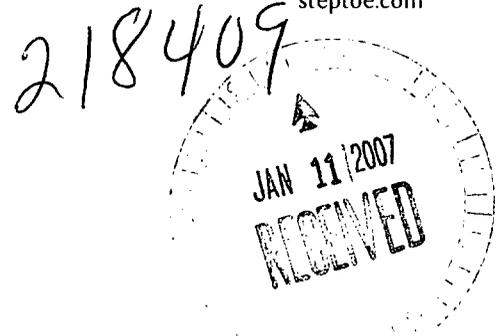


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January 11, 2007

Via HAND DELIVERY

The Honorable Vernon A. Williams
Secretary
Surface Transportation Board
1925 K Street, NW
Washington, D.C. 20423

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JAN 11 2007

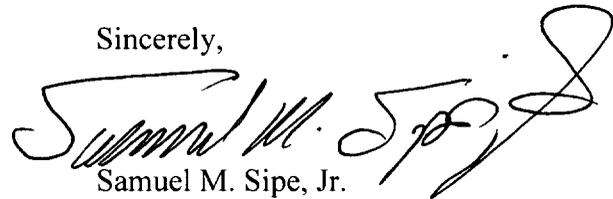
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Re: **Simplified Standards for Rail Rate Cases, STB Ex Parte No. 646 (Sub-No. 1)**

Dear Secretary Williams:

Enclosed are the original and twenty copies of the Rebuttal Comments of the Association of American Railroads ("AAR") submitted in response to the Board's decision served July 28, 2006, and its subsequent scheduling orders served September 15 and December 19, 2006, in the above-captioned proceeding. Please date stamp the extra copy of this letter and return it with our messenger.

Sincerely,



Samuel M. Sipe, Jr.
Counsel for Association of American
Railroads

Enclosures

cc: Parties of Record

BEFORE THE
SURFACE TRANSPORTATION BOARD



Ex Parte No. 646 (Sub-No. 1)

SIMPLIFIED STANDARDS FOR RAIL RATE CASES

REBUTTAL COMMENTS OF THE ASSOCIATION OF AMERICAN RAILROADS

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Of Counsel

Dated: January 11, 2007

**BEFORE THE
SURFACE TRANSPORTATION BOARD**



Ex Parte No. 646 (Sub-No. 1)

SIMPLIFIED STANDARDS FOR RAIL RATE CASES

REBUTTAL COMMENTS OF THE ASSOCIATION OF AMERICAN RAILROADS

I. Introduction

Pursuant to the Board's scheduling order, served December 19, 2006, the Association of American Railroads ("AAR") respectfully submits its rebuttal comments in the captioned proceeding.

Despite the extensive and substantive opening comments filed by AAR and its member railroads, the reply comments filed by shippers are abbreviated and, for the most part, non-responsive to the comments made by railroads. The joint reply comments filed on behalf of numerous shipper interests¹ ("Joint Shipper Reply Comments"), in particular offer little new

¹ The Joint Shipper Reply Comments were submitted on behalf of: American Chemistry Council, American Forest and Paper Association, American Soybean Association, Agricultural Retailers Association, Colorado Wheat Administrative Committee, Corn Refiners Association, The Fertilizer Institute, Glass Producers Transportation Council, Idaho Barley Commission, Idaho Wheat Commission, Institute of Scrap Recycling Industries, Iowa Soybean Association, Montana Wheat and Barley Committee, National Association of Wheat Growers, National Barley Growers Association, National Corn Growers Association, National Council of Farmers Cooperatives, National Farmers Union, National Grain and Feed Association, National Sorghum Producers, The National Industrial Transportation League, National Oilseed Processors Association, National Petrochemical & Refiners Association, Nebraska Wheat Board, North American Millers Association, North Dakota Grain Dealers Association, North Dakota Public Service Commission, North Dakota wheat Commission, Oklahoma Wheat Commission, Paper and Forest Industry Transportation Committee, PPL EnergyPlus, LLC, South Dakota Wheat

beyond their initial complaints regarding the Board's simplified rate case guideline proposals. The Joint Shippers make scant effort to respond directly to specific issues raised by railroad commenters, and instead resort to rhetorical criticisms of the railroads' supposed motives. Notwithstanding the Joint Shippers' dismissive attitude towards the Board's proposals, AAR continues to believe that the Board's proposals can form the basis for a workable simplified approach to rate disputes where the amount in dispute does not justify a full stand-alone cost presentation.

