

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

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EXPANDING ACCESS TO RATE RELIEF

COMMENTS OF UNION PACIFIC RAILROAD COMPANY

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Union Pacific Railroad Company submits these comments in response to the Advance Notice of Proposed Rulemaking served August 31, 2016 (“ANPR”). Union Pacific also joins in the comments submitted by the Association of American Railroads.

I. INTRODUCTION

The Board should not proceed with efforts to develop a more simplified version of its Three-Benchmark (“3B”) test. The Board should consider streamlining the 3B test process, but simplifying the test would be inappropriate. In *Coal Rate Guidelines, Nationwide*, 1 I.C.C.2d 520 (1985), the agency adopted a set of principles for judging the reasonableness of rail rates called constrained market pricing (“CMP”). The current 3B test has, at best, only a tenuous connection to CMP. In adopting the 3B test, the Board said it was “crude” and “very rough and imprecise.” *Simplified Standards for Rail Rate Cases*, EP 646 (Sub-No. 1), slip op. at 73 (STB served Sept 5, 2007). Union Pacific agrees. We also agree with InterVISTAS Consulting, an independent firm the Board retained to examine rate regulation, which recently concluded that “[a]ny additional simplification” of the 3B test would “deviate further from the[] characteristics of CMP and would compromise the nature of the test and its adherence to the CMP principles.”¹

¹ InterVISTAS Consulting Inc., *An Examination of the STB’s Approach to Freight Rail Rate Regulation and Options for Simplification* (“InterVISTAS Report”) at 129 (Sept. 14, 2016).

Union Pacific does not believe that the cost of 3B cases discourages shippers from filing meritorious cases. Instead, as the Board recognizes in the ANPR, shippers object to the elements of the 3B test that provide the test's connection to CMP; namely, the exclusion from comparison groups of traffic priced below the 180% R/VC level and non-defendant traffic, and the right to submit evidence regarding "other relevant factors." *See* ANPR at 6-7. Moreover, as discussed below, we believe that the proposed new procedures would on balance actually increase litigation costs.

In Part I, we discuss the Board's proposed approach to developing comparison groups for a new, more simplified version of the 3B test. In Part II, we discuss the Board's proposals to streamline proceedings.

II. COMPARISON GROUP APPROACH

The 3B test's method of having parties develop and tender a proposed comparison group is far superior to the Board's proposal to determine an initial comparison group based on default parameters. A mechanical application of inflexible default parameters to the tremendous variety of movements that occur on the nation's railroad system will not reliably produce an appropriate comparison group. The parties, who will be more familiar with the traffic at issue in each case, will inevitably propose changes to the initial comparison group. As a result, each party will be required to address the Board's initial group, develop counterproposals, and respond to the other party's counterproposals. This process will increase litigation costs as compared to the 3B test, not reduce them.

In the sections below, we first discuss some of the challenges the Board will encounter in using inflexible default parameters to identify traffic that shares similar shipping characteristics with the issue traffic. We then address issues relating to three other potential default parameters:

the use of both contract and tariff traffic, the use of traffic at or above 180% R/VC, and the use of non-defendant carrier traffic.

A. Traffic With Similar Shipping Characteristics

Union Pacific believes that parties familiar with the issue traffic are best suited to make the decisions required to develop appropriate comparison groups. A brief review of the Board's tentative proposals for identifying traffic that shares similar shipping characteristics highlights some of the challenges that would be involved in attempting to develop appropriate default parameters.

1. Mileage Band

The Board proposes to use a “+/- 15% mileage band” to identify comparable traffic. *See* ANPR at 13. Any proposal that uses a fixed mileage band will likely capture too much dissimilar traffic when evaluating longer movements and ignore too much similar traffic when evaluating shorter movements. For example, for a 1500-mile issue movement, a 15% mileage band would include all traffic moving between 1275 and 1725 miles (a range of 450 miles), while for a 500-mile movement, a 15% mileage band would include only traffic moving between 425 and 575 miles (a range of 150 miles).

