Pleadings WH
224248 12/22

United States of America
Surface Transportation Board

Ex Parte No. 680

STUDY OF COMPETITION IN THE FREIGHT RAIL INDUSTRY

COMMENTS OF CONSUMERS UNITED FOR RAIL EQUITY (CURE) ON NOVEMBER 2008 REPORT OF L.R. CHRISTENSEN ASSOCIATES, INC.

Robert G. Szabo, Executive Director
and Counsel
Michael F. McBride
Van Ness Feldman, PC
1050 Thomas Jefferson Street, N.W.
Washington, DC 20007
(202)298-1800 (Telephone)
(202)338-2416 (Facsimile)

Attorneys for Consumers United for Rail Equity (CURE)

United States of America
Surface Transportation Board

Ex Parte No. 680

STUDY OF COMPETITION IN THE FREIGHT RAIL INDUSTRY

COMMENTS OF CONSUMERS UNITED FOR RAIL EQUITY (CURE) ON NOVEMBER 2008 REPORT OF L.R. CHRISTENSEN ASSOCIATES, INC.

Introduction

Pursuant to the Notice issued by the Board on November 6, 2008 (as corrected by the Notice issued on November 7, 2008), Consumers United for Rail Equity ("CURE") hereby submits its Comments on the November 2008 Report by L.R. Christensen Associates, Inc.("Christensen Report" or "Report"). CURE appreciates the opportunity to submit its Comments on the Christensen Report.

On balance, CURE believes that the Christensen Report makes the case for changes in the Board's current policy on competition issues. CURE believes that some of the conclusions contained on page five of the Executive Summary of the Report are misleading and, in fact, are not sustained by the data contained in the remainder of the Report. Indeed, the statement on page six of the Executive Summary that the very issue of "market power abuse", which GAO said the STB's follow-up study should address, is a policy issue beyond the capacity of the consultant to opine sheds significant doubt on the very purpose of the Report. Nevertheless, we find that some of the data contained in the Report is new and extremely supportive of the improvements to the <u>status quo</u> that CURE advocates.

Interests of CURE

As the Board may be aware, CURE is an incorporated non-profit advocacy group with the single purpose of seeking rail policy favorable to rail-dependent shippers, who are often referred to as captive rail customers or captive shippers. We are sustained financially by the annual dues and contributions of our members, who are individual captive rail customers and their national trade associations. Included in our group are electric utilities that generate electricity from coal, chemical companies, forest and paper companies, cement companies, agricultural entities, various manufacturers and national governmental associations whose members work to protect consumers.

Public policy regarding railroads is contained primarily in the Staggers Rail Act of 1980 and the Interstate Commerce Commission Termination Act of 1995. The cornerstone of current national rail policy regarding economic regulation is that competitive rail transportation matters should be regulated by the transportation market. Rail customers without access to transportation competition are to be protected by the Surface Transportation Board.

Our focus is not on average rates paid by rail customers or even average rates paid by all rail customers moving specific commodities. All such average rates include both rail customers with access to transportation competition and captive rail customers. Rather, we are focused on whether specific rail-dependent customers have access to railroad competition, whether that competition is physically available, but denied due to a ruling by the Board or an action by a railroad, and whether those rail-dependent customers without access to competition have access to a workable and affordable rate challenge process at the Board.

As the Board is surely aware, we believe that there are many rail customers without access to railroad competition, sometimes due to rulings of the Board or its predecessor, the Interstate Commerce Commission. We believe that several rulings by the Board and its predecessor should be overturned to allow ~~rail~~ customer access to competing railroads. We also believe that the Board's rate challenge process is unworkable and unaffordable for nearly all captive rail customers. We believe that the Christensen Report, after the first five pages of the Executive Summary, provides ample evidence of railroad market power abuse and ample support for our recommended policy improvements.

CURE'S POSITION ON THE CHRISTENSEN STUDY

Railroads provide an essential service to rail customers, especially to shippers of bulk commodities such as coal, grain, and chemicals. Indeed, a viable and efficient national rail system that moves freight reliably at reasonable rates is essential to the energy, economic and defense security of our nation. Due to their fundamental importance to our nation, Class I railroads have been and continue to be provided a number of governmental benefits and are subject to limited governmental regulation in those markets where a single railroad has a monopoly position. The express statutory objective of continuing STB regulation of monopoly railroads is to prevent railroad market power abuse of captive rail customers.

We believe, of course, based on the experiences of our members, the GAO study, the Christensen Report, and the repeated statements of Wall Street analysts, that the four major U.S. railroads possess market power, sometimes called pricing power, over many of their customers and that they are abusing this market power in many cases. Moreover, we believe that this market power has grown since 2003-04 and that the four major U.S. railroads are less and less interested in competing for rail customer business. Rather, the current focus of the four major U.S. railroads is to obtain the highest rates possible from their existing captive customers. While such behavior is permissible in competitive markets where competition serves as a limitation on pricing power, allowing such behavior in markets where railroads are not subject to market forces contravenes the intent of Congress as embodied in the Staggers Rail Act of 1980 and continued in the ICC Termination Act of 1995.

The entire case for the policy improvements we advocate can be found in Table ES-3 on page ES-11 of the Christensen Report. This table states that:

- measured by tonnage, the amount of rail traffic that we would consider to be captive (paying a rate with a Revenue/Variable Cost ratio ("R/VC") that equals or exceeds 180%), was 43% in 2001 and grew to 44% in 2006;

- the percentage of that traffic that was paying rates with an R/VC ratio more than 300% grew from 12% in 2001 to 17% in 2006; and

- the amount of traffic that moves on the rail system at less than 100% of variable costs was 14% in 2006

While the Christensen Report is based only on data through 2006, we believe that the situation confronting captive rail customers has worsened substantially since 2006. The Christensen Report does not capture the 7% overall average rail rate increase that the Government Accountability Office reports to have occurred between 2006 and 2007. Since this is an average rate increase, clearly the rates of at least some captive rail customers increased substantially more than the 7%. Escalation Consultants, a railroad economic consulting firm in Maryland, reports in the December, 2008 edition of its Rail Price Advisor that average rail rates, including fuel surcharges, on the four major rail carriers increased between 21% and 24% from the third quarter of 2007 to the third quarter of 2008. These steep price increases are not captured by the Christensen Report. Thus, we believe Table ES-3, if produced based on 2008 data, likely would present even a less favorable picture for captive rail customers.

Based on this Christensen Report Table and the average rate increases that have occurred since 2006, we are not surprised that the four major U.S. railroads reported record third quarter profits in 2008 on falling volumes. The very fact that the major railroads can, during an almost unprecedented economic recession and despite falling volumes, report record profits, indicates that the major railroads have pricing power over at least a substantial portion of their customers and are exerting it vigorously.

We captive rail customers are deeply concerned that, over a quarter of a century after Congress deregulated competitive rail traffic, the Christensen Report finds that, on a rail system that the railroads claim is capacity constrained, 14% of the freight moved, by tonnage, is moving for less than its variable costs. That simply should not be. Our obvious concern, of course, is that the railroads will "make up" any under-recovery from this traffic on the only rail customers available for such "surcharges": captive rail customers.

Recently, there have been a number of Wall Street analyst statements that the railroads are "pressing the regulatory envelope" with their pricing and expect no substantial restraint from the STB. Unfortunately, based on past actions, CURE agrees with these analyst observations. CURE encourages the Board to counteract this perception by taking aggressive action to restrain railroad abuse of pricing power, particularly in this time of economic difficulty for the consumers and businesses of America.

