BEFORE THE
SURFACE TRANSPORTATION BOARD

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RAILROAD REVENUE ADEQUACY

DOCKET NO. EP 664 (Sub-No. 2)

PETITION OF THE WESTERN COAL TRAFFIC LEAGUE TO INSTITUTE A RULEMAKING PROCEEDING TO ABOLISH THE USE OF THE MULTI-STAGE DISCOUNTED CASH FLOW MODEL IN DETERMINING THE RAILROAD INDUSTRY'S COST OF EQUITY CAPITAL

REPLY COMMENTS OF ARKANSAS ELECTRIC COOPERATIVE CORPORATION

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Dated: November 4, 2014

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REPLY COMMENTS OF
ARKANSAS ELECTRIC COOPERATIVE CORPORATION

Arkansas Electric Cooperative Corporation (AECC) 1/ replies in these comments to arguments made by other parties, principally railroads, in their opening comments regarding changes in Board practices to reflect the achievement of revenue adequacy by the Class I railroad industry, and changes that ought to be made in the Board's procedures for estimating the railroad cost of capital.

SUMMARY

The Staggers Act implemented a regulatory regime that sought to maximize the reliance on competition to remedy railroad industry losses of traffic share and diminished financial health that had occurred under previous regulatory practices. Market forces in general tend to improve price and service options available to customers, while simultaneously providing suppliers with opportunities to improve their financial condition by competing to

1/ AECC will refer in this Reply to parties by their customary acronyms.

attract and serve remunerative business, innovating to enhance productivity and reduce costs, divesting unneeded assets, and deploying capital efficiently. The Staggers Act addressed the unique economic characteristics of railroads by allowing rail carriers to exercise market power under Ramsey pricing principles, but only up to the point where the railroads could cover their reasonable costs, including fixed costs and a market rate of return on required capital. The statutes explicitly defined the elements of "revenue adequacy", and directed the ICC and Board to foster and monitor its attainment. With the attainment of revenue adequacy under the Board's own criteria, the Board reasonably, properly, and logically has initiated these proceedings to consider the meaningful changes in its practices that have become appropriate under these new circumstances.

But the railroads, faced with the prospect of new and meaningful limitations on their exercise of rail market power, have effectively declined the opportunity the Board has offered them to help shape the future environment in which they will operate. Instead, they have flooded the record with every imaginable excuse for maintaining the status quo. These range from complaints regarding the methodology used in the Board's revenue adequacy determination; to fear-mongering claims that any constraints on earnings will undermine the availability of capital; to wishful assertions that even more differential pricing is needed because revenue adequacy has not actually been attained. Even when revenue adequacy is plainly indicated by the numbers, the railroads choose to fantasize that the public interest would permit the Board to sit idly by and allow the railroads to increase differential pricing still further, rather than adopt appropriate means to curtail it.

The railroad arguments, while many and varied, share two common features: (1) they would lead the Board to avoid implementing any meaningful new constraint(s) on the exercise of railroad market power; and, (2) in doing so they would trample the public interest and the Board's essential role as a guardian thereof. The statutes, the economic theories on which they rest, and the ICC/Board's own past policy statements plainly require that the Board now adapt its regulatory practices to account for the reality that revenue adequacy has been achieved by the Class I railroads. The railroad preference to preserve and extend the status quo may be understandable, but does not provide a legitimate basis for delaying or derailing needed reforms in regulatory practices.

In these reply comments, AECC addresses four major themes that the railroads have advanced in their campaign to avoid any tightening of constraints on differential pricing. Contrary to railroad arguments, AECC's reply comments demonstrate that:

- Revenue adequacy is an indicator both that railroads have achieved financial health, and that there now is a need for changed regulatory practices. The statutes, as interpreted in the Coal Rate Guidelines, require stricter regulation once revenue adequacy is achieved, and Congress has ratified that interpretation;
- New constraints on differential pricing that follow the principles articulated in the Coal Rate Guidelines would not undermine the railroads' ability to attract and retain needed capital;
- Changes in the Board's cost of capital methodology that would inflate the computed revenue adequacy level – including the proposed reliance on replacement costs and

retention of the flawed MSDCF model - are distractions that should not delay the Board's adoption of needed reforms; and,

- Such reforms are needed because current levels of competition and regulatory practices are not sufficient to prevent excessive differential pricing.

In this Reply, AECC demonstrates that the core railroad arguments do not withstand scrutiny, and that a failure to initiate meaningful change (i.e., maintaining the status quo, as the railroads advocate) would be the most harmful possible outcome of this proceeding. AECC further demonstrates that the evidence, including the few instances where the railroads have cited legitimate economic considerations, supports advancement of reform proposals presented in AECC's opening comments.

AECC does not attempt to respond to every incorrect or misleading assertion within the hundreds of pages of comments and witness statements submitted by the railroads. Such a response is not needed for the Board to put in perspective the railroads' blanket opposition to changes in the status quo, and the need for that opposition to give way under the Class I industry conditions of greatly (and to some extent, excessively) strengthened carrier financial health that have evolved.