II. Shippers Continue to Ignore the Fundamentals of Railroad Economics and the Need for Capacity Investment

The Joint Shippers pay lip service to the desirability of "a healthy, responsive, and efficient railroad system in the United States." Joint Shipper Reply Comments at 5. But their proposals in this proceeding are patently inconsistent with that goal. Indeed, their continuing primary objective appears to be to encourage the Board to regulate as much traffic as possible under the admittedly crude Three Benchmark approach. At no point do the Joint Shippers address the consequences for railroads or the nation's transportation infrastructure of widespread application of a benchmark rate methodology that is so disconnected from Constrained Market Pricing ("CMP") principles and the fundamentals of railroad economics that underlie Full-SAC procedures.

It is worth noting, as AAR did in its Reply Comments, at 4-6, that when shippers assert that all they are seeking is "reasonable" rates, they do not appear to be talking about reasonable rates as defined by the statute. Shippers appear to believe that "reasonableness" has something to do with price levels in the abstract. In their view, prices over a certain level are

Commission, Texas Wheat Producers Board, USA Rice Federation, Washington Wheat Commission, Alliance for Rail Competition, and Consumers United for Rail Equity.

“unreasonable” regardless of market conditions and regardless of whether competition constrains rail pricing. Indeed, at least one shipper states that (1) any price over marginal cost reflects market power and (2) any price increase is an exercise of market power.² The statute contemplates something different. Regulation of rail rates is only permitted where railroads have market dominance. 49 U.S.C. § 10701(d)(1). The Board has also acknowledged the “express legislative determination that no traffic with rates set below 180% is captive.”³ Even when market dominance exists, rates are subject to limitation only where a railroad abuses that market dominance to charge prices that exceed what is necessary to recover its full costs.

The shippers continue to contest the importance of revenue adequate railroads. They appear to believe, for example, that the railroads’ argument that additional revenue is needed to expand capacity to meet shipper demand for transportation is some sort of sham. The Joint Shippers assert that “the Board is not in a position to guarantee that increased revenues will in fact wind up as increased investments that will directly or even indirectly benefit the shippers who are already paying differentially higher rates.” Joint Shipper Reply Comments at 7. Apparently, shippers believe that railroads would somehow “misuse” additional revenues.⁴

The Board is well aware of both the existing shortage of capacity on portions of the nation’s rail network and the substantial expenditures being made by railroads to enhance capacity. It is only logical that increased capital investment requires increased revenues to fund that investment. Moreover, while the Board cannot order railroads to fund infrastructure

² See Reply Comments of Arkansas Electric Cooperative Corporation (“AECC”), at 4. AECC’s comment ignores the fact that railroads have substantial fixed costs that cannot be recovered when rates are set at marginal cost.

³ *Rate Guidelines – Non-Coal Proceedings*, 1 S.T.B. 1004, 1026 (1996)(“*Non-Coal Guidelines*”).

⁴ AECC suggests that railroads have no intention of expanding capacity and that they want to “charge more and invest less.” Reply Comments of AECC, at 5.

improvements, it can adopt policies that promote such investments. The most straightforward policy is to allow the market to work, as the statute contemplates. All the Board needs to do is reject shipper calls for widespread price regulation and continue to permit the market to function. When capacity tightens due to increased demand for transportation, prices go up. Higher prices are the marketplace signal to railroads that help them determine how to allocate investment resources. Railroads respond to higher prices by building additional capacity to satisfy the increased demand those prices represent. Such expansion can only take place, however, if revenue to fund expansion is available and if the additional investment will earn a reasonable return. That is why the opportunity to achieve sustained revenue adequacy – the ability of railroads to earn their cost of capital – continues to be important.

The Joint Shippers seek to create the impression that the railroads believe that their persistent revenue inadequacy, and the need for additional revenues for infrastructure investment, trump the statutory requirement that rates on market dominant traffic must be reasonable. Joint Shipper Reply Comments at 8. AAR is not proposing that revenue adequacy considerations should override relief in individual cases. Rather, AAR believes that the overall framework for simplified rate case standards and the related eligibility criteria must, as the statute requires, take account of the need for railroads to achieve revenue adequacy. 49 U.S.C. §§ 10101(3), 10701(d), 10704(a)(2). If the Board were to adopt standards that prevent railroads from achieving revenue adequacy, it would violate the statute and Congress' clear direction to the contrary. The Board would also be pursuing an unwise policy as the adverse impact on the nation's transportation system of financially unstable railroads would be profound.

