

BEFORE THE
SURFACE TRANSPORTATION BOARD

In the Matter of:)	
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STUDY OF COMPETITION IN THE)	STB Ex Parte No. 680
FREIGHT RAILROAD INDUSTRY)	
)	

The Western Coal Traffic League (“WCTL” or “League”)¹ hereby submits its comments in response to the Notice that the Surface Transportation Board (“STB” or “Board”) served in this proceeding on November 6, 2008, requesting comments on the study prepared by Christensen Associates, Inc., entitled *A Study of Competition in the U.S. Freight Railroad Industry and Analysis of Proposals That Might Enhance Competition* (the “Christensen Study”).

I. THE CHRISTENSEN STUDY TAKES THE WRONG APPROACH, FOCUSES ON THE WRONG RATES, AND REACHES THE WRONG CONCLUSIONS

The Request for Proposal that resulted in the Christensen Study, United States Department of Transportation Solicitation No. DTOS59-07-R-00020, sought “a

¹WCTL is a voluntary association, whose regular membership consists entirely of shippers of coal mined west of the Mississippi River that is transported by rail. WCTL members presently ship and receive in excess of 175 million tons of coal by rail each year. WCTL’s members are: Ameren Energy Fuels and Services, Arizona Electric Power Cooperative, Inc., CLECO Corporation, Austin Energy (City of Austin, Texas), CPS Energy, Kansas City Power & Light Company, Lower Colorado River Authority, MidAmerican Energy Company, Minnesota Power, Nebraska Public Power District, Omaha Public Power District, Texas Municipal Power Agency, Western Farmers Electric Cooperative, Western Fuels Association, Inc., Wisconsin Public Service Corporation, and Xcel Energy.

rigorous analysis of the state of competition in the U.S. railroad industry.” This analysis was prompted by the GAO-07-94 study previously conducted by the Government Accountability Office (“GAO”) in 2007, which recommended that the STB “analyze the state of competition and consider appropriate actions.” The GAO noted that “the STB does not accurately collect railroad revenue data,” with specific reference to the Carload Waybill Sample (“CWS”), and also noted the “recent rate increases” experienced by some shippers.

A “rigorous analysis of the state of competition in the U.S. railroad industry,” particularly one addressing “recent rate increases,” must focus on the extent to which railroads can and do exercise market or pricing power when they establish rates. Such a study must address the rates that a shipper pays for transportation in a given situation (origin, destination, commodity, distance, etc.) and the extent to which changes in those rates reflect changes in competition. In particular, the study must address whether shippers are paying more for such transportation and whether those increases, especially the recent increases noted in the GAO study, reflect changes in costs or increased exercise of market power by the railroads.

A study of the sort recommended by GAO must focus on currently and recently established railroad rates as contrasted with rates that were established in the past. In this regard, it must be recognized that most railroad rates, especially for coal, the commodity of interest to WCTL members, are largely governed by multi-year

arrangements. In other words, only a modest portion of effective rail rates are established in any particular year. Thus most rates in effect as of any point (or year) in time reflect only periodic adjustments of rates established in prior years.

Regrettably, the Christensen Study chooses to focus on average rates rather than contemporaneous rates.² In particular, when the study purports to analyze 2006 rates, for example, relatively few of the rates reviewed were actually established in 2006.³ For these reasons, the study is deficient in determining whether competition in the railroad industry today has changed and whether the higher rates that shippers, captive and so-called competitive alike, are now forced to pay today reflect reduced competition. Because the study fails to fulfill its primary purpose, it cannot suffice as the analysis recommended by the GAO.

²The term “average rates” is something of a misnomer since much of the study’s focus is directed to normalized median revenue per ton-mile, which will reflect changes in the characteristics and mix of movements over time (such as increased shipments from the Powder River Basin relative to shipments from eastern origins), rather than changes in the rates and costs for individual movements themselves. Additionally, the study normalizes rates by adjusting them for inflation on the basis of GDP-IPD, which is a measure of general inflation that often does not track changes in railroad costs (either input prices or productivity-adjusted output costs). The study also makes some effort to reflect railroad costs using the RCAF-A, but those efforts are flawed for reasons noted *infra*. The study’s focus on median rates introduces additional distortions, also noted *infra*.

³Current rail rates and prices could have been obtained easily by simply asking for them from the railroads and the shippers.