CURE COMMENTS ON SELECTED CHRISTENSEN REPORT FINDINGS

We would like to focus our Comments on two statements made in the Christensen Report and then conclude our main Comments by also discussing Christensen Report statements concerning some of the proposed policy changes contained in legislation pending in the 110th Congress.[1]

On page ES-5 of the Report, there is the following conclusory statement:

"Current market circumstances imply that providing significant rate relief to certain groups of shippers will likely result in rate increases for other shippers or threaten railroad financial viability."

We strongly disagree with this statement and, in fact, believe it does not reflect sound economic theory. The very basis for deregulating the major railroads, which the recent Rand Study for the UPS Foundation references as a "natural monopoly," was that the rates for competitive traffic would be regulated by the competitive transportation market. In deregulated markets, Congress intended that railroad rates be established by the market, rather than set by the railroad.

We believe that the operating assumption of the Board, Wall Street, rail customers, and railroad shareholders, is that the railroads are collecting the maximum rates the market will allow them to collect from rail customers with access to transportation competition. Thus, if captive rail customers begin winning substantial rate relief from the STB, the railroads may wish to increase rates on competitive rail customers but will only be able to raise them if the competitive market will allow such rate increases. If this operating assumption is

[1] The attached Addendum contains additional comments on specific aspects of the Christensen Report that we submit "for the record."

not correct and railroads are price setters in every transportation market, then this fact, along with the new information that almost half of the rail freight by tonnage is captive, would seem to cast significant doubt on whether the major railroads should be partially deregulated. CURE has not, to this date, in its advocacy suggested that partial deregulation should be revisited. Rather, our goal is to ensure that regulatory mechanisms function as intended by Congress, balancing properly the interests of captive rail customers and the financial needs of the railroads.

In enacting the Staggers Rail Act of 1980, Congress clearly contemplated that some rail customers, namely captive rail customers, could obtain significant rate relief from the Interstate Commerce Commission, now the Surface Transportation Board, if the challenged captive rate is "unreasonably high." By directing the ICC, now the STB, to protect captive customers from unreasonable rates, Congress anticipated in 1980 that some captive rail customers could achieve reductions in their rates. Congress did not suggest that other rail rates would increase if captive rail customers achieve a reduction in a rate that is "unreasonably high". Of course, this issue has been largely academic in recent years, given the very limited relief that the Board has granted to those few rail customers who have challenged captive rail rates.

Finally, the "threaten railroad viability" portion of this statement can only be read to mean that the authors of the Report were focused only on the revenue to the major railroads and may even suggest that the authors of the Report were perhaps disproportionately focused on the interests of the major railroads.[2] As we all know from handling our personal finances, the profitability of the railroads depends not simply on the revenue received by the railroads, but the delta between the revenue received and the expenses of the railroads. The authors' statement seems to completely ignore reduction of expenses as an option for the railroads to maintain their profitability. For example, perhaps the railroads could cease moving the 14% of their freight that does not pay at least its variable costs of transportation.

---

[2] GAO recognized the limitations of the Carload Waybill Sample (CWS), and recommended that the STB develop better data to determine the answers to some of the questions it could not answer. Unfortunately, Christensen Associates seems to have relied on the CWS, despite its limitations. For example, we know that in their filings with the STB, some railroads included fuel surcharge revenues in the Rate field, others in the Miscellaneous field. Therefore, it is not possible to determine total rate and surcharge revenues accurately from this data. The STB did not require uniformity in reporting until 2008. Therefore, the Christensen Report could not arrive at reliable conclusions about railroad revenues, rate reasonableness, and profitability by using CWS data only through 2006.

On page ES-26, the authors include this interesting statement:

"Railroads appear to exercise some degree of local market power where possible, but are tempered by the prospect that large markups may elicit regulatory attention if not direct intervention. That is, monopoly railroads may effectively cede some market power to avoid regulatory scrutiny".

Monopoly railroad temperance may be the view from the perspective of the economists who prepared the Report, but we assure the Board that our captive rail customer members are not confronting monopoly railroad temperance in their contract negotiations or even their daily interaction with their railroad carriers.

First, this statement is, of course, an acknowledgement of the obvious: as to some rail customers, the major railroads continue to have monopoly power. We are pleased that the Christensen Report acknowledges this basic fact.

Second, in enacting the Staggers Rail Act of 1980, Congress did not believe it was adequate to hope that monopoly railroads would restrain their market power to avoid regulatory scrutiny. Rather, Congress directed the federal regulatory agency to ensure that the railroads are not abusing their market power. We believe strongly that the current policies of the STB do not protect captive railroad customers from monopoly abuse, as directed by Congress. The recent statements of Wall Street analysts applauding the railroads for the aggressive exercise of their pricing power, while running little risk of STB intervention, verify this concern.

Third, this notion of "self control" is a dubious proposition. Railroad companies, as privately held for-profit organizations, have a fiduciary duty to maximize their profitability for their shareholders. Indeed, we are all aware of the controversy surrounding CSX and a contingent of its shareholders that believes that CSX is not maximizing its profitability and that are calling for a doubling of CSX average rates over 10 years. In light of these countervailing pressures, captive rail customers cannot rely on monopoly railroads "tempering" their monopoly power. Given the level of their current rates, many rail customers would wonder how high "un-tempered" rail rates would be anyway.

Finally, the nature of the public policy concern is more properly whether the potential for abuse of market power exists. Antitrust regulation in the U.S. is focused on the potential to harm customers (see, e.g., FTC v. Indiana Federation of Dentists, 476 U.S.447, 459 (1986)), because it is unreasonable to assume that a business, with an obligation to maximize profit, would opt to forgo profit. When that profit motive, otherwise proper, comes from a monopoly entity, the inquiry is properly on the potential to abuse. Because the major railroads do retain monopoly power over at least some of their customers and the STB, we believe, has failed to restrain this monopoly power effectively, CURE strongly supports enactment of the Railroad Antitrust Enforcement Act of 2007 (H.R.1650 and S.772 in the 110th Congress). This legislation will require STB's regulatory program and decisions, as well as the actions of the railroads, to comply with the nation's antitrust laws. We are pleased that the American Bar Association's Section on Antitrust Law has recently called on Congress to enact this important legislation.

CHRISTENSEN REPORT COMMENTS ON PROVISIONS IN LEGISLATION PENDING IN THE 110TH CONGRESS

Pro-Competitive Provisions

The Christensen Report comments on four so-called "open access" provisions, three of which it says are contained in pending legislation: reciprocal switching agreements, terminal agreements, the quotation of bottleneck rates and trackage rights agreements.

First, CURE wants to be on record clearly that it has not in the past advocated, and does not contemplate in the future advocating, mandatory trackage rights, other than in the context of terminal agreements, which are well-established as ordinary operating arrangements between railroads. We understand fully that comprehensive trackage rights would undermine a major premise of the Staggers Rail Act of 1980, namely differential pricing, and would require an entirely new economic regulatory treatment for the nation's major railroads.

Second, we agree with the Christensen Report that reciprocal switching agreements and terminal access agreements can allow more captive rail customers access to transportation competition and the STB's policy on such arrangements should be improved. Consistent with the provisions on this subject in the pending legislation, the STB can improve access to these arrangements by simply removing its restriction on the "public interest" test that was added in the mid-1980's by the ICC's Midtec decision. By restricting its finding of "public interest" to those situations where "monopoly abuse" can be shown, the ICC, predecessor to the STB, transformed a relatively simple and straightforward proceeding into a mini-antitrust case. We would encourage the STB to remove the "monopoly abuse" restriction on the "public interest" test from its rules and procedures immediately.