Remarkably, given current capacity issues, the Joint Shippers suggest that expanded capacity cannot be justified – at least to the extent existing shippers would be required to help

pay for it – and would be of no benefit to them. The Joint Shippers assert that railroads want “funds to expand their infrastructure to accommodate new traffic.” Joint Shipper Reply Comments, at 6. Because new capacity would purportedly serve new traffic, shippers argue that charging rates that will help fund expansion is inconsistent with CMP. They state that a complainant in a SAC case cannot be required to bear the cost of facilities “*from which it derives no benefit*” and that a SAC analysis relates only to “*existing facilities used to serve the captive shipper.*” *Id.* at 7 (emphasis in original). This argument suffers from multiple defects.

First, contrary to the Joint Shippers’ assertion, Full-SAC proceedings typically do take account of future traffic growth – both in terms of projected increases in traffic volume from shippers served in the base year and in terms of additional traffic that is expected to be added in future years. The SARR is typically configured to accommodate peak year volumes. The issue traffic in the SAC case shares facilities with the “new” traffic, and all the traffic that uses the facilities is called upon to bear an appropriate portion of the costs of those facilities based on their demand.

Second, as a general matter, existing shippers do benefit from an expanded rail network. The Joint Shippers themselves state that: “Enhanced railroad infrastructure is a desirable and necessary goal from the shippers’ perspective.” Joint Shipper Reply Comments at 7. If capacity constraints are present, expansion is likely to improve service for all shippers that use the network, including those existing shippers that wish to ship larger volumes of traffic by rail than they have in the past. In addition, if more traffic is carried on the railroad, fixed costs are borne by a greater number of shippers, thereby reducing the portion of fixed costs borne by each individual shipper.

Third, the Joint Shippers' attempt to distinguish between existing shippers and new shippers makes no economic sense. Demand, and ultimately price, is determined by the transportation needs of every shipper that wishes to use a railroad for transportation. If aggregate demand exceeds supply, whatever the source of that demand, market forces will naturally lead to increased prices. Indeed, new shippers will replace existing shippers if they are willing to pay enough to do so. If the Board were to devise a regulatory structure that permitted railroads to earn revenue sufficient to maintain only the infrastructure necessary to serve the current needs of existing shippers, the result would be an ongoing capacity crisis because railroads would not have the ability or incentive to invest in capacity necessary to serve future demand and likely growth. An already problematic capacity situation would become much worse.

III. Shippers Offer Nothing New on Eligibility Thresholds

The Joint Shippers continue to insist that eligibility rules must be "altered drastically to make them more realistic," Joint Shipper Reply Comments at 12, but they make no concrete suggestion as to what appropriate eligibility levels would be. Instead, they foreshadow their resistance to accepting eligibility thresholds set by the Board and announce their expectation that each case will begin "with a pitched battle involving the shipper's effort to overcome the eligibility presumptions." *Id.* The railroads do not envision that such pitched battles would be necessary, and have expressed a willingness to comply with the eligibility limits established by the Board. AAR also proposed in its Reply Comments that the Maximum Value of the Case ("MVC") determination could be made more flexible by calculating the amount in dispute based on the difference between the challenged rate and a stipulated floor as opposed to the difference between the challenged rate and 180 percent of variable costs. AAR Reply Comments at 11-12. Thus, a "pitched battle" would arise only if shippers seek to shoehorn ineligible cases into medium sized and small rate case categories established by the Board.

The Joint Shippers Reply Comments are entirely silent regarding the concerns expressed by the railroads about the impact of significant departures from CMP and widespread application of less accurate rate reasonableness standards. The Joint Shippers ignore these issues and simply argue that an “effective rate remedy” would not be available to “the large majority of shippers” unless those shippers are entitled to bring a case under simplified procedures. Joint Shipper Reply Comments at 12. By “effective,” the Joint Shippers apparently mean that simplified procedures would be satisfactory only if they result in rate reductions. But there is no evidence whatsoever that significant numbers of shippers are entitled to any rate reduction. What the Board should be attempting to develop in this proceeding is not a path to guaranteed rate relief but procedures and standards that reduce litigation costs and thereby make it more practicable for shippers who cannot justify Full-SAC cases to pursue rate complaints.

IV. Shipper Arguments Against Simplified SAC Are Unfounded

The Joint Shippers attempt to support their claim that Simplified SAC is too expensive and complicated by itemizing the burdens that will be placed on *railroads* under the Board’s proposal. Joint Shipper Reply Comments at 12-15. The railroads have concerns about the burdens that will be placed on them in Simplified SAC proceedings. For this reason, AAR suggested a “loser pays” rule for discovery costs. AAR Opening Comments at 9. Under that rule, shippers bringing meritorious cases could avoid discovery costs altogether. The shippers, however, have rejected the proposal out of hand. In the absence of a cost-shifting provision, the costs that will be incurred by the railroads are not relevant to determining whether shippers with lower value cases can afford to pursue rate litigation. The appropriate question is how much it would actually cost a shipper to bring a case, and the Joint Shippers have not shown that the costs they are likely ultimately to bear to verify evidence that is largely prepared for them by the

railroad will be greater than the costs that the Board assumed in establishing its eligibility threshold for Simplified SAC cases.