II. OTHER FLAWS DETRACT FROM THE CHRISTENSEN STUDY'S PROBITY

Another shortcoming of the Christensen Study is its reliance on rates as reflected in the CWS. The GAO Study reviewed and explicitly criticized the accuracy of the CWS. As the Christensen Study itself notes, the rate trend varies considerably according to the data source. In particular, the Producer Price Index (PPI) for rail transportation shows a far less sanguine rate trend, as depicted on page ES-13 of the Christensen Study. That the Christensen Study would then proceed to rely on the CWS is disturbing and perplexing in light of its inaccuracies as highlighted by the GAO and the Christensen Study itself.

The CWS is a flawed data source for rates because, as the GAO noted and even the Christensen Study itself acknowledges, the CWS does not include all revenues collected by the railroads, particularly the fuel surcharges that have been a significant component of rates in recent years.⁴ The CWS's representativeness as a sample of movements is also in doubt, as demonstrated by the problems associated with calculation of the output portion of the productivity calculation for 2006. *See* STB Ex Parte No. 290 (Sub-No. 4), *Railroad Cost Recovery Procedures-Productivity Adjustment* (STB decisions served Feb. 22, 2008, March 17, 2008, and March 28, 2008).

⁴The exclusion of fuel surcharge revenues from any analysis of railroad competition is a substantial omission. A further example of the exercise of market power is BNSF's recent decision to postpone or eliminate the rebasing of the strike price for its fuel surcharge.

The problems with the study's reliance on the CWS are exacerbated by its frequent use of the median rate (or revenue per ton-mile), which gives little or no weight to the higher rates that have recently been established. For example, the median is unlikely to vary significantly even if the new rates that are established are higher by 50%, 100%, or even more than the expiring rates, so long as a relatively modest proportion of rates are established or reestablished each year and/or the remaining rates are relatively closely clustered. Indeed, there is ample evidence in the public record that individual shippers, including WCTL members, have been exposed to rate increases of 80%, 100%, or more in recent years as their contracts expire.⁵ A study that fails to address such individual rate increases says very little about the state of current competition in the railroad industry.

Accordingly, the study's acknowledgment that the railroad industry enjoyed a sharp increase in rates and earned significantly more than its cost of capital in 2006 is very telling.⁶ Because, as noted, only a modest portion of the rates "rollover" in each

⁵See, e.g., STB Docket No. 42088, *Western Fuels Association, Inc. and Basin Electric Power Cooperative, Inc. v. The Burlington Northern and Santa Fe Railway Company* (complaint filed October 19, 2004, involving initial rate increases of 100% upon contract expiration).

⁶The cost of capital is calculated under the Capital Asset Pricing Model ("CAPM") and appears to reflect the values that the Board initially proposed, which are lower than the values that the Board ultimately adopted. However, WCTL believes that even the initial values were overstated because they reflected a historical market risk premium that is higher than what is generally considered to be the prospective market risk premium. Use of a prospective market risk premium is appropriate since the objective is to reflect the opportunity cost of capital, meaning the return needed to attract capital relative to

year, the sharp increase in average rates (sufficient to match or exceed the increase in average costs apparently applicable to all traffic in the aggregate) experienced in 2006 (with a similar increase in 2005) indicates that additional traffic is in line to receive sharp rate increases in future years.⁷ The data thus indicates that railroad excess earnings will continue to increase substantially in the future. Moreover, the increase in real rates depicted for 2004-2006 confirms that the current pricing represents a sharp deviation from the past.

The Christensen Study, when placed in proper context, indicates that traffic is experiencing rate increases far in excess of cost increases associated with that traffic; that railroads are extracting revenues in excess of the level needed for sufficiency; and that the trend will likely be exacerbated, as confirmed by the continuing increases in railroad rates and earnings in 2007 and so far into 2008, notwithstanding declining volumes. Nothing more should be required to demonstrate that the railroads are harvesting the benefits of market power and market dominance and that rail rates do not

other investments in a competitive environment. Any return above that level represents an unwarranted addition to railroad wealth at the expense of shippers and a corresponding distortion of market welfare economics.

⁷The five-year earnings projections for the industry prepared by Wall Street indicate that earnings are expected to double over that period. *See, e.g.*, yahoo.finance.com (accessed Dec. 17, 2008) (showing UP's earnings are projected at 17.58% for the next five years, amounting to a 124.7% increase). Most of the growth is projected to come from rate increases since volume and productivity growth are apt to be modest. A number of reports focus explicitly on the major increases contemplated for so-called "legacy" contracts.

reflect the forces of competition, even for shippers that are, in theory, positioned to benefit from those forces.

