



**U.S. Department of  
Transportation**

Office of the Secretary  
of Transportation

**General Counsel**

1200 New Jersey Avenue, S.E.  
Washington, D.C. 20590

December 19, 2008

Hon. Anne K. Quinlan  
Acting Secretary  
Surface Transportation Board  
395 E Street, S.W.  
Washington, D.C. 20423

Re: Ex Parte No. 680

Dear Secretary Quinlan:

Enclosed herewith for filing please find a letter comprising a summary of the comments of the United States Department of Transportation in the above-referenced proceeding. A complete response to the Board's request for comments in this matter, with an appropriate motion, will be forthcoming in the near future.

Please contact me if you have any questions.

Respectfully,

A handwritten signature in cursive script that reads "Paul Samuel Smith".

PAUL SAMUEL SMITH  
Senior Trial Attorney

(202) 366-9280

Enclosure



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Dear Secretary Quinlan:

The Surface Transportation Board (“STB” or “Board”) has asked for comment on an independent report it commissioned entitled *A Study of Competition in the U.S. Freight Railroad Industry and Analysis of Proposals that Might Enhance Competition* (“Rail Competition Study” or “Study”). 73 Fed. Reg. 67252 (November 13, 2008). The U.S. Department of Transportation (“Department” or “DOT”) is pleased to offer a summary of its comments on this very comprehensive review of the rail industry.<sup>1</sup>

The Rail Competition Study analyzes many critical issues germane to regulatory policymaking, including market power and its manifestation, railroad efficiencies, network capacity, and shipper captivity. DOT considers the Study balanced and thorough; it evaluates the contentions of rail carriers, shippers, and others with respect to these issues in light of existing economic analyses and other available data covering a twenty year period. The Study’s overall findings appear solidly grounded, and where the authors (Christensen Associates) cannot reach firm conclusions they appropriately call for more information and/or analysis.

The Study’s most fundamental conclusions are that railroad deregulation has been a success, that the industry must be able to engage in differential pricing to remain viable, and that overall there is no probative evidence of market power abuse -- rate increases in recent years notwithstanding. In addition, the Study finds that railroads have continued

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<sup>1/</sup> DOT has been unable to finalize its more detailed, technical response to the Study within the procedural schedule allotted for comments due to a number of factors. We nonetheless thought it preferable to provide some notice of the Department’s basic views rather than filing nothing at this time. Consistent with the Study’s view that additional data and analysis are advisable on various important issues, DOT will move for leave to file its technical discussion of the Study shortly after the Holiday season. This should not prejudice either any party or the Board’s consideration of what we anticipate will be an economically sophisticated record.

to invest in additional capacity and to improve their efficiency. Generally, then, the Study identifies no cause for immediate regulatory attention.

But the Rail Competition Study by no means dismisses all potential grounds for concern. It confirms that in recent years railroad costs and rates have increased while productivity growth has declined. The Study also identifies capacity constraints (albeit not systemic ones), and evidence of deteriorating service quality. The Study recounts that in the face of these conditions certain classes of shippers have pleaded for changes in regulation to better protect themselves, particularly as the industry has appeared to approach “revenue adequacy.”

Given its favorable assessment of the state of rail competition generally, the Study urges caution in response to these calls. It notes the need for more and better data to refine its findings in a number of areas (including the determination of shipper captivity) and to better evaluate the results of recent revisions in STB rate regulations.

The Department supports those recommendations. The Study provides no basis for taking precipitous regulatory action in any area, and in these circumstances sound public policy counsels in favor of a more measured course before considering regulatory changes. We recommend that the Board invite additional data and analyses beyond the date for comment in this proceeding.<sup>2</sup> We also encourage the Board to address the Study’s recommendations for further research. Vol. 3, Chapter 23.

In this regard DOT urges the STB to focus on two of the Study’s findings as particularly worthy of priority attention. The first is the weak correlation between revenue-to-variable cost (“R/VC”) ratios and railroad market dominance, and the second is not a stated theme but one that can be derived from the Study -- the unreliability of the current Uniform Rail Costing System (“URCS”).

The first point is important because Federal law now fixes a particular R/VC ratio as the jurisdictional threshold for the Board’s consideration of complaints about rail rates. 49 U.S.C. §§ 10701(d)(1), 10701(d)(1)(A), 10702. Although R/VC ratios above that level do not compel a specific outcome on the merits in an individual case, the Study’s finding could tend to erode confidence in the application of this metric as an indicator of market power. This is so because marginal cost, especially as measured by URCS, fails to capture structural cost issues (such as those that determine marginal costs) that are critical to any assessment of market power and abuse. Further analysis is therefore warranted.

The second point is one the Department has expressed concern about previously. The Board uses URCS, *inter alia*, to estimate the variable costs of Class I rail carrier

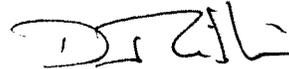
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<sup>2/</sup> Economic studies like those considered by Christensen Associates in preparing this Study are valuable resources when contemplating policy choices, but they require much more time than is allowed in administrative proceedings like this one.

movements in order to determine its rate jurisdiction and for other regulatory purposes.<sup>3</sup> The STB recently decided to use unadjusted URCS costs in rate cases, which makes the accuracy of the cost information derived from URCS ever more important.<sup>4</sup> In each proceeding DOT urged that URCS be updated to reflect the current rail industry and its costs.<sup>5</sup> The Study finds that a representative R/VC ratio for a shipment is dependent on a “good alignment of actual and measured costs.” Study, Vol. 2 at 11-26. The issue here is the accurate “measurement” of those costs. URCS now performs this function, and, as the Department has repeatedly noted, the inability of R/VC ratios as currently produced to reliably identify rail market dominance indicates that URCS does not measure variable costs accurately. Thus, URCS needs to be reformulated.

In sum, this Study should play an important role in any consideration given to proposals to alter the regulation of the railroad industry. Changes should be made only with careful attention to railroad industry economics to ensure they continue to serve the goals established by Congress for a competitive and robust rail system. The method by which rail costs are measured and the significance of R/VC ratios require further attention.

Respectfully submitted,



D.J. GRIBBIN  
General Counsel

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<sup>3</sup>/ *Adoption of the Uniform Rail Costing System for all Regulatory Costing Purposes*, 5 I.C.C.2d 894 (1989).

<sup>4</sup>/ Ex Parte No. 657 (Sub-No. 1), *Major Issues in Rail Rate Cases* (served October 30, 2006); Ex Parte No. 646 (Sub-No. 1), *Simplified Standards for Rail Rate Cases*, (served September 5, 2007).

<sup>5</sup>/ *See, e.g.*, DOT Rebuttal Comments in Ex Parte No. 657 (Sub-No. 1), filed June 30 2006; DOT Supplemental Comments in Ex Parte No. 646 (Sub-No. 1), filed February 26, 2007.