The Joint Shippers also argue generally that the various proposed modifications to Simplified SAC would render an already expensive and complex procedure even more unworkable. Without specifying which modifications they believe would be necessary to ensure that Simplified SAC produces results consistent with CMP, the Joint Shippers state that the Board cannot “completely reject all exceptions to its Simplified-SAC procedures without acting arbitrarily and capriciously.” Joint Shipper Reply Comments at 20. The Joint Shippers further argue that Simplified SAC could be workable only if “the Board flatly and thus arbitrarily forbids any adjustments whatsoever to its proposed Simplified-SAC procedures regardless of the facts of a particular case.” *Id.* at 21. According to the Joint Shippers, because the Board must allow exceptions to ensure consistency with CMP, but can not do so while at the same time engaging in simplification, Simplified SAC must be abandoned.⁵

The Joint Shippers’ logic proves too much. If applied to all proposed methodologies – including the Three Benchmark approach – it would effectively preclude them all due to the inherent tension between simplification and fidelity to CMP principles. Regarding Simplified SAC, AAR believes that much of what the Board proposes is acceptable and would produce SAC-like results. However, individual railroads have identified a number of modifications that they believe would improve the accuracy of Simplified SAC without overly complicating the procedure.

⁵ Curiously, the Joint Shippers do not appear concerned that their alternative, vastly expanded use of a modified Three Benchmark approach, is not at all consistent with CMP principles.

V. Competitive Traffic Should Not Be Included in Three Benchmark Comparison Groups

AAR's member railroads who are participating in this proceeding have diverse views on the utility and proper structure of a simplified benchmark approach for the smallest cases. AAR is not, therefore, in a position to offer general recommendations on how the Three Benchmark approach could be modified. AAR's member railroads do agree, however, that under no circumstances would it be appropriate to include presumptively competitive traffic – traffic with an R/VC of less than 180% – in a comparison group used as part of a procedure to determine a maximum reasonable rate for traffic with respect to which a railroad has market dominance.⁶ The Board rejected inclusion of <180% traffic in comparison groups as inconsistent with the statute in 1996.⁷ The Board reiterated its intention not to include such traffic in comparison groups in the notice for this proceeding.⁸ The Board is clearly correct to exclude such traffic from comparison groups as rates on competitive traffic are not instructive as to how much differential pricing should be permitted on traffic without competitive modal options.

The proposed justification for inclusion of competitive traffic in the comparison group is that “[t]he test of a reasonable rate should not be just that the rate matches the contribution of other captive traffic, but that the rate matches the contribution of similar traffic.”⁹ This statement, however, amounts to nothing other than a declaration that railroads should not be

⁶ See Reply Comments and Recommendations of Snively King Majoros O'Connor & Lee, Inc., at 10. AAR's member railroads also agree that eligibility thresholds for the Three Benchmark approach certainly should be no higher than the Board has proposed.

⁷ *Non-Coal Guidelines*, 1 S.T.B. at 1026.

⁸ *Simplified Standards for Rail Rate Cases*, STB Ex Parte No. 646 (Sub-No. 1), slip op. at 28 (served July 28, 2006)(Three Benchmark approach would compare “the challenged rate against rates for other potentially captive movements”).

⁹ Reply Comments and Recommendations of Snively King Majoros O'Connor & Lee, Inc., at 10.

allowed to engage in differential pricing. Thus, if there are both competitive and market dominant moves for a given commodity, the shippers would maintain that all movements of that commodity are to be priced at the competitive market level. For obvious reasons, *see* AAR Opening Comments at 3-5, the Board cannot entertain such a frontal assault on differential pricing.

VI. The Railroads' URCS Proposals Are Reasonable and Do Not Add Undue Complexity

AAR made clear in its Reply Comments, at 16-18, that the railroads are not seeking the right to augment URCS costs in the vast majority of cases. Under AAR's proposal, adjustments would be permitted only in those very limited circumstances where URCS does not properly account for or grossly understates actual costs. The Joint Shippers appear to concede that such situations could exist. They acknowledge, for example, that "[h]azardous materials shipments pose [a] problem." Joint Shipper Reply Comments at 30. Similarly, shippers do not deny that unique shipments such as high/wide movements also have unique costs that are not adequately reflected in URCS. With respect to hazardous materials, they simply assert that attempting to determine actual costs would be too complicated. With respect to unique shipments, they wave their hands and assert that issues probably will not arise because such shipments are likely covered by contracts.