Third, we disagree with the Christensen Report in its comments on the "quote a rate for bottlenecks" remedy and believe that its statements are based on some confusion regarding this remedy. The confusion is exhibited in Table ES-8 on page ES-39 and the graph in Figure ES-15 on page ES-40. The Table states that the bottleneck solution would have a potentially large effect on railroad profitability while being the least likely to provide shipper gains. Of course, this statement seems to make little sense on its face: how could a remedy have a large effect on railroad profitability while providing little relief for a shipper?

The answer to this confusing statement, based on our conversations with the authors, lies in the graph in Figure ES-15 and, perhaps, the economists' assumption that moving cars from a bottleneck carrier to a competing carrier would be an inefficient effect of the "bottleneck" remedy. The graph indicates the "bottleneck" quote-a-rate provision would provide significant shipper benefits where the "bottleneck" is relatively short, but the least benefits where the "bottleneck" is one-half the overall length of the movement.

Rail customers only view "bottlenecks" as those situations involving relatively short distances to a competing carrier, relative to the overall length of the movement. Apparently, the authors considered this length of movement to be covered by the reciprocal switching remedy. Rail customers do not consider a "bottleneck" to be one-half the length of the overall movement. According to Figure ES-15, quoting rates over relatively short "bottlenecks" to a competing railroad would provide significant savings for shippers.

Finally, shippers understand – and the Christensen Report authors conceded to the STB during its open hearing questioning on November 6, 2008 - - that the rail carrier that holds a customer captive at either the origin or the destination has an advantage in the competition to keep the customer's freight on their system for the entire length of the movement. If the freight remains on the incumbent carrier's system, there would be no additional costs, such as reciprocal switching fees, for moving cars to the competing railroad. Thus, the incumbent carrier will have an advantage in the negotiation to hold the traffic on its system. Of most importance to captive rail shippers, however, is that the total price for the entire movement from the incumbent carrier is likely to be lower if the bottleneck quote a rate provision is adopted. Based on their strong statements in support of the free market system, rail customers are assuming that non-incumbent major railroads will compete vigorously for the competitive portion of these movements. If strong competition is to emerge for the competitive length of these movements, then the rail customer will pay a lower price for the entire movement, regardless of whether the incumbent or non-incumbent carrier wins the right to move the freight over the competitive portion of the movement.

While the Christensen Report seems to misunderstand the fundamentals of shipper concerns regarding bottlenecks, it totally ignores another pro-competitive issue of great importance to shippers: "paper barriers". These provisions in track lease agreements prevent customers of a short line from gaining access to two or more major railroad systems. CURE believes that "paper barriers" are inconsistent with the Staggers Act, would violate the nation's antitrust laws if those laws applied to these transactions, and are a serious impediment to increased competition in the industry, all reasons that these provisions must be removed from existing line lease agreements and prohibited from being included in future line lease agreements, either by the Board or through legislation pending in the 110th Congress.

Rate Challenge Process

The Christensen Report does not address this issue, except to report that, based on its qualitative interviews, rail customers are deeply frustrated by the current rate challenge process. We would add that the Board should be concerned about its current rate challenge process in light of two facts: (1) the high percentage of grain movements that Christensen identifies as being captive and reported rail rates on those grain movements of more than 7 times the variable costs of those shipments; and (2) the fact that a rate challenge can only be brought to the STB and no agriculture rate challenge has been brought to the STB or its predecessor since 1982!

One of the reasons that the rate challenge process is unworkable is the financial cost and delay in obtaining a decision on these challenges. For this reason, CURE advocates that the Board adopt the policy that market dominance is proven when the rail customer proves that the rate being challenged exceeds 180% R/VC. The Christensen Report objects to this policy noting that some rail traffic moving below 180% may be captive and some rail traffic moving above 180% may have access to competition. Thus, the Report recommends the use of the Lerner index to prove the presence of railroad market dominance.

The last thing the Board's rate challenge process needs is the introduction of a complicated new "proof" of the presence of railroad market dominance. This would make an already costly, unworkable and long process even more costly, more unworkable and more time consuming.

We continue to believe, in light of the level of most competitive rail rates, that the simple proof that the rate in question is 180% R/VC is sufficient to show the presence of railroad market dominance. That some rates below this level may be captive is moot, because the STB lacks jurisdiction to provide relief. That some competitive rates are higher than 180% R/VC is of little consequence because the competitive shipper is likely to be happy with the rate (surely not unhappy enough to encounter the Board's rate challenge process) and likely the rate in question is in a contract anyway, thus shielded from review by the STB.

We acknowledge that the STB has attempted to improve its rate challenge procedures both for full rate cases and small shipment rate cases. Unfortunately, these improvements have fallen short, as indicated by the small number of cases that continue to be brought to the Board and the continuing complaints of shippers. We respectfully submit that the rate challenge process will not become workable and affordable until the STB requires railroads to justify their captive rates in rate challenge cases and abandons its "stand alone cost" methodology. We believe the stand alone cost rate standard should be replaced by the "cost of service plus a reasonable rate of return" standard that is used by almost every other American economic regulatory commission that exists at the federal or state level.

The Board has ample legal authority and ample discretion to adopt a more workable rate standard and, indeed, suggested in the Coal Rate Guidelines, Nationwide, 1 I.C.C.2d 520 (1985), that it would modify the "stand alone cost" standard when the railroads were earning adequate revenues. Clearly, based on the Report and current analyst statements from Wall Street, the railroads are financially healthy and the time has come for the STB to adopt a workable and affordable standard that will provide access to the STB for rate challenges by large and small shippers, regardless of their financial means. Anything less protects current railroad monopoly pricing power.

CONCLUSION

In conclusion, with the exception of some unfortunate and unsupported statements, we believe the Christensen Report contains important data that makes the case for the policy changes CURE advocates. As the data in the Christensen Report makes clear, and more recent pricing data suggests even more strongly, the status quo is not acceptable. Current policy is not providing the rail system the nation needs: a rail system that moves freight for all rail customers reliably and at reasonable rates. Until there is significantly more competition in the rail industry, the very basis of partially deregulating this "natural monopoly" must be questioned.

We suggest strongly that the time for studies is over and the time for action by the STB and the Congress has arrived.

Respectfully submitted,

Robert G. Szabo

Robert G. Szabo, Executive Director
and Counsel
Michael F. McBride
Van Ness Feldman, PC
1050 Thomas Jefferson Street, N.W.
Washington, DC 20007
(202)298-1800 (Telephone)
(202)338-2416 (Facsimile)

Attorneys for Consumers United for Rail Equity (CURE)

December 22, 2008

ADDENDUM TO COMMENTS OF CONSUMERS UNITED FOR RAIL EQUITY ON NOVEMBER 2008 REPORT OF L.R, CHRISTENSEN ASSOCIATES, INC.

Introduction

Until 2004 or so, there was evidence of substantial competition in the railroad industry, such as for coal movements from the Powder River Basin ("PRB"). However, starting at about that time, rates began to increase substantially, railroads have refused to compete (even when coal shippers have access to two railroads), and there has been at least tacit collusion by the railroads, such as in the establishment of their fuel-surcharge programs.