DISCUSSION

I. The Statute Requires The Board To Revise Its Regulatory Policies To Reflect The Class I Railroads' Achievement Of Revenue Adequacy.

The railroads argue that the Board should make no changes in its regulatory policies to reflect the fact that the industry has achieved revenue adequacy, and contend that revenue adequacy is irrelevant to rail regulation. 2/ This ignores the provisions of the Staggers Act, as they have been interpreted and applied for the last three and a half decades by this Board, the ICC, and the federal courts. It also violates the entire theory of Constrained Market Pricing, which provides the basis for the permissible levels of differential pricing reflected in the statutes and in their interpretation and application. Each of these is discussed in detail below.

A. Staggers Act Requirements

As the D.C. Circuit put it, in 49 USC §10101 the Staggers Act "set forth as the nation's rail transportation policy fifteen different and not entirely consistent goals." Baltimore Gas and Electric Co. v. United States, 260 U.S. App. D.C. 1, 11, 817 F.2d 108, 112 (1987) (emphasis added). Therefore, the ICC and this Board have held an important responsibility to balance and trade-off the extent to which specific individual goals are achieved.

Not surprisingly, given the deteriorating financial condition of the freight railroad industry at the time the Staggers Act went into effect, 3/ and the explicit mandate that the agencies "shall make an adequate and continuing effort to assist those carriers in attaining" revenue adequacy (49 USC § 10704 (a) (2)), the ICC and the Board have often given priority to fostering revenue adequacy, and the courts have upheld that priority. 4/ However, the mandate provided by 49 USC § 10704(a) (2) on its face is limited to "attaining" revenue

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2/ AAR Comments (EP 722) at 6-7, 12, 26; BNSF Comments (EP 722) at 2, 5; UP Comments (EP 722) at 1; NS Comments (EP 722) at 7-9; CSX Comments (EP 722) at 27-28.

3/ See AECC Comments at 6-7.

4/ See, e.g., MidAmerican Energy Co. v. Surface Transportation Board, 169 F. 3d 1099 (8th Cir. 1999); Baltimore Gas and Electric Co. v. United States, supra; Central States Enterprises v. ICC, 780 F. 2d 664 (7th Cir. 1985).

adequacy, and provides no basis for Board action that would have the effect of supporting earnings above the revenue adequacy level. 5/ The Staggers Act explicitly contemplated that, as a result of its policies, the goal of revenue adequacy would be achieved, and that then regulatory priorities would change to provide a tighter regulatory constraint on differential pricing. Thus, the rail transportation policy specifies that when "rail rates provide revenues which exceed the amount necessary to maintain the rail system and to attract capital" – that is, when revenue adequacy is achieved – an additional obligation is imposed on the Board "to maintain reasonable rates where there is an absence of effective competition". 49 USC § 10101 (6).

When the ICC adopted its Coal Rate Guidelines in 1985, it addressed plainly and unambiguously how regulatory approaches would change once revenue adequacy was achieved. The Guidelines explain that revenue adequacy "represents a reasonable level of profitability for a healthy carrier" that "fairly rewards the rail company's investors and assures shippers that the carrier will be able to meet their service needs". Based on these principles, the Guidelines provide the following unequivocal summary:

> Carriers do not need greater revenue than this standard [revenue adequacy] permits, and we believe that, in a regulated setting, they are not entitled to any higher revenues. Therefore, the logical first constraint on a carrier's pricing is that its rates not be designed to earn greater revenues than needed to achieve and maintain this "revenue adequacy" level. In other words, captive shippers should not be required to continue to pay differentially higher rates than other shippers when some or all of that differential is no longer necessary to ensure a

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5/ For example, Merriam-Webster's definitions of "attain" include: "(1) to reach as an end; . . . and (3) to come to as the end of a progression or course of movement." By definition, "attain" does not in any way connote "exceed".

financially sound carrier capable of meeting its current and future services needs.

Coal Rate Guidelines, Nationwide, 1 ICC2d 520, 1CC LEXIS 254, *37-38 (1985) (emphasis added), *aff'd sub nom.* Consolidated Rail Corp. v. U.S., 812 F.2d 1444 (3rd Cir. 1987).

The AAR complains that "[t]his constraint is not found in the statute but rather is a creation of the ICC in *Coal Rate Guidelines*" (AAR Comments (EP 722) at 2), but this complaint is clearly wrong. The "Revenue Adequacy Constraint" discussed by the ICC puts into effect the explicit intent of 49 USC 10101 (6) that differential pricing be particularly limited where rates provide revenues that exceed the amount needed for revenue adequacy. 6/ For the last three and a half decades, rail revenues generally have not exceeded that level (as determined by the Board's methodology), so the Revenue Adequacy Constraint has essentially been dormant. This does not alter its plain basis in the statutes, or the fact that the circumstances that caused its dormancy are now past.

The AAR also issues an implied threat to challenge any action by the Board to implement a revenue adequacy constraint. 7/ But this constraint is nothing new. From the

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6/ The Coal Rate Guidelines specifically state, in fn. 36, that railroads should have an opportunity to prove, on a case-by-case basis, that they need higher than adequate revenues in specific circumstances. This shows that the baseline envisioned in the Coal Rate Guidelines is one in which the railroads do not retain earnings above the revenue adequacy level, and that the Board should ignore general and unproven claims that railroads should not face meaningful constraints on their supracompetitive earnings.