Giving parties the flexibility to establish appropriate mileage bands would allow them to develop comparison groups with traffic that is more like the issue traffic than would be possible using default parameters. For example, if a comparison group would otherwise have a great deal of traffic, use of a narrower mileage band may be more appropriate. If a comparison group would otherwise have little traffic, use of a broader mileage band may be more appropriate, especially if the alternative method of expanding the comparison group would be to use a less-specific STCC. We believe that appropriate mileage cut-offs will typically be apparent from the parties' review

of the Waybill Sample data, and that the Board's establishment of an arbitrary, default mileage band would do little or nothing to reduce litigation costs.

2. Shipment Type

The Board apparently proposes to consider only one factor related to “shipment type” in identifying comparable traffic—shipment size. *See* ANPR at 13. However, other factors can have a meaningful impact on rates and costs, and thus on R/VC levels. These other factors include car type, car ownership (railroad or private), and movement type (single-line or interline). In fact, in one of the few 3B cases decided by the Board, the agency used comparison groups that included movements of different commodities, because it was concerned that the alternative comparison groups included a mix of single-line and interline traffic. *See US Magnesium, L.L.C. v. Union Pac. R.R.*, NOR 42114 (STB served Jan. 28, 2010). We believe that the parties are able to identify the relevant factors related to shipment type and to select comparable traffic from Waybill Sample data.

3. STCC Code

The Board proposes to identify comparable movements based on five-digit STCC, except for chemicals, for which the agency would use a seven-digit STCC. The Board also proposes to relax the STCC restriction if it yields a comparison group that is too small. *See* ANPR at 13-14. Again, flexibility would permit the development of more appropriate comparison groups. For example, in a case involving non-chemical traffic, if a comparison group would otherwise have a great deal of traffic, use of a seven-digit STCC may be more appropriate. If a comparison group would otherwise have little traffic, use of a broader mileage band may be more appropriate than use of a four-digit STCC. Additionally, if relaxing the five-digit or seven-digit STCC restriction would produce a large increase in the size of the comparison group, it may be better to select a smaller number of more comparable commodities at the five-digit or seven-digit level.

The STCC provision is especially inappropriate to apply as a default parameter because products at the same STCC level can have very different shipping and market characteristics. For example, STCC 32952 (clays or slags) includes commodities that move as dry bulk in hopper cars, as a slurry in tank cars, or bagged in box cars—reflecting different shipping characteristics. These various commodities are used as a filler and coating material in paper, as a filler in food, drugs, and cosmetics, as part of making foundry molds, as an ingredient in drilling mud, and as a filler in paving materials—reflecting different market characteristics. Other non-chemical STCCs include a similarly broad variety of commodities. The use of five-digit STCCs would also be problematic for chemicals shipments. For example, STCC 28123 includes both soda ash, which is used for making glass and detergent, and sodium cyanide, a very poisonous commodity used in mining for the extraction of gold and other precious metals. STCC 28182 includes ethylene oxide, a toxic inhalation hazard (“TIH”), but also non-TIH commodities. STCC 28194 includes anhydrous hydrogen fluoride, a TIH, but also non-TIH commodities. There are many other circumstances in which commodities similar enough in certain respects to share a five-digit STCC nonetheless have very different shipping and market characteristics.

Conversely, there may be commodities that are not within the same five-digit STCC that the parties most familiar with the traffic may consider to be comparable. For example, the commodities in the fourteen seven-digit STCCs most commonly used for fertilizer shipments are distributed among nine different five-digit STCCs and four different four-digit STCCs.² The

² See Reply Comments of the Fertilizer Institute at 4, *United States Rail Service Issues – Performance Data Reporting*, EP 724 (Sub-No. 4) (June 28, 2016). We are not saying that all fertilizers should always be treated as comparable commodities. We are pointing out that parties may have plausible arguments for looking at commodities more broadly than the seven-digit or five-digit STCC, depending on the facts of the particular case.

parties shipping and moving the commodities will be aware of the important distinctions and similarities; the Board’s proposal would ignore them.