Railroads often act as monopolies, as evidenced by the fact that the amount of traffic with an R/VC ratio in excess of 180% (the threshold for STB jurisdiction) has increased substantially. In the circumstances, there is almost no limit to what railroads can charge their captive customers. Such abuses are not legitimate, but the current rate-reasonableness process at the STB does not permit most shippers to obtain a reasonable rate (even though Congress directed the STB to create a process that produces such rates).

GAO's 2006 Report stated that it could not reach final conclusions about important aspects of the state of competition (or the lack thereof) in the railroad industry, due to lack of data. It urged that the STB conduct a follow-on report, relying on its access to the necessary data, and draw conclusions about abuses by railroads of their market power.

The Christensen Report presented a wonderful compendium of data, which is useful, but as we have already stated, it did not address the fundamental problem, which is whether railroads are abusing their market power. Moreover, the Christensen Report ended with 2006 data, and so it was instantly out-of-date. Everyone knows that railroad rates generally have increased substantially in 2007-08, and therefore the Christensen Report is not helpful in determining whether railroads are abusing their market power or whether they are now earning returns in excess of their cost of capital. There are many reports of Wall Street analysts in 2007-08 which make clear the extent of the railroads' market power, their determination (indeed, at Wall Street's urging) to raise rates as high as possible, and the fact that railroad earnings are now sufficiently high to make railroads generally among the best investments Wall Street can identify, so the authors could have relied on such reports to answer GAO's fundamental question, even if they do not consider themselves competent to do so.

The Christensen Report also failed even to address certain issues of great significance in the railroad industry, such as "paper barriers," whether railroads are refusing to compete even if a shipper has access to two railroads, and whether railroads have colluded with respect to various ratemaking practices, such as their fuel surcharges (now the subject of several class actions) and their universal refusal to quote a "bottleneck rate" or agree to a contract over the supposedly competitive portion of a joint movement so that a shipper could obtain a reasonable "bottleneck rate" from the STB.

The analysis that authors of the Christensen Report did was also unhelpful in other ways. For example, whether a rate is reasonable is determined rate-by-rate, not with respect to whole categories of commodities. CURE has never maintained that all railroad rates for any particular commodity, be it coal, grain, chemicals, or something else, are unreasonably high. Therefore, to analyze only the *overall* amount of revenue produced by *all* rates applicable to a particular commodity or group of commodities is of little or no value. Similarly, determining whether the railroad industry *as a whole* is earning the appropriate cost of capital is also of little value. Rather, the STB regulates railroads on a railroad-by-railroad basis, and rates are determined (at least in theory) on the basis of whether the particular railroad involved is itself revenue-adequate, not whether the entire industry is revenue-adequate.

The Christensen Report opined that the twin derailments, and resulting inadequate capacity, experienced in the PRB starting in 2004 caused the rate increases Christensen identified starting at about that time. But if the authors were correct, now that the capacity constraints in the PRB have been eliminated, rates should again decline. Instead, rates have continued to increase, demonstrating that the railroad industry has changed fundamentally, so that there is essentially no competition any longer for PRB coal shipments, even where shippers supposedly are served by two railroads. The STB has not studied why railroads no longer compete for business that they could carry.

In the remainder of this Addendum, we discuss at considerable length the matters that were analyzed in the Christensen Report, so that the record is complete and so that there can be no confusion about whether CURE agrees, or disagrees, with key aspects of the Christensen Report, and why. Fundamentally, however, the Christensen Report is more notable for what it did not do – determine whether effective competition continues to exist in the railroad industry and, if not, whether the rate-reasonableness process at the STB is providing an appropriate methodology for expeditious and cost-effective determinations of the reasonableness of rates charged captive shippers. Indeed, the failure of the Christensen Report to address whether effective competition continues to exist in the railroad industry, and (except in reporting anecdotally what shippers think of the STB's rate-reasonableness process) whether the STB's rate process is appropriate, mean that the Report can perhaps best be characterized as Sherlock Holmes would have – as "the dog that didn't bark."

Detailed Responses to Christensen Report.

Inappropriateness of Portions of the Christensen Report.

The Christensen Report is very detailed and thorough. The data in the Christensen Report are quite useful. The Christensen Report generally is transparent (albeit technical) in explaining the methodologies used and the reasons for its conclusions. For those reasons, Christensen Associates should be commended for the extent of its efforts, even though CURE disagrees with many of its conclusions.

Many of the Christensen Report's conclusions are policy judgments and therefore inappropriate for such a report. Moreover, many of those conclusions are not supported by the data in the Christensen Report. Precisely because the authors did not feel it was appropriate to answer GAO's key question – are railroads abusing their market power -- judgments about policy (especially legislative policy) were not appropriate for such a study.[1] In the circumstances, therefore, it was particularly inappropriate for the Christensen Report to comment on the appropriateness of legislative proposals under the guise of an economic analysis.[2] Not only did Congress and the GAO did not ask for such an analysis,[3]

[1] The authors themselves told the STB at its hearing on November 6, 2008 that they could not say what is "fair" or whether a railroad has "abused" its market power, because they are economists.

[2] Portions of that analysis may also have been based on incorrect premises. For example, while the Christensen Report advocates remedies other than "bottleneck rate" relief to promote competition for shippers, the Report's conclusion that "bottleneck rate" relief would produce significant reductions in railroad profitability is based in substantial part on the conclusion that, if a "bottleneck rate" were quoted, the shipper would then use the non-"bottleneck" carrier for the remainder of the entire movement. But the authors conceded, at the STB's hearing on November 6, 2008, that economic theory assumes that the carrier with the lowest costs (*i.e.*, the "bottleneck" carrier) will retain the entire movement precisely because it has lower costs.
Also, the authors concluded that, just because that revenue/variable cost ratios for railroad wheat rates range from 43 to 757 percent, the Board's URCS costing system must be producing inaccurate values for variable costs. But it is at least as likely that railroad rates are not being set on the basis of the railroads' costs (after all, the railroads' pricing officers often say precisely that) or that railroads do not know what the URCS variable costs are for a movement when setting the rate on that movement. Moreover, the railroads advocated, and the ICC found, that a rate was not unreasonably low so long as it at least equaled the "directly variable costs" associated with a movement, a standard far lower than variable costs. So, the authors' conclusion does not necessarily follow from the data they cite.

[3] GAO recommended that the "STB conduct a rigorous analysis of the state of competition nationwide and, where appropriate, consider the range of actions available to address problems associated with the potential abuse of market power." Government Accountability Office, *Freight Railroads: Industry Health Has Improved, but Concerns*

but also the authors could not rationally address proposed solutions to the problem of the railroads' abuse of their market power if the Report could not determine whether such abuse exists.

When GAO issued its Report in 2006, it concluded that a follow-up report was needed to assemble or develop additional data beyond that available to GAO, so as to better evaluate competition or the lack thereof in the freight railroad industry. GAO stated (at 64-65):

> The Staggers Rail Act achieved far-ranging benefits in helping to create and sustain a healthy and vibrant freight railroad industry, as well as an efficient rail transportation system that supports the important role freight plays in the nation's economy. Critical to the Staggers Rail Act was the concept of balance—on one hand, the act sought to allow rail carriers to earn adequate revenues so that they could meet their current and future capital needs. On the other hand, the act recognized the need for a remnant regulatory regime that would maintain reasonable rates and prohibit undue concentrations of market power in areas where no effective competition existed. The act recognized that it was vital for the federal government to promote competition and rely on it to set rates....
>
> The continued existence of pockets of potential captivity, together with the increase in traffic at higher thresholds, at a time when the railroads are, for the first time in decades, experiencing increasing economic health, raises the question whether rail rates in selected markets reflect justified and reasonable pricing practices, or an abuse of market power by the railroads. Answering this question requires a rigorous, national analysis of competitive markets. Our analysis provides an important first step; however, we are constrained by the inherent limitations of the *Carload Waybill Sample* and the available proxy measures for assessing captivity. In contrast, STB has the statutory authority to inquire into and report on railroad practices and could conduct a rigorous analysis of competition in the freight rail industry that would rely on more than sample data and could determine whether the inappropriate exercise of market power is occuring in specific markets. Should STB find evidence of abuse, it could consider several methods for creating the balance envisioned by the Staggers Rail Act. For example, STB could consider initiating a generally applicable rule making to address competition issues or prescribe specific remedies in response to a complaint.