III. THE STUDY'S CLAIM THAT RAILROAD RATES ARE ONLY KEEPING TRACK WITH INCREASED RAILROAD COSTS IS UNTENABLE

The study's statements to the effect that railroad rates are only keeping track with increases in their costs and that competition has not been reduced in the railroad industry in recent years (*see, e.g.*, Christensen Study at ES-22) is belied by the surge in railroad earnings,⁸ the sharp appreciation in railroad stock prices,⁹ the glowing discussion of the "railroad renaissance" among not only the railroads themselves, but also Wall Street analysts,¹⁰ and the attention that the railroads have attracted from long-term equity investors to hedge funds. All of these developments are relatively recent, and all reflect both the surge in railroad earnings and rates and predictions that those increases will continue. The study's apparent suggestion that the railroads are just keeping up with increased costs cannot be reconciled with reality.

⁸*See, e.g.*, data at yahoo.finance.com (accessed Dec. 17, 2008), showing annual growth in earnings for the past five years of 23.289%, 26.572%, 23.682%, and 33.51% for BNSF, UP, NS, and CSX, respectively.

⁹*See, e.g.*, data at yahoo.finance.com (accessed Dec. 17, 2008), showing stock price appreciation for the past five years (as of December 15, 2008) of 132% for BNSF, nearly 100% for NS and CSX, and 43% for UP, as opposed to a 16% decline for the S&P 500.

¹⁰*See, e.g.*, Anthony B. Hatch, "'Railroad Renaissance': Proven True," *Traffic World* (Nov. 17, 2008), <http://www.trafficworld.com/newssection/columns.asp?id=48614>.

A possible explanation for why the study's finding that railroad rates are just keeping up with railroad costs contrasts sharply with reality probably lies in part with the study's treatment of rail costs. Instead of basing railroad costs on the Board's URCS model, the study creates its own railroad cost model. A critique of the Christensen railroad cost model is beyond the scope of these comments. Suffice it to say here, however, that the study's treatment of rail costs is both novel and vague and is lacking the workpapers needed to test its veracity, especially in terms of whether it captures the full range of efficiencies inherent in unit train operations. As an example, it is very difficult to understand why the study represents that the marginal cost for movement of agricultural products such as barley, corn, soy, and wheat is lower than that of coal. Under these circumstances, there is no reason to give any credence to the study's general conclusions. The study's notion that the railroads merely kept up with increased costs in 2006 is simply not tenable.

IV. THE STUDY'S SUSPECT PORTRAYAL OF RAILROAD REVENUES AND COSTS FLAWS ITS OTHER ANALYSES AND CONCLUSIONS

The Christensen Study's discussion of other matters is flawed by the defects noted above as well as by additional considerations. For example, the study relies heavily on its Lerner Markup Index ("LMI") analysis. The LMI analysis has two "moving parts": the rate (price) and the marginal cost. Since the rate is flawed by, among other things, use

of the CWS (which does not include fuel surcharges) and a “median” movement,¹¹ and the marginal cost analysis is flawed by use of a new and untested costing methodology that may not fully reflect unit train efficiencies, the LMI analysis is unreliable.

The LMI suffers from theoretical defects as well. Consider, for example, the software industry, where the marginal cost of an additional unit of output is effectively zero. Reliance on the LMI would lead to the conclusion that every firm in the software industry has achieved maximum market power, a conclusion that makes no sense on its face.

An additional problem with the LMI is that it focuses on the percentage mark-up rather than the absolute mark-up. Consider, for example, a product with a marginal cost of 1 and a price of 2, which equates to an LMI of 0.5 $((2-1)/2)$, that experiences a 10% increase in marginal cost (going from 1 to 1.1). In order to maintain the LMI of 0.5, the price would need to increase to 2.2 $((2.2-1.1)/(2.2))$. Under those circumstances, maintaining an LMI of 0.5 requires that the price increase (0.2) be double the amount of the increase in the marginal cost (0.1). In other words, the LMI may remain the same, but the selling firm has extracted a price increase twice as large as its increase in marginal cost.

¹¹WCTL reiterates that use of the R-1 or the PPI data regarding changes in rates over time would yield a different outcome. Those studies show rates staying the same or increasing substantially (in real terms) over the period, which should yield an increase in LMI figures.

Significantly, if the marginal cost were to decline (due to productivity gains, increasing economies of density, or other factors), the opposite would be true, that is, holding the LMI constant would require a greater than 100% pass-through of the savings. For example, with an LMI of 0.5, the 14.8%-15.1% decrease in the values forecasted for the RCAFs for the first quarter of 2009 would require a rate decrease of around 30% to maintain an LMI of 0.5 (assuming the RCAF applies to the marginal cost). For this reason, it is very significant whether one uses the GDP-IPD or some measure (such as the RCAF-5, discussed *infra*) as the deflator for the rate and cost data. In any event, the LMI is not a sufficient instrument for measuring market power under these circumstances.