4. Number of Observations

The Board proposes to use a 20-observation minimum for comparison groups. *See* ANPR at 14. A 20-observation group may be appropriate if the observations have a relatively normal distribution. However, if the distribution is skewed, a larger sample size may necessary for a comparison to be statistically valid. Although the Board could establish a minimum number of data points that may be required for a sample, it cannot simply dictate that a given number of data points will constitute a statistically valid sample size in the absence of the data.

* * *

The 3B approach allows parties to use their knowledge of the transportation conditions at issue to develop more appropriate comparison groups than would result from the use of default parameters. Under the Board’s proposal, parties would have an opportunity to propose changes to the initial comparison groups. *See* ANPR at 11. However, that opportunity would be limited. *See id.* at 18-20. Moreover, under the Board’s proposal, the parties would have to address three different potential comparison groups—the Board’s initial group, their own proposed changes, and the other party’s proposed changes. We believe that such a process will prove more costly and time consuming than the current 3B process, in which each party develops its own comparison group and responds to the other party’s proposed comparison group.

B. Other Proposed Default Parameters

1. Contract and Tariff Traffic

The Board proposes to include both contract and tariff traffic in comparison groups and to apply a “common carrier adjustment” for contract traffic in comparison groups. *See* ANPR at 14. This is another area in which flexibility would permit the development of more appropriate

comparison groups. For example, if a comparison group would otherwise have a great deal of tariff traffic, use of a tariff-only group may be more appropriate and would avoid the need to apply a “common carrier adjustment.” Similarly, use of a broader mileage band may be more appropriate in some cases to allow use of a tariff-only group. We do not believe that a default rule is appropriate.

2. Traffic at or Above 180% R/VC

Union Pacific agrees with the Board that including shipments below 180% R/VC in comparison groups would be contrary to the principle of demand-based differential pricing. *See* ANPR at 13. The only reason a comparison group approach has any connection to demand-based differential pricing principles is that the R/VC ratios for issue traffic, over which railroads may have market dominance, are being compared with R/VC ratios for traffic moving under similar demand conditions (under rates constrained by the Stand-Alone Cost test).³ A comparison group approach would make no sense if the comparison group could include traffic that is presumed competitive (because the R/VC ratio is less than 180%), and thus presumably has a higher elasticity of demand.

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

³ *See Simplified Standards*, slip op. at 73 (“A comparison approach can be instructive as to the reasonable level of contribution to fixed costs (the R/VC ratio) for a particular captive movement when a second, cost-based approach is also employed to constrain rail rates. We can assume that, in setting rail rates on captive traffic, a carrier will not exceed substantially the level permitted by the SAC constraint.”).

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

Simplified Standards, slip op. at 17; see also *Rate Guidelines – Non-Coal Proceedings*, 1 S.T.B. 1004, 1026 (1996) (holding that using traffic priced below the 180% R/VC level in a comparison group “would be inconsistent with the statute, . . . which contains an express legislative determination that no traffic with rates set below 180% is captive”).

3. Non-Defendant Carrier Traffic

Union Pacific agrees with Board decisions recognizing that non-defendant traffic must be excluded from comparison groups because “R/VC ratios of one carrier cannot fairly be compared with the R/VC ratios charged by another railroad.” *Simplified Standards*, slip op. at 82. As the Board has explained: “The reasonable level of contribution to joint and common costs (reflected by the R/VC ratio) is first and foremost a function of the amount of joint and common costs that need to be recovered,” and “[t]his will vary between carriers, creating inevitable and proper differences in R/VC ratios.” *Id.* Moreover, “the reasonable degree of differential pricing one carrier can exercise is also a function of the mix of traffic; for example, a carrier with little revenue from competitive traffic will need to recover a larger share of joint and common costs from its potentially captive traffic.” *Id.*

In addition, the use of non-defendant traffic would produce absurd results in connection with the application of a “revenue need adjustment” similar to the adjustment performed in the 3B test. See ANPR at 21. Specifically, Railroad A, if revenue inadequate, should not be required to charge lower rates simply because Railroad B is revenue adequate. Indeed, such a rule would

impair Railroad A's ability to achieve revenue adequacy. Similarly, Railroad B should not be allowed to charge higher rates simply because Railroad A is not revenue adequate.