Accordingly, GAO made the following recommendations for action (*id.*, at 66-67):

---

about Competition and Capacity Should Be Addressed, GAO-07-94, October 2006 (at 3-4) ("GAO Report"), *quoted in* the Christensen Report (at ES-3).

• Undertake a rigorous analysis of competitive markets to identify the state of competition nationwide; in specific markets, determine whether the inappropriate exercise of market power is occurring; and, where appropriate, consider the range of actions available to address problems associated with the potential abuse of market power. If the Chairman determines that STB requires more resources to conduct this analysis, then STB should request additional resources from Congress.

• Review STB's method of data collection to ensure that all freight railroads are consistently and accurately reporting all revenues collected from shippers, including fuel surcharges and other costs not explicitly captured in all railroad rate structures.

Congress did not appropriate money for the study GAO envisioned, but rather the STB apparently paid the approximately $1 million from general funds appropriated by Congress for the administration of the agency.[4] Accordingly, Congress did not request that the study make policy recommendations, especially comments on pending legislative proposals.

As stated *supra*, the Christensen Report did *not* answer the key question raised by GAO: "whether rail rates in selected markets reflect justified and reasonable pricing practices, or an abuse of market power by the railroads." Instead, the authors stated:

> While the GAO posed the question of whether recent performance of the U.S. freight railroad industry is indicative of "a possible abuse of market power," our analysis provides evidence on whether there has been a change in the exercise of market power by U.S. railroads. By definition, the setting of price above marginal cost is what economists consider to be an exercise of market power, but exercise does not imply abuse. To address the question of whether there has been an "abuse of market power" would require judgments as to the fairness of the distribution of value between the railroads and the shippers, and on the distribution of overhead cost collection among the shippers. These judgments are policy questions and are not resolvable through economic analysis alone. Instead, we have answered the economic questions of the extent to which recent railroad pricing behavior reflects changing cost conditions, and the extent to which it represents an increase in the overall exercise of market power. Furthermore, our analysis sheds light on how recent railroad

[4] On September 13, 2007, the STB announced the award of the contract to Christensen Associates, stating: "The Surface Transportation Board (Board) announced today that it has awarded a contract to Christensen Associates (Christensen), headquartered in Madison, Wisconsin, to conduct an independent study that will assess the current state of competition in the freight railroad industry in the United States. The study will cost approximately $1 million and will be completed and made public in the Fall of 2008."

pricing behavior has shifted the burden of overhead cost collection among the different sets of shippers.

At the same time, as we read it, the STB's Request for Proposals ("RFP") did *not* solicit a study stating the authors' views on pending legislative proposals.[5]

---

[5] What GAO and Congress intended was for the study conducted by the STB's contractor to evaluate whether "the range of actions available" are adequate "to address problems associated with the potential abuse of market power," *i.e.*, whether the existing statute and the STB's resources are adequate to protect captive shippers where railroads exert their market power. The terms of the STB's RFP appear to have been consistent with GAO and Congressional intent. The RFP (https://www.fbo.gov/?=opportunity&mode=form&id=c686c9e1e4fcb3a21554b224dea3ebfc&tab=core&_cview=1) stated, in relevant part:

> The STB believes that capacity and competition are inherently linked and is concerned that the railroads may not be capable of generating the capital resources to provide sufficient capacity to adequately serve the public based on widely available forecasts. This concern led us to initiate Ex Parte 671, Rail Capacity and Infrastructure Requirements. The record developed in that proceeding has strengthened our belief that there is a direct link between railroad capacity and service levels. A goal of this study is to examine the relationship between known capacity requirements and the railroads ability to meet those needs.
>
> The purpose of this task is to conduct in-depth interviews and focus group discussions with shippers, railroad managers, academic experts, consultants, financial analysts, and key Government staff. In particular, attention is to be focused on the importance of competition, capacity, and regulatory policy as drivers of the industry's performance. In conducting these interviews, the Contractor shall include in its inquiries topics not limited to: (1) competition in the U.S. railroad industry both nationally and in selected geographic markets to be identified; (2) competition for grain, coal, chemical, general merchandise (boxcar) and intermodal movements; and (3) the effects of competition and capacity availability on service quality. NOTE: Geographic markets have not been selected. The Government will work with the vendor to identify representative markets for analysis.
>
> Armed with the results obtained from Task 2, the Contractor will develop an appropriate analytical methodology to verify the results of its qualitative research. This methodology must employ techniques from industrial organization and econometrics best suited to verifying the information obtained in Task 2. The Contractor will report the details of its proposed methodological approach to the STB prior to proceeding with the verification process. The Contractor should highlight how the proposed approach is similar to or different from previous studies of competition in the U.S. railroad industry. The Contractor will explain why the methodological approach it has chosen will provide new insight into the state of railroad competition. Before the Contractor commences work on Tasks 4 and 5, the Government will provide appropriate technical comments on the methodological approach proposed by the Contractor.

In any event, whatever the STB's RFP or the STB's interaction with Christensen Associates requested or envisioned, it was not appropriate for a private contractor, working for an independent agency charged with regulating railroad monopoly abuses under existing law, to evaluate the economic impact and propriety of certain legislative policy changes recommended by CURE and other shipper organizations, while at the same time stating that it is not the place of economists to determine what is "fair" or otherwise to express opinions on appropriate policy. The STB should not compound the error by adopting any or all such recommendations, but rather should leave analysis of proposed legislation to Congress for its evaluation, unless Congress requests its views.

Although the Christensen Report focuses on the data and economic analysis, the Report's conclusions to some extent seemingly promote the *status quo* for existing policies. The *status quo* is unacceptable, because it is strongly tilted in favor of the railroads. The current statute was enacted in 1980, when railroads were not earning adequate revenues and had excess capacity. Today, the industry has little excess capacity and is earning adequate or more than adequate revenues. It follows that either the STB's policies with regard to, *inter alia*, rates, charges, competition, service, mergers, and acquisitions need to change, or Congress will feel compelled to change the provisions of the Staggers Rail Act to do so.

The Christensen Report Properly Concluded That, Where There Is (or Was) Competition, Rail Shippers Benefitted, That Much Traffic Is Captive (Necessitating Continued Regulatory Protection), and That the Railroad Industry Is Earning Adequate Revenues; However, Railroads Are No Longer Competing for Much Coal Business.

The Christensen Report found that rates for coal shipments on BNSF and UP, "suggesting there may be effective competition at the origin point via the joint serving the south Powder River Basin." While CURE believes that the competition that the Christensen Report found in the data may have been the product of competition before the capacity constraints that developed in 2003-04 eliminated such competition,[6] the finding nevertheless demonstrates that, where

---

The Contractor will examine how competition and capacity constraints influence the quality of service provided by rail carriers.