As discussed further below, curbing earnings above the revenue adequacy level also is supported by Section 10101 (5), which calls for the Board "to foster sound economic conditions in transportation".

7/ AAR Comments (EP 722) at 37 (the railroads didn't challenge the revenue adequacy constraint in 1985 because it was "purely theoretical", but now . . .).

beginning, it has been part of the common understanding of the Staggers Act that railroads were to be supported in attaining revenue adequacy, but when revenues exceeded the revenue adequacy level additional constraints on differential pricing would come into play. This interpretation of the statute was formally published 30 years ago in the Coal Rate Guidelines, and most recently was quoted by this Board in the notice initiating this proceeding. When Congress amended (in other respects) and re-enacted the Staggers Act through the ICC Termination Act (ICCTA), it implicitly ratified that understanding. "Congress is presumed to be aware of an administrative or judicial interpretation when it re-enacts a statute without change." Forest Grove School District v. T. A., 557 U.S. 230, 239-40 (2009) (quoting Lorillard v. Pons, 434 U.S. 575, 580 (1978)). See, also Commissioner Of Internal Revenue v. Estate Of Noel, 380 U.S. 678, 682 (1965) ("We have held in many cases that such a long-standing administrative interpretation, applying to a substantially re-enacted statute, is deemed to have received congressional approval and has the effect of law."); Altman v. Securities And Exchange Comm'n, 666 F.3d 1322 (D.C. Cir. 2011) (citing Commodity Futures Trading Comm'n v. Schor, 478 U.S. 833, 846 (1986)). 8/

Therefore, the principles and standards stated in the Coal Rate Guidelines should be taken as established and as governing the issues under consideration in the present docket.

8/ Altman quoted Schor as follows:

> It is well-established that when Congress revisits a statute giving rise to a longstanding administrative interpretation without pertinent change, the "congressional failure to revise or repeal the agency's interpretation is persuasive evidence that the interpretation is the one intended by Congress." quoting from NLRB v. Bell Aerospace Co., 416 U.S. 267, 274-75 (1974).

B. Economic Foundation

The statutes and the portion of the Coal Rate Guidelines referenced above implement and are rooted in fundamental economic principles that form the basis for the differential pricing by railroads permitted under the theory of "Constrained Market Pricing (CMP)". 9/ CMP recognizes that the "declining marginal cost" or "natural monopoly" characteristics of railroads mean that railroads need to charge prices above the theoretical competitive market baseline of price = marginal cost to be able to cover all of their costs and earn a market return on required capital. A zone of railroad pricing freedom above the marginal cost level is allowed because it is assumed and understood that railroad pricing will closely approximate the principles of so-called "Ramsey pricing". Under Ramsey pricing, deviations from marginal cost pricing are made in a manner that minimizes distortions in the allocation of resources relative to the competitive market standard. This is accomplished by permitting the largest deviations above marginal cost pricing for the traffic that is least sensitive to changes in price, and vice-versa (so-called "inverse elasticity" pricing). 10/ Ramsey pricing does not assume, require, or condone the unlimited exercise of rail market power. On the contrary, the entire purpose of Ramsey pricing, and the application of Ramsey pricing principles to the rail

9/ A thorough description of CMP and its relationship to rail regulatory practices is presented in ICC Ex Parte No. 347 (Sub-No. 1), Coal Rate Guidelines – Nationwide, Verified Statement of Economists Supporting the Principles of Constrained Market Pricing (June 1983) (hereafter, "VS Economists"). A copy of this document is accessible in Docket No. EP 657 (Sub-No. 1), Major Issues in Rail Rate Cases, Comments of BNSF Railway Company (May 1, 2006), VS Willig, Exhibit RDW-2.

10/ In the rail industry, pricing consistent with Ramsey pricing principles is understood to occur in practice as a result of the pricing freedoms provided to the railroads. The railroads are able to price-discriminate, and have an economic incentive to price individual movements up to the point where the traffic might be lost to its next-best option.

industry, is to minimize the harm to the economy that results from deviations from marginal cost pricing. The harms are minimized when the overall deviations are as small as possible.

Economic theory goes one step further and defines the magnitude of the deviation from marginal cost pricing needed by railroads to attract and retain capital. In a competitive marketplace, firms may temporarily succeed in achieving earnings that exceed the cost of capital, but such earnings systematically tend to attract market entry by new competitors. Such new competitors typically provide improved price/service options to attract customers while pushing returns on capital for successful incumbent firms back towards market levels. At the same time, firms that achieve returns below their cost of capital are pressured to improve performance through such actions as cutting costs, developing more attractive price/service options, etc. If such firms cannot achieve a market return on needed capital, market forces push the deployment of that capital toward other uses.