The Board's concern that allowing non-defendant traffic into the comparison group would complicate the proceeding and increase the time and expense is well-founded. *See id.* at 15. In addition, the use of non-defendant traffic would create a practical problem; namely, railroads would be less able to avoid litigation by establishing rates they know will be found reasonable. If comparison groups can include non-defendant traffic, a railroad will not know the level at which its rates will be found unreasonable because it will not have access to other railroads' rate data. One benefit of establishing clear rules is that parties can conform their behavior to the rules and avoid litigation. The Board's proposal to use non-defendant traffic in comparison groups would lead to more rate litigation and greater uncertainty about the outcome, not less. The use of non-defendant traffic in comparison groups also raises fairness and due process issues. If such traffic were included in comparison groups, then the defendant railroad's in-house personnel presumably could never see the key data used to evaluate the defendant's rates.

The Board's proposal to include non-defendant traffic in comparison groups appears to be motivated by a concern for developing sufficiently large comparison groups. *See ANPR* at 15. However, the Board cannot solve the sample size problem by including non-defendant traffic, since the "R/VC ratios of one carrier cannot fairly be compared with the R/VC ratios charged by another railroad." *Simplified Standards*, slip op. at 82. If the Board is concerned about sample size, the appropriate solution is to modify the Waybill sampling rate—a step the Board is apparently considering. *See ANPR* at 15 n.14. If the Board chooses to advance some features of

this ANPR to a proposed rulemaking, we believe that consideration of a greater sampling rate should be part of such a rulemaking.

III. PROCEDURAL CONSIDERATIONS

The ANPR contains various proposals for “streamlining” procedures under the proposed new rate case methodology. We comment on the procedural elements of the proposed new methodology and offer a suggestion for streamlining the existing 3B test process in the sections below.

A. Preliminary Screen

If the Board were to adopt a more simplified version of the 3B test, Union Pacific would support the use of a preliminary screen to limit the amount of traffic that would be eligible for the more simplified approach. However, Union Pacific disagrees with the Board’s suggestion that the use of a preliminary screen would allow the agency to make market dominance and rate reasonableness determinations based on abbreviated evidentiary submissions. *See* ANPR at 15.

The Board lacks a statutory basis for developing special market dominance standards for small cases. While Congress requires the Board to maintain simplified methods for determining the reasonableness of challenged rates in small cases, *see* 49 U.S.C. § 10701(d)(3), it has not directed the Board to establish simplified methods for market dominance determinations.

To the extent the Board has authority to develop special market dominance standards for small cases, the proposed preliminary screen would not identify cases in which the application of a simplified approach would be appropriate. The Board is incorrect when it claims that the proposed 500-mile “length of haul” screen would “identify those movements for which truck transportation alternatives are unlikely.” ANPR at 15. There is no evidence that truck transportation alternatives are “unlikely” for traffic moving more than 500 miles. There *is*

evidence that traffic moving less than 500 miles is *highly truck competitive*.⁴ As a result, the proposed length of haul screen would screen out the easy cases—cases in which trucking is likely a competitive option. But screening out the easy cases would not make the remaining cases any easier to decide.

Similarly, the proposed “revenue per ton mile” screen would not identify cases in which the application of a more simplified rate test is appropriate. Rates “in the top 10% or 20%” of a comparison group are not “outliers.” ANPR at 16. In any group, some rates will necessarily be “in the top 10% or 20%.” Nor is it correct to say that rates are outliers if they are “one standard deviation above the mean” of a comparison group. *Id.* If rates follow a normal distribution, more than 15% will be at least one standard deviation above the mean—far too many movements to be considered outliers.