The Contractor will evaluate how the policy reforms suggested by GAO would affect the future financial health and stability of U.S. railroads and whether such proposals would stimulate or discourage private investments in the railroad industry.

[6] The Christensen Report (Volume 2 at 18-27), did find that, in general, only three percent of the railroads' system are at capacity, while "[a]pproximately 88 perecent of system mileage is substantially below capacity and nine percent is near capacity." *citing* Cambridge Systematics, *National Rail Frieight Infrastructure Capacity and Investment*

shippers have competition from two railroads capable of serving them, both shippers and the involved railroads benefit.[7] (However, many shippers in recent years have found that, even if two railroads can serve them, the railroads are less and less interested in competing for shippers' business. Indeed, it is now typical, especially for Western coal shipments, that a coal-fired power plant with access to two railroads cannot get a rate quotation from both railroads.)

Also, the data in the Christensen Report document (a) the large amount of traffic that is captive (especially on the basis of tons, as opposed to ton-miles), particularly in certain portions of the country without effective transportation competition, (b) the increase in traffic over 300 percent of variable cost,[8] (c) the revenue adequacy of the U.S. railroad industry (at least in 2006, and apparently since 2001), and, therefore, (d) the appropriateness of rate relief for captive traffic.[9] In CURE's view, it is clear that rate relief is appropriate for at least two reasons: one, if the railroad industry as a whole is revenue-adequate, some individual railroads must be more than revenue-adequate, justifying relief across the board under the "revenue adequacy" constraint that the Board has never implemented. Two, in any event, the fact that the proportion of traffic with rates with R/VC ratios above 300 percent is increasing demonstrates that rate relief is

---

Study, prepared for the Association of American Railraods, Septemeber 2007, Table 4.4. The Christensen Report (Volume 2 at 16-28) also properly found that recent projections of limitations in railroad capacity "cannot provide a precise forecast of capacity needs far into the future." The Report found that there is still an excess amount of roadway and structures. *Id.* at 16-30 to -31.

[7] Christensen Report (Volume 2 at 12-9 to 12-11, especially 12-9).

[8] The Christensen Report found (Volume 2 at 11-25) that the R/VC ratio is a relevant indicator of market power. While the Report concluded that the R/VC ratio is only "weakly correlated with railroad and water competition measures," the Report placed excessive reliance on the so-called Lerner Index as a measure of railroad market power. There is considerable reason to question whether the Lerner Index itself is a reliable indicator of market power; certainly, neither the STB nor Congress has ever adopted it as such a measure The Christensen Report found that the R/VC ratios are "suspect" because of the large variation in those ratios. But, as noted *supra*, there are other possible logical reasons for the variation, including whether railroads know their variable costs or whether railroads set prices with regard to costs. Railroad marketing officers boast that the they do not set rail rates on the basis of cost, so the Christensen Report's conclusion that R/VC ratios are "suspect" merely because there is a wide variation in them, is itself suspect.

[9] The Christensen Report states (Volume 2 at 18-37) that "Regulatory oversight is required to ensure that shipper captivity, driven by unavoidable limitations of shipment geography, does not result in railroad prices that are determined to be unreasonable."

appropriate for some traffic without regard to the sufficiency of overall industry-wide or railroad-specific revenues.[10]

The Christensen Report properly found that, while in some circumstances, policies can be adopted that promote additional railroad competition, many shippers, because of geography and shipper-density characteristics restrict possible competition, which in turn requires continued regulatory protection for captive traffic.[11]

Although the Christensen Report did not analyze 2007 and 2008 data, it is clear from proceedings before the STB and from public information that additional, excessive rate increases were imposed by railroads in those years. Those years were not considered in the Christensen Report (apparently due to lack of data). Hence the Christensen Report was out-of-date the moment it was published. It would be useful to update the Christensen Report to determine if the U.S. railroad industry, and individual railroads, earned even higher returns in 2007 and 2008.

The Christensen Report and Other Evidence of Which the Board Is on Notice Demonstrates That There Are Inappropriate Cross-Subsidies Continuing in the Railroad Industry.

Railroads are a fundamental part of the overall economy in the United States. They should grow their businesses in a healthy competitive environment, where customers are sufficiently protected from abusive practices. The present statute, given the STB's limited oversight of the railroad industry, has proven not to appropriately protect captive shippers.

The Christensen Report suggests that it is acceptable for certain shippers/industries to pay higher rates than for other shippers or industries, intrinsically implying, almost suggesting, a policy that it is acceptable for one industry to be subsidizing another industry or competitors within an industry. With the arrival of revenue adequacy, the justification for differential pricing is diminished. If railroad track capacity is limited, there is no justification to carry traffic at rates below full cost, while charging captive traffic very high rates. Yet,

---

[10] According to the Christensen Report (at ES-23 Table ES-6), farm products (including barely, grain, corn, wheat and soybeans) are marked up more than all other commodities carried on the railroads in substantial tonnages, followed by coal, non-metallic minerals, food products, lumber and wood products, chemicals, and petroleum and coal products.

[11] Christensen Report, Volume 2 at 18-37.

according to the Christensen Report, railroads charged rates with R/VC ratios as low as 43 percent, to as high as 757 percent, for wheat shipments.[12]

Other evidence suggests that the highest R/VC ratios in the Christensen Report are far too low, demonstrating that updating the Christensen Report to take into rates imposed on shippers in 2007-08 would be highly informative. For example, in the recent Complaint filed at the STB by E.I. Dupont de Nemours & Co., Inc. against CSX Transportation, Inc., Dupont showed that, on an unadjusted URCS-cost basis, Dupont is being charged rates as high as 1085 percent.[13]

The Christensen Report Provides No Data to Justify Its Conclusion That Railroad Market Power Is "Tempered by the Prospect that Large Markups May Elicit Regulatory Attention if Not Direct Intervention."

The Christensen Report states (at ES-26) that "Railroads appear to exercise some degree of local market power where possible, but are tempered by the prospect that large markups may elicit regulatory attention if not direct intervention. That is monopoly railroads may effectively cede some market power to avoid regulatory scrutiny." This conclusion appears to be anecdotal; no data is cited to support it.

In reality, the railroads, especially in recent years, have been pressured by large investors to raise rates substantially.[14] Indeed, the Christensen Report

---

[12] Christensen Report (at ES-11). The ICC concluded that a rate is not unreasonably low just because the R/VC ratio is below 100 percent. Ex Parte No. 355, *Cost Standards for Railroad Rates*, 364 I.C.C. 898 (1981), *aff'd sub nom. Water Transport Ass'n v. ICC*, 684 F.2d 81 (D.C. Cir. 1982). However, the ICC's conclusion was merely that rates with such low R/VC ratios are not unlawful *per se*. It appears that Christensen is of the view that a rate with an R/VC ratio as low as 43 percent is evidence, *ipso facto*, of flaws in the URCS costing system. While such flaws could exist, it is at least equally plausible that such rates are the result of a system in which the railroads do not set rates with regard to cost (or at least URCS costs), but rather with regard to demand (as railroad marketing officers repeatedly state is the manner in which most rail rates are set).

[13] STB Docket No. 42112, Complaint (filed November 10, 2008), Exhibit B, page 1 of 4.