For the Board's purposes, the bottom line from all of this is that there is no foundation in competitive market principles for the type of open-ended license to engage in differential pricing that the railroads are seeking. By definition, revenue adequacy provides earnings just sufficient to provide a market return on needed assets, which replicates the outcome of a competitive marketplace. 11/

11/ Railroad parties advocate reliance on what they call "market forces" and "competitive market principles", (see, for example, BNSF Comments (EP 722) at 2, and UP Comments (EP 722) at 7), but what they describe is wanting to be left alone to engage in differential pricing to their hearts' content. That is not the pricing behavior that true competitive market principles imply for the railroad industry today.

Earnings above the competitive level cannot be sustained in most industries due to market forces, as discussed above (e.g., entry into the market of new competitors attracted by the high earnings). If such ("supracompetitive") earnings occur in industries (like railroads) with substantial barriers to entry or other limitations on the exercise of market forces, they quickly and easily can produce distortions in resource allocation that are harmful to the economy unless they are promptly and properly curtailed through regulatory or other means. Supracompetitive earnings by railroads, for example, draw investment capital away from productive uses and into bidding up of the price of rail equity, thereby harming the economy in ways the Board's regulation is supposed to prevent. 12/ For this reason, retention by railroads of sustained earnings above the revenue adequacy level would be harmful essentially by definition, and should not be given any serious consideration by the Board.

This has not stopped the railroads from imagining that the Board nevertheless will permit them to systematically retain supracompetitive earnings. 13/ UP goes so far as to suggest that the Board should compel current and future captive shippers to pay rates that support supracompetitive earnings up to the point where they offset past revenue adequacy

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12/ Even if the Board has concerns over the prospect that adverse developments could cause substandard railroad earnings in the future, the railroads already have demonstrated that they hold a huge cushion of market power above the level of revenue adequacy that they are able to exercise if needed. Based on the Board's current cost-of-capital methodology, AECC Comments, Appendix A at 3, Table A-1 shows that this cushion is over $1.8 billion per year, and has been growing in recent years. As long as any new Revenue Adequacy Constraint acts only on earnings above the revenue adequacy level, the industry already possesses a deep demonstrated reserve of protection against adverse future developments.

13/ See, for example, BNSF Comments (EP 722) at 7-8.

shortfalls. 14/ Of course, the statutory definition of revenue adequacy directs that the Board's determination be made annually, without reference to past shortfalls. 15/ Likewise, CMP provides no trace of support for this concept. The Board can safely assume that members of Congress, along with the 16 eminent economists who signed VS Economists, were well aware that individual firms and the industry as a whole were not at the revenue adequacy level at the time of the Staggers Act, and might not be for some time thereafter. The economists nevertheless identified supracompetitive earnings as a competitive abuse, and Congress provided for the identification and limitation of such earnings, all without any caveat that the railroads would be entitled to abuse future captive shippers to "make up" for adverse effects in the past. Instead, Congress defined and limited the special consideration railroads would get in the form of section 10704 (a) (2). There is no basis in the statutes or any credible economic theory for the type of reimbursement hypothesized by the railroads in their comments here.

The only stable outcome that is consistent with the public interest and with competitive market principles is for the Board to act effectively to curtail earnings above the revenue adequacy level when they arise. This mirrors the conclusion that the ICC published in the Coal Rate Guidelines almost 30 years ago, and it has not lost validity just because it has had to wait for the time to come to implement it.

14/ See UP Comments (EP 722) at 40.

15/ Section 10704 (a) (3) requires that the Board "annually determine", under standards and procedures maintained by the Board, "which rail carriers are earning adequate revenues" (emphasis added), not which ones have aggregated adequate revenues over the decades since the Staggers Act was passed.

II. Proper New Constraints on Railroad Differential Pricing Would Not Undermine the Attraction and Retention of Capital, or Productivity Improvement

Railroad parties complain at length that constraints on their earnings would interfere with their ability to attract and retain needed capital. 16/ Such arguments are completely inconsistent with the type of constraint described in the Coal Rate Guidelines. As discussed in Section I, above, the Coal Rate Guidelines describe a constraint that would only apply to the situation where carriers "earn greater revenues than needed to achieve and maintain this 'revenue adequacy' level." As long as a new Revenue Adequacy Constraint does not push earnings below the revenue adequacy level, by the definition of revenue adequacy it could not and would not interfere with the ability of carriers to attract and retain needed capital.

Some railroad parties argue further that hard caps on the earnings of individual railroads at their respective revenue adequacy levels would undermine incentives to invest in productivity improvements and cost reductions, because any profits generated as a result would be lost to the Revenue Adequacy Constraint. 17/ The Revenue Adequacy Constraint proposed in AECC's opening comments would address this concern. AECC's Revenue Adequacy Constraint proposal (AECC Comments at 22-24) is to be applied only at the regional or industry

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16/ See, for example, UP Comments (EP 722) at 3-6; NS Comments (EP 722) at 62-63.