Even if the Board had an appropriate definition of outlier, relying solely on a revenue per ton mile screen to identify “outliers” would be problematic. A revenue per ton mile screen makes no allowance for shipments with higher than average costs or shipments moving in congested or constrained locations. For example, rates set to recover the absorption of switching charges or fees paid to a handling short line may appear higher on a revenue per ton mile basis, even if they actually yield a lower margin than shipments that the line haul railroad moves directly. Likewise, rates set to recover the extra fuel, maintenance, and operating costs associated with moving trains over more difficult terrain may appear higher on a revenue per ton mile basis. In addition, traffic that moves over lanes or through terminals with capacity constraints should be expected to make a relatively greater contribution to pay for the costs of adding expensive capacity. In competitive

⁴ See, e.g., Railroad-Shipper Transportation Advisory Council, Position Paper on Short Haul Rail: Challenges and Opportunities at 1 (Nov. 3, 2011), <https://www.stb.gov/stb/docs/RSTAC/RSTAC%20Short%20Haul%20Rail%20102911.pdf>.

markets, prices rise when demand is strong relative to supply, which encourages the provision of additional supply.

We believe that it is sensible to limit the application of any simplified rate reasonableness tests so as to reduce the impact of errors. Focusing on outliers seems like a reasonable limitation for a very simplified test. However, the fact that a rate appears to be an outlier would not by itself justify the application of abbreviated market dominance or rate reasonableness determinations—especially when the method of identifying outliers is itself very crude. The Board still would have to determine whether there is an absence of effective competition for the traffic at issue using its standard tools, and if the rate is subject to regulation, it would have apply a rate test based on CMP principles.

B. Limits on Discovery

If the Board were to adopt a more simplified version of the 3B test, the Board should not eliminate party-initiated discovery. *See* ANPR at 18. Parties should be allowed to pursue limited discovery regarding market dominance. The Board’s proposed initial disclosures would not give parties a fair opportunity to explore this critical issue. Under the Board’s proposal, complainants would not even be required to produce their studies and internal communications addressing alternative transportation. *See id.* at 17. In 3B cases, parties are limited to ten interrogatories, ten document requests, and one deposition. Similar limits would be appropriate for a more simplified version of the 3B test.

The Board should not, however, allow discovery of non-parties relating to non-defendant traffic. *See id.* at 18. Such discovery could impose significant burdens on non-parties that have no connection to a case. This is another reason not to permit the use of non-defendant traffic in comparison groups.

C. Submission of Evidence

Union Pacific supports the concept of reducing the number of evidentiary submissions in small rate cases. Based on our experience, we believe that simultaneous submissions of opening and reply evidence would be sufficient in 3B cases. We urge the Board to consider this and other opportunities to streamline the 3B test as an alternative to adding a fourth type of rate case proceeding.

If the Board were to adopt a more simplified version of the 3B test, we believe that two simultaneous rounds of evidence would be appropriate. Parties could use their simultaneous opening submissions to respond to the Board's initial comparison group and propose modifications. They could use their simultaneous reply submissions to respond to each other's proposed modifications. The Board could then determine whether to conduct an evidentiary hearing.

Union Pacific does not support the concept of precluding parties from filing evidence that addresses "other relevant factors." *See* ANPR at 20. Parties' ability to submit evidence regarding "other relevant factors" is already very limited in 3B cases. Parties must be able to "quantify the impact of these 'other relevant factors' on the presumed maximum lawful rate." *Simplified Standards*, slip op. at 22. Moreover, the Board prohibits parties from submitting evidence of product and geographic competition or movement-specific adjustments to URCS. *See id.* The Board has also expressly "reserve[d] the right to prohibit other categories of evidence if experience demonstrates that the introduction of such evidence would or does unduly complicate this process." *Id.*

Leaving a door open to consideration of "other relevant factors" is critical to ensuring that a crude comparison group test does not overlook significant information. This is especially so as the Board insists on considering only system-average URCS costs with no movement

specific adjustments allowed beyond the nine input variables. Indeed, the Board has already recognized one adjustment in 3B cases—an adjustment to account for use of contract rates in comparison groups—that it considers useful enough to include in its proposed new test. *See* ANPR at 14. Eliminating consideration of “other relevant factors” could preclude the Board from making important refinements to what would otherwise be an almost entirely mechanical process.

D. Board Determinations

Union Pacific disagrees with the Board’s view that the use of the proposed “preliminary screen” would allow the Board to apply a qualitative market dominance analysis that is “far more limited than in other rate reasonableness methodologies.” ANPR at 20. As discussed above, the proposed preliminary screen may screen out the easy cases, but it does nothing to simplify the market dominance analysis that must be performed before the Board can proceed with a rate reasonableness analysis in connection with any case that survives the screen.