[14] In May 2007, a representative of The Children's Investment Fund, one of the largest shareholders in CSX, called for rate increases of seven percent per year for the next ten years. Railroad analysts also trumpeted railroad stocks because they believed that the railroads had (and have) so much ability to raise rates, even if volumes are declining. Morgan Stanley stated, with respect to the rate complaints recently filed at the STB by Oklahoma Gas and Electric Company and E.I. Dupont de Nemours & Co., Inc.: "the cases also highlight the on-going re-pricing opportunity and price discipline among rails. Rails continue to push the regulatory envelope on pricing, which we view as a positive."

itself states (at ES-5) that "Class I railroads' rates (real revenues per ton-mile) rose substantially above short-run marginal cost in 2006." Chapter 8 of Volume 2 of the Christensen Report provides details for various commodities about the significant rate increases since approximately 2003.[15]

The railroad industry also sought to have the "adequacy" of its members' revenues determined using replacement costs, rather than the current and widely used "net investment" methodology, in order to attempt to justify even higher returns – **more than $17 billion**/year for just the four largest U.S. railroads (BNSF, CSX, NS, and UP) according to the Petition (at 36 Table 1) -- than they are now earning.[16]

If that is evidence of "tempering" their market power, the Class I railroads clearly have a lot of it.[17]

The Christensen Report Inappropriately Evaluated the Appropriateness of Certain Types of Relief for Captive Shippers.

The Christensen Report finds that policies as reciprocal switching and terminal agreements could address some of the shippers' concerns, but downplays the utility of "bottleneck rate" relief. Yet, the Christensen Report assumed that shippers obtaining such relief would involve a second carrier, in addition to the "bottleneck" carrier, in the movement. But, in reality, when questioned about the Christensen Report, the authors stated to the Board at its hearing on November 6, 2008 that, applying standard economic theory, the "bottleneck" carrier would have lower costs and therefore would be able to prevent the second carrier from participating in the haul. Accordingly, "bottleneck rate" relief would not change the railroads' costs. The Christensen Report's

---

"Rate Cases Show Durability of Pricing," Morgan Stanley & Co., November 13, 2008. Justice Holmes would have said "Upon this point, a page of history is worth a volume of logic." *New York Trust Co. v. Eisner*, 256 U.S. 345, 349 (1921).

[15] Christensen Report, Volume 2, at 8-8 (Figure 8-2, Grain and Farm Products), 8-15 (Figure 8-6, Coal).

[16] *See* "Petition of the Association of American Railroads to Institute a Rulemaking Proceeding to Adopt a Replacement Cost Methodology," filed May 1, 2008 in Ex Parte No. 679. The STB is to be commended for denying that Petition, in an extremely well-reasoned decision issued on October 24, 2008 in Ex Parte No. 679.

[17] In this respect, it is of considerable significance that the Christensen Report found that the recent mergers and acquisitions "in the railroad industry generally [do] not appear to be driven by an attempt to garner dramatic cost savings." Apparently, then, Christensen Associates implies that those mergers and acquisitions were driven by the railroads' interest in increasing their market power. That, certainly, is the view of CURE and most of the shipping community.

objection to such relief is, therefore, based on the conclusion that it would be effective, *i.e.*, shippers would obtain significant rate reductions from such relief, either through regulation or through the competition that would ensue from such relief. But such a conclusion is a policy matter, as one of the authors admitted at the Transportation Forum of the Association of Transportation Law Professionals held at the STB on November 10, 2008, so it is inappropriate for the Christensen Report to have commented on that matter.

The Christensen Report also concludes that "Current market circumstances imply that providing significant rate relief for certain groups of shippers will likely result in rate increases for other shippers or threaten railroad financial viability."[18] That conclusion is incorrect, for at least four reasons. First, if a rate exceeds "stand-alone costs," a shipper is entitled to relief under the STB's applicable rate-reasonableness standards, regardless of the railroad's revenue adequacy.[19] Second, if a railroad's other traffic is competitive, the rate is constrained by competition, and rate relief to captive traffic will not affect the rates on the competitive traffic. Third, if a railroad is earning more than adequate revenues (which some must be, if the industry as a whole earned adequate revenues in 2006), the STB's "revenue-adequacy" constraint (which it has never implemented) would require rate relief to the railroad's captive traffic without the need to increase rates on the railroad's other traffic.[20] Finally, if a railroad achieves productivity gains, it could reduce rates and still improve its profitability, without raising other rates.

The Christensen Report's Conclusions About the STB's URCS Costing Methodology and URCS Data Are Not a Basis for Rejecting Use of R/VC Ratios as a Basis for Regulation.

The Christensen Report claims that the URCS methodology and resulting data are flawed, based on data showing R/VC ratios ranging from 43 percent to 757 percent for wheat shipments.[21] Unfortunately, the Christensen Report does not provide any insights on the reliability or potential flaws in the data, or the reasons why it may be flawed.

An assertion that R/VC ratios for existing traffic range from 43 percent to 757 percent (as Christensen concluded at ES-11) is not necessarily a basis for

---

[18] Christensen Report, Executive Summary at ES-5.

[19] *Burlington Northern Railway Co. v. STB*, 453 F.3d 473, 480-81 (D.C. Cir.1987).

[20] Christensen Report, Vol. 3 at 20A-35, *citing Major Issues in Rail Rate Cases*, Ex Parte No. 657 (served October 30, 2006), *citing Coal Rate Guidelines, Nationwide*, 1 I.C.C.2d 520, 535-36, 537-42, 542-46 (1985), *aff'd sub nom. Consolidated Rail Corp. v. ICC*, 812 F.2d 1444 (3rd Cir. 1987).

[21] Christensen Report, (at ES-11).

concluding that URCS methodology and resulting data are flawed. Logically, there are other possible reasons for such a range, including that railroads do not price with respect to their costs (as railroad pricing managers repeatedly state) or that railroads do not know what their costs are. In any event, the STB is in charge of the URCS costing process, and so long as the URCS data and methodology are the result of the STB's processes and requirements, they remain the best and only data that can be used. If the STB is of the opinion that the URCS methodology and data are flawed, it should promptly convene a proceeding for the purpose of correcting the methodology, rather than rely on a Report that uses such data to conclude that relief for captive shippers is not appropriate.

Moreover, the Report also does not consider the change-of-traffic composition, and makes conclusions on the overall aggregate traffic, ignoring, for example, the fact that most intermodal traffic did not exist in the early 1980s. These types of changes may explain some of the reasons why URCS data seem unreliable or inaccurate. Intermodal traffic, for example, has been known to have very low R/VC ratios on some railroads (such as Union Pacific), due to long-term contracts (on Southern Pacific).

The Report Fails to Recognize Some of the Inadequacies of the STB's Rate-Reasonableness Process.

Many shippers have not invoked the STB's rate-reasonableness procedures, despite paying very high rates, because those procedures have proven inadequate for several reasons. One is the limit on rate relief in the so-called "small-shipment" rate proceedings. Another is the STB's standard that implies that a rate must exceed the average (or even a factor substantially above the average) of comparable traffic in order to be entitled to relief. The STB's standard therefore relies on the premise that, if all rates for a particular commodity on a particular railroad are relatively close together, no relief is available. That policy seems wrong in and of itself, but especially if a railroad is revenue-adequate.