At the same time the Joint Shippers claim that URCS adjustments would introduce too many complications, even if limited to special circumstances where they are necessary, the Joint Shippers also argue, *id.* at 31, that the Board should allow parties to advance undefined arguments about "considerations of non-URCS related factors" that would determine whether or not the calculated result of a Three Benchmark analysis establishes a reasonable maximum rate in a given case. The conflict in the Joint Shippers' positions regarding the Board's simplification

goals in these two related contexts is troubling. While the simplification goal is laudable in both contexts, AAR believes that controlling principles of administrative law require the Board to allow departures from system average URCS costs in limited circumstances where such departures are necessary because URCS does not properly account for or grossly understates actual costs.

VII. Revocations of Exemptions Must Comport with the Statutory Standards for Revocation

In its prior comments, AAR has expressed its deep concern that the Board's invitation to shippers of exempt traffic to file rate complaints, coupled with individualized requests for revocation of exemptions, threatens to undermine the statutorily mandated regime of exemptions. In the guise of defending a "simplified" approach to revocation of exemptions, the Joint Shippers support the Board's proposal and advocate a piecemeal approach to revocation of exemptions. The dismantling of class exemptions would be accomplished one case at a time, with individual shippers who make rate complaints entitled to ignore the basis for the original grant of a class exemption. According to the Joint Shippers, there is no need to revisit the basis for a prior grant of exemption, to address market conditions as a whole, or to demonstrate that the prior grant of exemption was wrong. Joint Shipper Reply Comments at 34. These factors can supposedly be ignored in favor of an individualized showing by a shipper that it needs rate relief. However, a shipper of exempt traffic that seeks to invoke the Board's rate reasonableness jurisdiction should, at a minimum, be required to demonstrate that the basis of the exemption no longer applies to it.

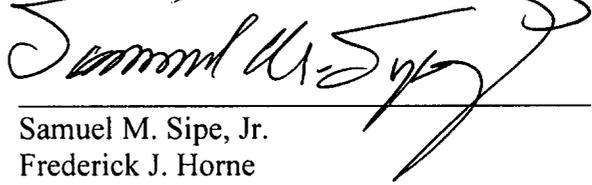
The statute speaks clearly to the issue of revocation of exemptions. *See* 49 U.S.C. § 10502(d). The Board may not avoid the statutory requirements by taking a shortcut approach to exemptions where a rate complaint has been filed. The Joint Shippers' support for this approach does not cure its legal deficiencies.

The Joint Shippers seek to bolster their argument that a streamlined exemption determination is permissible by presenting a transparently faulty statutory analysis that seeks to equate market dominance, a jurisdictional requirement in rate proceedings, with the broader market power considerations of the National Rail Transportation Policy that must be evaluated in the context of revoking an exemption. The Shippers erroneously claim that one of the rail transportation policies, 49 U.S.C. § 10101(6), “tracks *word for word* the market dominance standard.” Joint Shipper Reply Comments at 34 (emphasis in original). In fact, the language of the rail transportation policy relating to market power is broader and more general than the market dominance standard. The Board has chosen to read the market dominance standard narrowly to include only competition for movements between specific origins and destinations from other rail carriers or other modes of transportation. *Market Dominance Determinations – Product and Geographic Competition*, 3 S.T.B. 937 (1998), *aff’d*, 306 F.3d 1108 (D.C. Cir. 2002). But even in doing so, the Board has acknowledged that railroad rates are also constrained by product and geographic competition. 3 S.T.B. at 946 n.49. The Board’s revocation analysis must apply the broader framework mandated by the transportation policy of 49 U.S.C. § 10101.

VIII. Conclusion

For the reasons articulated in the AAR’s comments in this proceeding, the Board should implement its proposals, modified to reflect the AAR’s suggestions.

Respectfully submitted



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CERTIFICATE OF SERVICE

I, Frederick J. Horne, hereby certify that on this 11th day of January, 2007, I caused a copy of the Rebuttal Comments of the Association of American Railroads to be served by first-class mail or a more expeditious method of delivery upon all persons identified on the Board's service list for STB Ex Parte No. 646 (Sub-No. 1).



Frederick J. Horne