 (Apr. 30, 2012) ("the Board has developed an increasingly well-defined set of precedent that has established consistent principles for deciding a number of . . . key issues dealing with the overall design of the SARR").

[8] Indeed, DuPont touted its experts as being "intimately familiar with the operating requirements of carload railroads" and as "eminently qualified." Rebuttal Evidence of E.I. du Pont de Nemours & Co., *DuPont*, STB Docket No. NOR 42125, at III-C-13-14 (Apr. 15, 2013).

simplified remedies in Ex Parte 646. Simplified-SAC cases will be far less expensive for shippers to litigate than SAC cases. Almost every aspect of a shipper's SAC presentation will be considerably easier in a Simplified-SAC case. In Simplified-SAC cases, shippers need not hire experts to develop an operating plan, or to develop operating expenses in areas like maintenance of way or general and administrative spending. There is no dispute over what traffic to include in the SARR traffic group, for all traffic on the relevant route must be included. And the development of road property investment expenses is much more straightforward. In a SAC case, road property investment requires determination of both what infrastructure is necessary and what that infrastructure would cost. In a Simplified-SAC case, the only question is the cost of replicating existing facilities used to serve the issue traffic. And any shipper that believes this vastly simplified Simplified-SAC test is too expensive can bring a Three Benchmark challenge.

Finally, Board members suggested that SAC cases have grown difficult for the Board itself to manage. If that is the case, the Board has several tools at its disposal to make SAC cases easier to process internally. It could require that evidence be submitted in a form that is preferred by the Board (as it appears to have done in the *Consumers* case).[9] It could make better use of technical conferences to address points of contention (as it appears to have done in the *TPI* case).[10] And it could create an advisory group of technical experts, run by the Board's own Office of Economics, to recommend ways to streamline the SAC and Simplified-SAC process.

SAC and Simplified-SAC are targeted measures of revenue adequacy. No shipper contested this fact. The Board's existing suite of remedies thus already accounts for revenue adequacy, to the extent it should be considered, and the Board should reject proposals to develop another revenue adequacy constraint.

Best regards,

Raymond A. Atkins

---

[9] *See Consumers Energy Co. v. CSX Transp., Inc.*, STB Docket No. 42142 (served July 15, 2015) (adopting procedures for the format of evidence in this pending SAC case).

[10] *See Total Petrochemicals & Refining USA, Inc. v. CSX Transp., Inc.*, STB Docket No. 42121 (served May 18, 2015) (directing parties to participate in a technical conference).