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Before the U.S. Surface Transportation Board

STB Ex Parte No. 722

RAILROAD REVENUE ADEQUACY

Reply Comments

of

National Grain and Feed Association

November 4, 2014

I. Introduction

The National Grain and Feed Association ("NGFA") appreciates the opportunity to submit these Reply Comments in response to Opening Comments filed by railroad shipper and railroad interests in these proceedings on September 5, 2014.

The NGFA elected not to submit opening comments in this proceeding because it had addressed Class I railroad revenue adequacy and submitted recommendations on how the Board could take it into account in rate cases for agricultural commodities – the vast majority of which are “smaller” cases – in Docket No. EP 665 (Sub-No. 1), *Rail Transportation of Grain, Rate Regulation Review* (hereafter, “EP 665-1”). More specifically, NGFA (1) asserted that the railroads clearly are revenue adequate by any definition, even based upon what we believe to be the Board’s flawed methodology implementing 49 U.S.C. 10704(a); and (2) developed and presented to the Board a new rail rate review methodology that incorporates a Revenue Adequacy Adjustment Factor ("RAAF") into an analysis that compares the rates of movements that are similar to the issue traffic whose rate-reasonableness is being challenged by a captive rail user. Moreover, the RAAF utilizes whatever methodology the Board develops and utilizes for determining railroad revenue adequacy under 10704(a).

However, the NGFA finds it necessary to submit these reply comments to address several general points raised by rail shipper and Class I railroad parties in the opening round that relate to or expand upon points raised by the NGFA in EP 665-1, and to contest – yet again – railroad parties’ continued misrepresentation of the degree to which rail traffic for agricultural commodities is subject to market competition.

II. **Identity and Interest of the NGFA**

The NGFA, established in 1896, consists of more than 1,050 grain, feed, processing, exporting and other grain-related companies that operate more than 7,000 facilities and handle more than 70 percent of all U.S. grains and oilseeds. Its membership includes grain elevators; feed and feed ingredient manufacturers; biofuels companies; grain and oilseed processors and millers; exporters; livestock and poultry integrators; and associated firms that provide goods and services to the nation's grain, feed and processing industry. The NGFA also consists of 26 affiliated State and Regional Grain and Feed Associations, has a joint operating and services agreement with the North American Export Grain Association, and has a strategic alliance with the Pet Food Institute.

NGFA-member companies are major users of the nation's rail system. Rail carriers hauled approximately 28 percent of all commercial movements of U.S. whole grains and oilseeds in 2011, the most recent year for which data are available. While that was down significantly from the 50 percent share hauled by rail at the time of enactment of the Staggers Rail Act of 1980, rail still represents a significant modal share for major agricultural commodities. U.S. Class I railroad revenues for STCC 01 Farm Products and STCC 20 Food Products equaled $10.54 billion and $10.60 billion in 2011 and 2012, respectively. This represented 16.1 percent of Class I railroad revenues in 2011 and 15.5 percent of the revenues in 2012.

Rail also is the only viable transportation mode available to many agricultural producers and shippers. For example, nearly all the grains and oilseeds grown in Montana, more than 70 percent of the commodities produced in North Dakota, and more than half of the agricultural commodities raised in Arizona, Oklahoma and South Dakota are transported by railroad.[1] In addition, an average of 72 percent of U.S. wheat moved to domestic and export markets by rail from 2007 to 2011, as did an average 56 percent of U.S barley. For total corn movements during the same five-year period, a still-significant 26 percent moved by rail (compared to 11 percent by barge and 63 percent by truck), while 24 percent of all U.S. soybeans moved by rail (compared to 20 percent by barge and 55 percent by truck).[2]

[1] *Study of Rural Transportation Issues*, U.S. Department of Agriculture and U.S. Department of Transportation (April 2010).
[2] *Transportation of U.S. Grains, A Modal Share Analysis*, 1978-2011 Update, U.S. Department of Agriculture Agricultural Marketing Service (May 2013).

Many shippers of agricultural commodities nationwide are captive or potentially captive to a single railroad for service. Some facilities have access to only a single railroad to transport their commodities hundreds of miles to an interchange point with another railroad or to a final destination – and do not have access to economically viable or competitive truck or barge transportation. Thus, this proceeding is of great importance to shippers of grains, oilseeds and processed agricultural products derived therefrom.