Railroads tend to offer a package of contract rates to many shippers each year, and insist that the shippers take all of them, or none at all. Shippers cannot compete while paying much higher tariff rates than the proposed contract rates (which are themselves excessive), so unless the STB will require the railroads to allow shippers to accept those contract rates they are willing to pay, and challenge the others if they so choose, the STB's rate-reasonableness process is not available to such shippers. There is no public policy rationale for requiring a shipper to reject some contract rates it is offered in order to challenge all of the rates published by the same railroad under tariff. Unfortunately, the Christensen Report does not deal with this sort of railroad pricing practice (which is another example of the railroads' market power).

The Christensen Report Did Recognize Other Inadequacies In the STB's Rate-Reasonableness Process.

The Christensen Report did cite statements made to the authors by a number of shippers who described the STB's "stand-alone cost" process for determining a maximum reasonable rate as "expensive, time-consuming, and one-sided."[22] Clearly, that is correct. Shippers report having spent in excess of $6 million to present such a SAC case, and one railroad has told the undersigned that it costs at least $10-12 million to defend such a case.

Recently, in two proceedings before the STB, UP has stipulated with coal shippers that the maximum rate standard to be used in those proceedings is an R/VC ratio of 180 percent.[23] As rail rates continue to increase, and railroads achieve revenue adequacy, a rate-reasonableness standard other than SAC is appropriate, according to the STB's own *Coal Rate Guidelines.*[24] In those *Coal Rate Guidelines*, the ICC stated that its "revenue-adequacy constraint" would be applied to revenue-adequate railroads.[25] Although the STB has not taken action to determine what that 'revenue adequacy" constraint should be, those two coal rate proceedings at the STB, and the UP's stipulation to use of an R/VC ratio of 180% to establish the maximum reasonable rate, strongly support CURE's advocacy of the same standard for maximum reasonable rail rates, as proposed in S. 953 and H.R. 2125 in the current Congress.

---

[22] Christensen Report, Vol. 1 at 5-18.

[23] STB Docket No. NOR 42111, Stipulation filed November 21, 2008 by Oklahoma Gas and Electric Company and UP. A similar stipulation was entered into to adjudicate the Complaint filed by Kansas City Power & Light Company against UP, and the Board prescribed the maximum reasonable rate at 180% of variable costs.

[24] *Coal Rate Guidelines, Nationwide,* 1 I.C.C.2d 520 (1985), *aff'd sub nom. Consolidated Rail Corp. v. United States,* 812 F.2d 1444 (3rd Cir. 1987).

[25] The Christensen Report quotes the STB's *Major Issues in Rail Rate Cases,* Ex Parte No. 657 (Sub-No. 1)(served October 30, 2006), slip op. at 7, *citing Coal Rate Guidelines, Nationwide,* 1 I.C.C.2d 520, 535-36, 537-42, 542-46 (1985), that "The revenue adequacy constraint ensures that a captive shipper will "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 financially sound carrier capable of meeting its current and future service needs."

The Christensen Report Recognizes That the Railroad Industry Is Earning Adequate Revenues.

CURE is pleased that the Christensen Report recognizes that the railroad industry as a whole earned "sufficient"[26] revenues in 2006 and, if the CAPM method is used, the industry has earned adequate revenues since 2001 (*id.* at 8-35, 8-54). Indeed, the Christensen Report states that "By the STB's current standard (CAPM), there is recent evidence that the industry has become revenue[-]adequate and may have exceeded that standard." *Id.* The Christensen Report's authors also recognize that Wall Street analysts have reported that the railroads did even better in 2007. Such strong earnings require greater vigilance on the part of the STB. Unfortunately, the Christensen Report does not discuss means by which to apply the "revenue adequacy" constraint that the ICC adopted (without specifics) in 1985. It is past time that the STB do so.

The Christensen Report's Conclusions About Proposed Legislative Relief Were Inappropriate, and in Some Instances Are Clearly Incorrect.

CURE strongly objects to the Christensen Report's implied conclusion that "bottleneck rate" relief would be inappropriate, and to its analysis of pending legislation generally. Not only is that a policy issue (as one of the authors conceded at the Transportation Forum of the Association of Transportation Law Professionals, held at the STB on November 10, 2008), and therefore is a matter for the Congress, not a contractor to the STB, but also the conclusion was seemingly based on the notion that the provision of a "bottleneck rate" would mean that two railroads would participate in a movement whereas one had handled the entire movement previously. The Christensen Report's authors stated in their question-and-answer session with the Board on November 6, 2008 that economic theory provides that the "bottleneck" carrier, having lower costs than the other competitor carrier, should retain the entire movement. Therefore, the Christensen Report's implied premise is incorrect. CURE strongly believes that "bottleneck rate" relief should be available in order to permit competition from the interchange to either origin or destination to determine the competitive portion of the overall rate, because competition is what the Staggers Rail Act was intended to achieve. Competition is a vital force for overall public benefits in the U.S. economy.

The Christensen Report's conclusion about "bottleneck rate" relief is also based on false premises. In its Table ES-8 (at ES-39), the Christensen Report

[26] The authors of the Christensen Report used "sufficient" instead of "adequate" in most instances to attempt to avoid becoming engaged in the STB's function of determining whether railroads are earning "adequate" revenues, but the two terms are synonyms. Nevertheless, the authors did state (at 8-35) "that the industry has become revenue adequate and may have exceeded that standard.".

concludes that the impact of "bottleneck rate" relief on railroad profitability would be "potentially large." The premise is based on the incorrect assumption that the provision of a "bottleneck rate" would mean that a second carrier would be involved in the rest of the movement. Yet, the authors conceded in their answers to questions posed by the STB at its November 6, 2008 hearing that economic theory assumes that the "bottleneck" carrier would retain the entire movement because it would have lower costs than the non-"bottleneck" carrier.

Also, the authors concluded that "bottleneck rate" relief was inappropriate because, they asserted, "bottleneck rate" segments could extend hundreds of miles, whereas reciprocal switching and terminal trackage rights typically would apply to much shorter segments, and there are "diminished" length-of-haul economies "as interchange between two railroads…occurs further from an endpoint of a movement; the adverse effect on costs is maximized when the interchange occurs at the mid-point of the end-to-end movement."[27] But the Report is simply incorrect in asserting the shippers have, or would, seek "bottleneck rates" over segments hundreds of miles long. Instead, the typical "bottleneck rate" segment ranges from a mile or two up to 25-50 miles in length (because, typically, there is an interchange to a connecting carrier within that distance). So, there is no factual basis for the Report's conclusion that "Thus, because they have lower risks of adverse cost consequences, we believe that 'incremental' policies such as reciprocal switching and terminal agreements have a greater likelihood of resolving shipper concerns via competitive response, without leading to material adverse changes to railroad costs and efficiency."[28] Indeed, because the "bottleneck" railroad has lower costs than the competitor railroad (which could participate in a movement if a "bottleneck rate" were to be quoted), there would be no diminishment in length-of-haul economies in the hypothetical "bottleneck rate" scenario (because the "bottleneck carrier" would retain the entire movement due to its lower costs than its competitor), whereas there would be some diminution in length-of-haul economies if reciprocal switching rights are invoked (thereby involving two railroads instead of one).

Table ES-8 is therefore incorrect in concluding that "shipper gains" from "bottleneck rates" are "least likely." In fact, they are most likely, because only the monopoly portion of a movement would be required to bear the cross-subsidy now built into the statute (because the STB may not prescribe a rate with an R/VC ratio lower than 180 percent, despite the fact that the full-cost level is lower than that), and because a shipper with a "bottleneck rate" could then benefit from the existing railroad competition at the point of interchange.

---

[27] Christensen Report (ES-39 to ES-40).

[28] *Id.* (at ES-40).