Union Pacific also disagrees with the idea of using a commodity-specific “revenue need adjustment factor.” *See id.* at 21-22. The concept of commodity-specific revenue adequacy is inconsistent with the network nature of the railroad industry, in which assets are shared by a variety of traffic and substantial joint and common costs must be recovered using demand-based differential pricing. Given that the vast majority of the traffic that could potentially qualify for the proposed new procedures moves in manifest service, the notion of a commodity-specific revenue need factor is profoundly ironic. Single carloads moving in mixed freight trains and classified and sorted in yards along the route derive substantial benefits from the economies of scale and density by sharing assets and operations with other freight. In short, the vast majority of traffic that could qualify for the proposed new procedures benefits from the presence of the wide variety of commodities that move over rail network.

The shared nature of railroad assets is essential to CMP principles. It is reflected in the Stand-Alone Cost constraint by allowing the complainant to use non-issue traffic in their stand-alone railroad. It is reflected in the Management Efficiency and Revenue Adequacy constraints through tests that examine the defendant railroad as a whole. And it is reflected in the 3B test through application of the $RSAM \div R/VC_{>180}$ adjustment to R/VC ratios of comparison group traffic. RSAM is a system-wide, asset-based concept. It makes no sense to talk about “disaggregat[ing] the existing RSAM on a commodity-by-commodity basis.” ANPR at 22. Discarding the RSAM benchmark and altering the $RSAM \div R/VC_{>180}$ adjustment to implement some concocted commodity-specific revenue need adjustment factor would sever the 3B test’s tenuous connection to CMP.⁵

Moreover, we are puzzled by the Board’s statement that a railroad’s “revenue shortfall” should be allocated “in ways that reflect the different demand elasticities faced by different commodities.” ANPR at 22. Railroads cannot allocate their revenue adequacy shortfalls to particular commodities. We can only price each movement based on the demand conditions for that movement. It makes no sense to preclude a revenue-inadequate railroad from charging an appropriate, demand-based price for issue traffic (as determined using the current 3B test) just because other movements of the same commodity generally have lower R/VC ratios than the issue traffic and the comparison group traffic. That is a recipe for persistent revenue inadequacy.⁶ Nor does it make sense to require a revenue-adequate railroad to charge an

⁵ See InterVISTAS Report at 45 (“Each benchmark represents a simplified component of the CMP principles, and the combination of the three can be linked to the theoretical basis of CMP and Ramsey Pricing.”).

⁶ This outcome also seems contrary to the spirit of the Long-Cannon factors, because it would encourage railroads to focus on maximizing revenue from commodities that, on average, have less-elastic demand. *See id.* at 22 n.22.

especially low rate for issue traffic (as compared to a rate that would be found reasonable under the current 3B test) just because other movements of the same commodity generally have higher R/VC ratios than the issue traffic and the comparison group traffic. Rules producing such outcomes would be contrary to CMP principles.

In short, CMP principles provide some basis for adjusting permissible pricing based on system-wide revenue adequacy, as is done in the current 3B test; they do not provide any basis for adjusting permissible pricing based on average commodity R/VC ratios.

E. Limits on Relief

Union Pacific agrees with the Board that, if the Board were to develop a more simplified version of the 3B test, the relief available would “need to be significantly less than the relief available under the Three-Benchmark approach.” ANPR at 23. The limit on relief should be based on the litigation costs that a complainant would incur to bring a 3B case. *See Simplified Standards*, slip op. at 28 (“Each limit is based on our estimates of the litigation cost to pursue relief under the next more complicated, and more precise method.”).

IV. CONCLUSION

Union Pacific believes the Board’s proposed new procedures would not reduce litigation costs as compared to the current 3B test. The Board is not in a better position than the parties to develop an appropriate comparison group, and it cannot apply an abbreviated market dominance analysis. Moreover, the adoption of certain concepts the Board is apparently considering would result in a rate reasonableness methodology that is inconsistent with CMP principles. The Board should not proceed down that path.

Respectfully submitted,

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