III. Modifications to the Board's Formula for Determining Revenue Adequacy

The opening comments of rail shippers and rail shipper organizations provide a considerable amount of additional evidence and argument demonstrating there is no doubt that a principal policy goal of the framers of the Staggers Rail Act of 1980 has been achieved: the Class I railroads clearly have reached – and in some cases even exceeded – the revenue-adequate status Congress envisioned. For this reason, the NGFA agrees with the position of the Western Coal Traffic League ("WCTL") that "the Board's first order of business in this proceeding should be to reject any proposed changes to the revenue-adequacy model that would have the effect of making a railroad appear to be farther away from revenue-adequate status than the current methodology shows." WCTL Opening at 20. An example of the railroad parties' attempt to do this is found in the proposal by CSX Transportation, Inc. recommending that the Board revise its methodology to value rail assets by applying a methodology that uses replacement costs, rather than the "depreciated historical book value" utilized today. Attempts such as this to "move the goalposts" should be rejected by the Board.

The NGFA also continues to support the position of WCTL in EP 664 (Sub-No. 2) regarding the methodology the Board should use to calculate the cost-of-equity portion of the railroad industry current cost of capital.

IV. Implementation of the Revenue-Adequacy Constraint

A. The "Competitive Markets" Extolled by the Railroads No Longer Exist

The NGFA also concurs with the comments of rail shipper parties in this proceeding on the general consequence of a railroad achieving revenue adequacy on the rates that the railroad may charge its captive shippers. In short, legislative history of 10704(a) and the Board's rules and precedent are clear that once a railroad achieves revenue adequacy, its ability to engage in differential pricing *vis-a-vis* its captive customers is heavily circumscribed, if not prevented. WCTL Opening at 14; Alliance for Rail Competition, et al, Opening at 20-21; Concerned Shipper Ass'n Opening at 3-5.

In their opening comments, the railroad parties make various arguments which attempt to either rewrite the applicable law and precedent, argue that the revenue-adequacy constraint should not be applied to them, or both.[3] Having finally reached revenue-adequate status for the most part, the railroads now argue that finding them revenue adequate should not result in any changes to the *status quo* regarding the Board's regulation of railroad rates and service, which is the same general argument the carriers have made in EP 705, *Competition in the Rail Industry*, EP 715, *Rate Regulation Reforms*, EP 711, *Petition for Rulemaking to Adopt Competitive Switching Rules*, and EP 665-1.

A primary argument for asserting that the revenue-adequacy constraint should not be applied to them, as articulated by BNSF Railway, is that "market forces, rather than arbitrary regulatory decisions, are supposed to determine rail rate levels to the maximum extent possible." BNSF Railway Opening at 2. <u>See also</u> Union Pacific Railroad Company Opening at 1 ("Competitive market forces have fostered unprecedented private investment and service

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[3] In fact, Norfolk Southern Railway Company, having been found revenue adequate for seven of the last 10 years, and barely revenue inadequate for the two of the last 10 years, argues that "the revenue-adequacy constraint should be abandoned." Norfolk Southern Railway Company Opening at 51.

innovations in the rail industry since passage of the Staggers Act."). References to the competitive "market forces" envisioned by Congress when it enacted "the 4R and Staggers Acts, and ICCTA" also are found throughout the Association of American Railroads' Opening comments.

However, the competitive railroad market envisioned by the framers of the Staggers Act, ICCTA, and their predecessor statutes has not existed for at least a decade or more. To the contrary, this Board has heard – loudly and clearly – from the NGFA and dozens of rail shippers and rail shipper organizations in EP 705 and the proceedings spawned by it (EP 715, EP 711 and EP 665-1) that the current "market" for rail transportation is not the competitive market envisioned by Congress in 1980 and 1995 – which the railroad parties preposterously portray as continuing to exist today. For instance, railroad parties continue to leave the false impression that truck transportation is a viable competitive alternative regardless of the size of shipment or distance traveled, which in the fiercely price-competitive domestic and global grain market certainly is not the case. Further, competition from barge transportation is available to shippers and receivers only in certain specific geographic areas, and even then is highly dependent upon navigation restrictions or interruptions posed by drought-affected water levels, lock repairs or other disruptions – all of which have occurred to some degree over the past three years.