17/ See, for example, NS Comments (EP 722) at 59-62. AECC notes that the railroads make no reference to the possibility that hard earnings caps on individual railroads could also undermine carrier incentives to compete for the traffic of other carriers, because hard caps would remove the profit potential from such competitive initiatives. As discussed further below, the Board reasonably can view this omission as another indication of the low level of intramodal competition currently being practiced by the Class I railroads.

level. Individual railroads would remain able to achieve and retain earnings above the cost of capital to the extent that they innovate and compete more effectively than the other carriers in their region or industry group. The AECC proposal implements the principles established in the Coal Rate Guidelines because it would apply only to earnings above the revenue adequacy level. The AECC proposal therefore would avoid the harmful effects the railroads generically claim for revenue adequacy constraints.

III. Railroad Proposals Regarding the Board's Cost of Capital Methodology That Would Inflate The Computed Revenue Adequacy Level Are Distractions That Should Not Delay Needed Reforms.

Although railroad parties accuse shippers of result-driven support for cost-of-capital methodology refinements, they might do well to check the mirror first. In this proceeding, the railroads have advanced at least two proposals – including reliance on replacement costs and retention of the flawed MSDCF model – whose only "virtues" appear to be the upward pressure they apply to the estimated cost of capital.

AECC's opening comments showed that, even without the inclusion of replacement costs, the Board's cost-of-capital methodology has consistently overstated the cost of capital (and thereby understated the achievement of revenue adequacy) relative to the results found by competent independent sources. Ironically, those sources include Stewart Myers, an internationally-recognized expert in finance, who was the main witness AAR presented to the Board when the current Board methodology was being developed. AECC cited AAR's past work in this area in part because it is relevant to understanding the ways the Board's methodology has veered away from its initial performance, which largely comported with information Professor Myers had supplied. AECC also cited AAR's past work because of the

Board's own explicit reliance on it, 18/ and the possibility it could provide a basis for remedial action regarding the methodology problems AECC identified. AAR, on the other hand, seems to be focused solely on preserving or increasing the big numbers that now come out of the Board's methodology – no matter how illogical or inconsistent with other evidence they may be – rather than make any legitimate attempt to reconcile them with conflicting evidence **(including its own past evidence)**.

If the railroads were correct that revenues determined by the Board to be "adequate" were in fact insufficient to attract and retain needed capital, then one would observe that in the marketplace. But one sees just the opposite, that the rail industry has no trouble attracting needed capital, and has not had any such trouble for a lengthy period of time. As discussed in AECC's opening comments, the industry's "build and maintain" expenditure is typically over $20 billion per year, of which approximately $13.5 billion represents capital spending on track and equipment; the cumulative total investment in the network by carriers since 1980 is reported by AAR to be $525 billion; the Board's own consultant, Christensen Associates, found that the industry has had access to efficient quantities of capital since 1995, and that since 2001 the industry has achieved earnings in excess of the level required to attract capital; and since 1995 there has been a dramatic increase in the payment of premiums above the values of tangible assets involved in railroad

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18/ See Docket No. EP 664, Methodology to Be Used in Determining the Railroad Industry's Cost of Capital, decision served January 17, 2008 at 10, fn. 28, as discussed in AECC Comments, Appendix A at 5-8.

mergers and acquisitions. 19/ All of this empirical evidence refutes the railroads' argument that the actual cost of capital exceeds current return levels, and substantiates the reality that the industry already has achieved and exceeded revenue levels sufficient to "attract and retain capital adequate to provide a sound transportation system in the United States." Section 10704 (a) (2).

Viewed in this context, AAR's result-driven posture speaks for itself. While the Board has an ongoing obligation to consider issues that may affect the accuracy of the cost information it provides, it has no obligation to delay needed reforms while AAR grasps at straws to preserve or extend the "cover" for excessive levels of differential pricing provided by the flaws that have become evident in the status quo.

AECC's specific replies to the railroads' opening comments regarding use of replacement costs and retention of MSDCF are presented below.

Replacement Costs

The railroads argue that the Board's revenue adequacy findings should be ignored because the Board's methodology is based on book value rather than replacement cost. 20/ CSX argues that the Board should not consider revenue adequacy or any "application of its annual revenue adequacy findings", before "developing a methodology that uses replacement costs to value rail carrier assets." CSX Comments (EP 722) at 1. CSX's own description makes clear that developing such a methodology would be a complex and time-

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19/ See AECC Comments at 13.

20/ See AAR Comments (EP 722) at 11, 27, 41; CSX Comments (EP 722) at 1-27; NS Comments (EP 722) at 5.

consuming process (during which the railroads would continue to collect supracompetitive earnings), and in the end would be unlikely to succeed in finding a satisfactory replacement cost methodology. CSX Comments (EP 722) at 6-10.

Unlike CSX, AAR says it "is not advocating in this proceeding that the Board adopt an alternative method for determining railroad ROI" in its revenue adequacy determination. AAR Comments (EP 722) at 11. Rather, AAR advocates that the Board ignore the results of its existing revenue adequacy methodology. Id. Thus, AAR's position would have the same effect as CSX's: The industry's supracompetitive earnings would continue unabated indefinitely into the future, notwithstanding the mandate of the Act.