The study's financial analysis is also flawed. For example, the study compares the returns in the railroad and electric utility industries, but fails to consider the relatively low leverage in the railroad industry. If the railroad industry employed additional leverage, the railroad industry would have a substantially higher return on equity and earnings per share (since the earnings would be distributed over fewer shares). The analysis also fails to take into account the substantial asset write-ups that occurred as a result of the railroad mergers in the 1990s since the increase in asset values suppresses the return on equity. In addition, the analysis notes that the railroad continues to enjoy substantial excess assets for the most part, but fails to make any adjustment for the return on those assets in considering the sufficiency of the railroads' returns.

The study's focus on the lack of growth in the price-earnings ratios of the railroad stocks as an indication that the railroads are not enjoying excessive returns is also misdirected. The railroads have been enjoying remarkable price appreciation in recent years as their earnings have grown. Moreover, there would be still further growth if the railroads took on additional leverage. The study's implication that the railroads should be functioning as growth stocks if they were abusing their market power is unfounded. Investors correctly recognize that the railroads cannot qualify as "growth" stocks because the industry is mature and the excess growth in earnings cannot continue in perpetuity, in large part because the railroads can capture only so much of the market for transportation of goods (not the fastest growing segment of the economy), and in part because of the reality that excessive rates will, eventually, result in some form of meaningful rate regulation. Another constraint is the railroads' propensity for mismanagement of various sorts, including ill-conceived or ill-implemented mergers and a failure to maintain and expand their systems appropriately, as evidenced by the UP staffing problems, the PRB Joint Line problems, and criticisms such as those that TCI previously presented regarding CSX.

Another failing in the analysis is that it uses the RCAF-A instead of the RCAF-5 to reflect historical productivity. In Ex Parte No. 290 (Sub-No. 7), *Productivity Adjustment-Implementation* (STB decision served April 1, 1997), the STB explained that the RCAF-5 "more accurately reflects all productivity data collected by the agency since

1989” and that the RCAF-A “does not measure productivity as accurately as possible.” Sl. op. at 5, 6. Even so, the RCAF-5 incorporates a significant lag in the recognition of productivity (three quarters more than the RCAF-A, which has a very substantial lag itself), and the railroads benefit from the delayed recognition of productivity gains. The competition analysis suffers when there is delayed recognition of both productivity gains and price increases as costs appear higher and current rates appear lower than they really are. Moreover, as explained above, the choice of deflator has a substantial impact when considering the absolute pass-through under the LMI calculations.

V. CONCLUSION

The Christensen Study simply does not succeed in the accomplishment of what ought to have been its central objective, which is to provide “a rigorous analysis of the state of competition in the U.S. railroad industry.” Instead, the study focuses largely on rates established in past years, thus failing to address the state of today’s railroad competition, even as of 2006. In addition to missing its primary target, the study’s findings and analysis are virtually meaningless because they are predicated on suspect railroad cost and revenue data.

In spite of these crippling flaws, the study confirms that, as of 2006, the railroads are earning more than they need to sustain themselves and are actually enjoying excess earnings, a reality that has been greatly exacerbated in 2007 and 2008. The available information, including the Christensen Study, indicates that these excess

earnings are not being reinvested in the railroads, but are instead being distributed to stockholders in the form of dividends and stock buybacks or to reduce debt. Indeed, the railroads continue to use claimed capacity shortages as a reason that they should receive further rate increases. Because the study so severely misjudges the state of the railroad industry, its views concerning various policy recommendations as to how competition might be increased cannot be given any weight.

While the Board is to be commended for initiating a good faith effort to illuminate the state of railroad competition in the United States, the Christensen Study is not the answer. The reason why perhaps lies in the fact that railroading in the United States is a \$57 billion business where the bulk of the information and data lies solely in the hands of the carriers.¹² Under these circumstances, it was probably unrealistic to expect a true competition analysis for only one million dollars.¹³

¹²See, e.g., *Rail Transportation of Coal to Power Plants: Reliability Issues* (Congressional Research Service Sept. 26, 2007) at CRS-4 (“There is limited public information on rail system capacity or service for coal shipments and other traffic. This makes it difficult to quantify the current rail capacity and service situation... The rail industry may consider detailed capacity and service data to be business and sensitive and proprietary.”).

¹³Indeed, members of WCTL have spent millions of dollars just to extract some basic data from the carriers on point-to-point movements.

Respectfully submitted,

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