Most significantly, the consolidated U.S. rail marketplace today consists of regional duopolies, within which the major Class I railroads exercise substantial market power. This has reduced competitive options significantly for rail shippers and receivers of many agricultural products, as well as the degree to which meaningful rail-to-rail competition occurs even where it is physically possible. The railroads' portrayal in this proceeding of the "markets" as being competitive in the sense Congress intended, and at the levels that existed until approximately 2004, simply is not reality. The *absence* of such competitive markets, and their replacement with lesser duopoly competition (combined with cumbersome and ultimately ineffective rules whereby captive shippers can challenge rates they believe to be unreasonable), has resulted in significant rate increases for all rail users and has resulted in the Class I railroads becoming some of the most profitable businesses in the United States. As demonstrated by the NGFA in EP 705, EP 715 and EP 665-1, as well as its predecessor, EP 665, *Rail Transportation of Grain*, ineffective rate-reasonableness rules have enabled and emboldened railroads to extract excessive monopoly profits from captive agricultural commodity shippers, as well as to engage in practices that "de-market" shipments to and from certain types and sizes of rail users.

Remarkably, some railroad parties attempt to use the lack of competition resulting from railroad consolidation as a reason for not applying the revenue-adequacy constraint to limit their ability to extract additional revenues from captive shippers. For example, BNSF states, in criticizing the Board's use of RSAM, "But if a railroad is successful in expanding its competitive traffic base, as BNSF has been, and increasing the amount of contribution that it earns from competitive traffic, the amount of contribution it would need from its regulated traffic, as expressed in the RSAM calculation, would decline." BNSF Opening at 8. BNSF portrays this as "a perverse penalty" for expanding competitive traffic and increasing revenues from such traffic. *Id*. However, we submit that increasing a "competitive" traffic base mostly through consolidation, and thereafter increasing the contribution from that base through duopoly pricing, is not the "competitive market" for rail transportation envisioned by the framers of the Staggers Rail Act. Nor, arguably, did the framers envision that contribution from "competitive" traffic would equal or, in some cases, exceed the contribution from captive traffic, as exists today for some agricultural commodities in some regions of the United States. Rather, the framers of the Staggers Rail Act and ICCTA envisioned that true competition between carriers would result in measurably lower rates and charges for shippers with competitive options, and that the differential between revenues and costs could be made up through higher rates charged to captive shippers, until such time as the railroad achieved revenue adequacy. Contrary to BNSF's assertions, the substantial revenue benefits the carriers have received as a result of consolidation of the rail industry into regional duopolies mean that a revenue-adequate railroad is not penalized by the fact its status means it should receive less contribution from its captive shippers.

B. The Timing is Right for the Board to Consider Rail Rate Rules that Take into Account Railroad Revenue Adequacy

As NGFA asserted in EP 665-1, the combination of the Class I railroads achieving revenue adequacy and the burdensome and ineffective nature of the Board's current rate-challenge rules has created a timely opportunity for the Board to formulate new rate-challenge methodologies – which we commend the Board for undertaking with respect to "grain" in EP 665-1– that take into account the defendant railroad's revenue-adequate status. The NGFA has proposed such a methodology for agricultural shippers, the vast majority of which would not be considered "large" rate cases that are the Board's focus in this proceeding.

The opening comments of rail shipper interests in EP 722 expand upon the prior complaints of the NGFA and other shippers in other proceedings that testing the reasonableness of rail rates using the SAC constraint of the *Coal Rate Guidelines* is not workable for the vast majority of rail shippers. True to form, however, the opening comments of the railroad parties in this proceeding continue the familiar mantra that SAC must continue to be the standard to judge rail rate reasonableness. The NGFA maintains that the biggest reason for the railroads' obsessive adherence to SAC is precisely because they are well aware of the fact that it is useless for all but a very few high-revenue, high-volume, single-routing movements.