In arguing for reliance on replacement costs or a delay in implementation of a new Revenue Adequacy Constraint to enable a replacement cost methodology to be developed and implemented, the railroads have not effectively addressed the profound problems with replacement costs the Board already has identified. Barely six years ago, the Board denied AAR's petition to institute a proceeding to consider the use of replacement costs in the Board's determination of rail revenue adequacy. 21/ In its decision denying AAR's petition, the Board referenced the extensive past consideration of potential reliance on railroad replacement costs undertaken by the ICC and two other federal agencies, and the conclusions that were reached:

> [A]fter a multi-year analysis of the issue, the ICC concluded that "[w]hile current cost accounting is theoretically preferable to original cost valuation, it cannot be practically implemented in a manner that we can be confident would produce

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21/ STB Docket No. EP 679, Association of American Railroads – Petition Regarding Methodology for Determining Railroad Revenue Adequacy, decision served October 24, 2008 ("Replacement Cost Decision").

accurate and reliable results. Standards for Railroad Revenue Adequacy, 3 I.C.C.2d 261, 277 (1986)

Two other federal agencies reached the same conclusion: that a replacement-cost approach was infeasible. In its final report, the Railroad Accounting Principles Board (RAPB) concluded that, while "current market valuation is preferable to historical valuation from a theoretical economic viewpoint," there are "serious practical problems" with such an approach. See Final Report of the RAPB, Vol II at 60-61 (1987) (RAPB Final Report). One practical concern identified by the RAPB is "the need to identify and revalue existing assets which will not be replaced." Id. at 61. In a contemporaneous study, the United States General Accounting Office (GAO) also expressed concern that a current cost approach could overstate the value of the investment base, observing that "[t]he cost of reproducing a particular asset . . . may not be a good measure of the value of the asset." See Railroad Revenues: Analysis of Alternative Methods to Measure Revenue Adequacy, GAO/RCED-87-15BR at 109 (Oct. 1986) (GAO Report). After conducting its own independent inquiry, GAO concluded that it was "not able to identify an adequate solution for the potential problems of overstating asset values under a current cost approach." Id. at 110. It explained that no one could specify a satisfactory means of identifying assets that, over the long run, would not earn returns sufficient to justify replacement. 22/

In the same decision, the Board itemized even more of the litany of practical problems that would be caused by a reliance on replacement costs. Specific additional problems mentioned include:

- "the need to estimate the 'real' cost of capital to avoid double-counting the effects of inflation"; 23/
- "adopting an approach that provides a full return on the replacement cost of all rail assets—without any inquiry into whether all assets are still used and useful—would

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22/ Replacement Cost Decision at 2-3.

23/ In advocating the use of replacement costs in calculating rates of return, the railroads seem to have forgotten this. See, for example, UP Comments (EP 722), VS Murphy at 21-22, which reflects a blatant math error by excluding the needed correction for expected inflation that the Board already has recognized.

create the perverse incentive for railroads to maintain inefficient and obsolete facilities"; 24/

- The argument of Edison Electric Institute (EEI) that there is no applicable precedent for using replacement costs to value existing regulated assets.

In light of such considerations, the Board reasonably concluded that ". . . the railroad proponents have failed to overcome the practical difficulties associated with using a replacement-cost approach to perform the annual revenue adequacy determination." It found that the likelihood of anything useful coming out of the process was so low that it declined to commit its resources to any such effort. 25/

In the current proceeding, the railroads apparently are hoping that the Board has forgotten all of that, because nothing has happened in the past six years to substantively enhance the merits of the replacement cost approach. The rail parties have not made out any type of credible case that material error, new information or changed circumstances warrant reconsideration by the Board of its 2008 decision. And even if the Board chooses not to reject this repetitious request on procedural grounds, the overwhelming practical problems with it remain.

Even more fundamentally, the railroads have failed to make a case that original cost accounting is somehow unacceptable for this use. Such a case would be difficult or

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24/ This affirms portions of the discussion at pages 14-15 of AECC's opening comments regarding the need to avoid creating incentives for "'gaming' and cross-subsidy" that could undermine the efficiency of resource allocation.

25/ Replacement Cost Decision at 5, 7.

impossible to make, given the Supreme Court's approval of the use of original costs. 26/ Use of original costs not only satisfies the statute and the Constitution, it also satisfies criteria that the railroads mistakenly cite as justification for replacement cost accounting.27/ While the railroads have tried to portray as inadequate the returns produced by use of historical costs, the Board properly has recognized the way new investment leverages upward the permissible level of differential pricing when original costs are used. This essentially guarantees the investor a market rate of return on the actual investment made, supporting fully the attraction of capital contemplated in the statutes. 28/ The railroad parties have provided no justification for earnings or differential pricing above this level.

26/ The Board's 2008 decision summarized arguments presented by EEI "that the Supreme Court has held that the Constitution is satisfied if the assets devoted to the regulated business are valued on an historical-cost basis, rather than a replacement-cost or "fair value" basis, citing FPC v. Hope Natural Gas Co., 320 U.S. 591, 603 (1944); see generally Verizon Commc'ns v. FCC, 535 U.S. 467, 481-489 (2002)."