Several rail shipper commenters submitted proposals and/or recommendations on how the revenue-adequacy constraint could be applied, presumably to the "large" rate cases that are the subject of the Board's inquiry. All include recommendations on how utilizing the revenue-adequacy constraint would make the rate-review process simpler, and some describe methodologies that would entail capping or limiting rate increases by revenue-adequate railroads, in some cases utilizing revenue-to-variable cost ("R/VC") ratios. These concepts also are included in the NGFA's proposal in EP 665-1, and there are no legal or policy reasons precluding or preventing the Board from adopting such concepts in rate-challenge rules that take into account the revenue-adequate status of the defendant railroad. Arguments posited by the railroad interests to the contrary should be rejected. For example, while BNSF makes a half-hearted argument that the use of R/VC ratios for rate-setting would discourage efficient operations and capital investment, BNSF Opening at 5-6, this is merely, at bottom, a restatement of the railroads' "ratcheting" argument that has been rejected repeatedly by the Board. Moreover, BNSF fails to acknowledge that any methodology for challenging unreasonable rail rates is subject to the statutory requirement that the prescribed rate must exceed 180 percent of the defendant's variable cost of service, which helps to maintain a railroad's status as revenue adequate.[4]

<u>V. The Railroads' Claims that Applying the Revenue-Adequacy Constraint is Contrary to Shippers' Demands for Increased Investment and Better Service Should be Rejected</u>

Railroad parties also regurgitate their well-worn argument that any change to the process of giving captive shippers a reasonable opportunity to challenge rates they believe are unreasonable translates automatically into an Armageddon scenario for rail investment. Again, contrary to the assertions of the BNSF and other railroad parties, the NGFA is not "pursu(ing) the goal of reducing rail rates…." BNSF Opening at 9. Instead, the NGFA is proffering a

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[4] BNSF also erroneously asserts, without citation, that the NGFA's proposal in EP 665-1 would cap rates "at or near the jurisdictional threshold R/VC of 180%." *Id*. at 6, note 2. This is not true. Like maximum reasonable rates produced by any rail rate methodology administered by the Board, rates produced by the NGFA's formula "would still be constrained by the 180% floor, and the defendant railroad would continue to receive the revenue protections afforded by 10707(d)(1)(A)." NGFA Opening Comments and Evidence, *EP 665-1*, at 29.

simplified approach to give captive shippers the mere opportunity to challenge rates they believe are egregiously unreasonable, without any assurance they will prevail.

Further, as amply demonstrated in revenue-adequacy determinations referenced previously, the railroad industry is enjoying record profits from both competitive and captive traffic. If the rail marketplace were as truly and universally competitive marketplace as the carriers portray, they will continue to respond to the strong demand by attempting to maximize revenues by increasing the volume of traffic that is competitively served.

Contrary to BNSF's assertions, the current rail service problems being evaluated in EP 724, *United States Rail Service Issues*, are attributable in large part to the belatedness with which rail carriers foresaw and responded to the upturn in the U.S. economy and the resulting significant (and continuing) surge in demand for rail service from various sectors, including grain and agricultural products – a shortcoming that manifested itself most dramatically in shortages of available locomotive power and crews.

Further, the market power of the railroads has resulted in the elimination of service standards from shipper contracts and created uncertainty as to the extent to which, if any, their statutory common-carrier obligation continues to exist. The consolidation of the railroad industry has resulted in a handful of railroads that have increased profits dramatically while reducing service levels, and have little or no incentive to make investments in advance of projected increases in demand. Thus, there is no support for the proposition that if the Board merely refrains from applying the revenue-adequacy constraint to railroad rates and permits railroad revenues to increase further still, railroad investment, efficiency, and service levels to rail shippers subsequently would improve.

VI. Conclusion

In conclusion, the NGFA commends the Board for initiating this proceeding, and urges that it conduct a public hearing to discuss (1) potential changes to the Board's methodology for determining railroad revenue adequacy that do not have the effect of making any railroad appear to be farther away from revenue adequacy; and (2) explore the proposals discussed by shipper commenters on how to apply the revenue-adequacy constraint in large rail rate cases. In this regard, the NGFA also urges the Board to follow through on its statements that it intends to conduct a hearing in EP 665-1 to explore the proposals submitted by the NGFA and others in that proceeding.

Implementing simplified rate-challenge procedures for captive traffic that incorporate a revenue-adequacy component should provide better protection for captive shippers against abuse of rail market power while still providing more-than-sufficient revenues for rail carriers for investment in rail capacity and adequate rates-of-return.

Respectfully submitted,

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Randall C. Gordon
President

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