27/ For example, UP Comments (EP 722), VS Murphy at 5 describes how assets "...must be purchased at the market prices prevailing when those assets are acquired", as if this consideration supports use of replacement costs over historical costs. In fact it is historical costs – not replacement costs – that reflect the market prices prevailing when the assets are actually acquired. Replacement costs reflect the results of assumptions and estimates necessitated by the fact that they are not based on actual costs prevailing at the time of actual acquisition transactions.

28/ This demonstrates the propriety of AECC's recommendation that the Board rescind its practice of allowing write-ups of the values of rail assets involved in merger and acquisition proceedings. See AECC Comments at 30-31. The increased earnings and differential pricing that result from this practice were not needed to secure the investment that created those assets. Moreover, the Board elsewhere has recognized that the license for carriers to exercise increased market power that is conveyed by increases in the investment base can create perverse incentives and opportunities for carriers to engage in conduct to manipulate the outcome. Replacement Cost Decision at 6. The Board can and should rely on the same basic rationale to rescind the write-up of asset values in merger and acquisition proceedings, as discussed in AECC's opening comments.

Overall, in a mature and reasonably stable industry, there is no reason to expect there to be a substantial difference between providing a market return on the stream of investments actually made vs. the stream on investments likely to be needed in the future. The Board has repeatedly elected not to pursue replacement costs, and there is no legitimate basis for now allowing this zombie concept to delay Board implementation of needed revenue adequacy reforms.

Retention of MSDCF

Railroad parties advocate retention of the MSDCF portion of the Board's cost-of-capital methodology, which WCTL's petition sought to remove. Most of the railroad support for MSDCF is based on the proposition that "two methods are better than one". While that may be so as a general proposition, AECC's opening comments detailed serious deficiencies in both the CAPM and MSDCF methodologies. Basically, the Board currently is averaging a wrong number with a really wrong number and assuming the answer must be right. Although AAR's witness Villadsen suggests ways in which MSDCF and CAPM may complement each other, AECC's opening comments documented the extent to which both methods have been exhibiting a common tendency to overstate the true value of the quantity they are seeking to measure. If you are 5 feet tall, and one funhouse mirror makes you appear 7 feet tall while a second one makes you appear 9 feet tall, you are still 5 feet tall. The averaging of two systematically wrong numbers produces a systematically wrong average. For reasons described in detail in AECC's opening comments, the Board should take no comfort from averaging the current CAPM and MSDCF results.

AECC's opening comments do provide suggestions for making the CAPM results more useful, and for replacing the input that causes MSDCF to violate the earnings criteria detailed in the Coal Rate Guidelines. If such changes are made, the Board could revisit the issue of whether the results should be averaged. Until then, the incorporation of MSDCF does nothing to enhance the accuracy or reliability of the Board's estimate.

IV. Current Levels of Competition Are Not Sufficient To Prevent Excessive Differential Pricing

The railroads assert that competition is vigorous, 29/ but their own data show otherwise. AECC does not dispute the proposition that most of the first 15 years under the Staggers Act reforms were very positive for the rail industry and its customers. Mergers and abandonments enabled the railroads to rationalize their networks without materially sacrificing competition. Substantial increases in productivity enabled prices to drop – at least for competitively-served customers - while simultaneously improving carrier financial health. AECC and numerous other coal shippers actively supported such improvements by making substantial investments in fleets of lightweight aluminum railcars, expanded and improved unloading facilities, etc. With the exception of a period of serious flooding across wide areas of the Midwest in the early 1990's, comparatively few major service problems arose during this time.

Since the mid-1990's, however, the narrative has been completely different. The mega-mergers of the mid-1990's were approved on the basis of projected efficiencies and single-line service benefits, 30/ but largely failed to deliver

29/ See, for example, UP Comments (EP 722) at 24-39.

30/ See, for example, UP Comments (EP 722) at 9.

on those expectations. 31/ The Board's own consultant found that efficiency dropped almost instantaneously when those mergers were consummated, and the merged carriers began making use of the new, sometimes-circuitous single-line routes that were insulated from competition by the Board's Bottleneck Rule. 32/ Equally disconcerting from an economic and public interest perspective is the way the rate of productivity improvement plummeted and stagnated at a low level. 33/ The long-term downward trend in inflation-adjusted rates came to an end, and by 2004 had been replaced by a long-term upward trend. 34/ Large-scale service disruptions became regular events, rather than anomalies, not just at the time transactions were consummated but also thereafter. Even the one bright spot – the sustained achievement

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31/ UP's disavowal of the harmful impacts of mergers on rates (UP Comments (EP 722) at 11) is flatly contradicted by findings from the study of rail competition conducted for the Board by Christensen Associates, which found a measurable adverse impact on rates for coal movements associated with the types of 3-2 reductions in the numbers of serving carriers that occurred as a result of the mega-mergers. See Christensen Associates, Volume 2 - Analysis of Competition, Capacity, and Service Quality (November 2009) at 12-7 though 12-9, particularly Table 12-2 at 12-9, which shows the significant response of coal rates to reductions in the number of carriers serving the vicinity of the destination.

32/ AECC presented a detailed summary of evidence regarding the adverse impacts of the mega-mergers and the Bottleneck Rule on efficiency in Docket No. EP 705, Competition in the Railroad Industry, Initial Comments of Arkansas Electric Cooperative Corporation (April 12, 2011), VS Nelson at 13-14; 22. UP Comments (EP 722) at 8 references the harms that can arise when inefficient routes are shielded from competition, substantiating (perhaps unintentionally) one of the major public interest problems arising from the combination of the mega-mergers and the Bottleneck Rule.

33/ This is illustrated most concisely by the industry-level data presented in UP Comments (EP 722), VS Butler at 6, Figure ELB-2. Since the break in the productivity trend shown in that figure occurs at the time of the UP/SP merger, the figure also rebuts UP's specific claim of productivity benefits from the UP/SP merger (UP Comments (EP 722), VS Butler at 7-8).

34/ See, for example, UP Comments (EP 722) at 12, Figure 1; at 25, Figure 8.

of revenue adequacy by the Class I industry as a whole – has occurred as a result of a pronounced increase in the exercise of rail market power over a lengthy period during which rail traffic volume has experienced little if any net growth. 35/

Taken as a whole, the experiences of the past 20 years refute the industry position that rail traffic benefits from so much competition that changes in Board practices are not needed to maintain reasonable levels of earnings and differential pricing. The data plainly show a pattern consistent with a systematic lessening of competitive pressures, at least since the mid-1990's. Efforts to strengthen competitiveness, such as productivity improvement, reduced rates, and improved services, have dwindled, in favor of pervasive increases in rates relative to costs.

The railroads have become so comfortable with this as a way of doing business that they don't seem to recognize the real significance of one of their own arguments. When they point out that they have increased differential pricing to a greater extent on unregulated traffic than they have on regulated traffic, 36/ this does not provide any basis whatsoever for relaxing concerns regarding aggregate carrier earnings or rates on regulated traffic. What it says is: (1) carriers have materially reduced the effectiveness of their competitive efforts even on traffic where they ostensibly face (and create) competition; and, (2) the increased contribution achieved from regulated traffic should cause even tighter constraints on differential pricing for

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35/ See AECC Comments, Appendix A at 4. This is corroborated by UP Comments (EP 722) at 15, which confirms the general absence of net traffic growth during this period.

36/ See, for example, UP Comments (EP 722) at 22-23.

regulated traffic, pursuant to the clear testimony of AAR's own witnesses. 37/ It is difficult to imagine a more succinct proof that the Board cannot rely on current levels of competition to properly constrain differential pricing, and that a Revenue Adequacy Constraint is needed urgently to rein in levels of differential pricing on regulated traffic not required to support revenue adequacy.

Equally unfathomable are the railroad attempts to tout service levels as an excuse for increased levels of differential pricing. 38/ With the Class I industry as a whole having been revenue adequate for over 3 years, the Board nevertheless has had to open a proceeding (Docket No. EP 724) to pursue urgently-needed remedies for the latest in the long series of widespread service deficiencies that have plagued the Class I industry in the aftermath of the mega-mergers. Given that the Staggers Act contemplated competition would lead to good service, the conclusion is unavoidable that the amount of "effective competition among rail carriers" being provided by the duopolies and the other Class I's currently is less than what is required "to meet the needs of the public", as stated verbatim in Section 10101 (4), and

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37/ See, for example, Docket No. EP 705, Competition in the Railroad Industry, AAR Reply Comments, RVS Eakin/Meitzen at 6: "a lesser markup over marginal cost is needed to achieve sufficient revenues"; at 10: "A key finding of our revenue sufficiency analysis is that the needed markup has declined in recent years, but the actual markup observed has not declined by as much."

When increases in contribution from lower-markup traffic are realized, the Board applying tighter constraints on the exercise of market power with respect to the minority of rail traffic that is regulated would not alter the overall level of allowable contribution for the carrier. It would result in more of that contribution flowing from the lower-markup traffic, which is exactly what is contemplated in Section 10701 (d) (2) (B) and by CMP.

38/ See, for example, UP Comments (EP 722) at 19.

implicitly in Section 10705 (a) (2) (C). Once again, the Board cannot rely on current levels of competition to fulfill the role of market forces envision in the Staggers Act.

Overall, the evidence –including that provided by the railroads - demonstrates that the current combination of competition and regulation is not, and for a period of years has not been, effective at limiting carrier earnings to a competitive market standard, as articulated in the Coal Rate Guidelines. AECC's opening comments provided a menu of competitive and regulatory options available to the Board that would respond appropriately to the achievement of revenue adequacy under these circumstances, and the Board should not hesitate to use them. 39/

Respectfully submitted,

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39/ UP Comments (EP 722), VS Butler at 19 describes several tangible public interest benefits in the current marketplace that would result from increased reliance on competitive access (as opposed to new construction) as a way to make efficient use of carrier resources. This supports AECC's proposals related to competitive access options. See AECC Comments at 28-30.

CERTIFICATE OF SERVICE

I hereby certify that on this 4th day of November, 2014 I caused a copy of the foregoing document to be served electronically or by first class mail on all parties of record in this docket.

Eric Von Salzen