

**BEFORE THE
SURFACE TRANSPORTATION BOARD
Washington, DC 20423**

In the Matter of:

SIMPLIFIED STANDARDS FOR RAIL RATE CASES

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

**REBUTTAL COMMENTS OF
ARKANSAS ELECTRIC COOPERATIVE CORPORATION**

Arkansas Electric Cooperative Corporation (“AECC”) respectfully submits these comments, which address issues raised in the reply comments submitted by other parties in this proceeding.¹ The reply comments of the railroad parties address several points contained in AECC’s opening comments regarding the following issues:

- effects of the proposed eligibility criteria on negotiating leverage and rate levels;
- broadened availability of the “Simplified-SAC” (“SSAC”) methodology in larger cases;
- disaggregation of data from past SAC cases to be used in SSAC; and,
- the treatment of depreciation in SSAC.

The reply comments of the railroad parties also raise issues in the following general areas:

¹ AECC’s interest in this proceeding is described in Opening Comments of Arkansas Electric Cooperative Corporation at pp. 1-3 (Oct. 24, 2006) (“AECC Opening Comments”).

- the economic power of large shippers vs. railroads;
- route selection in SSAC;
- the need for revenues sufficient to support needed rail infrastructure; and,
- the relationships among rail capacity constraints, price levels and market power.

Each of these is discussed below.

In addition, some of the railroad parties raise methodological issues related to the Board's decision dated October 30, 2006 in STB Ex Parte No. 657 (Sub-No. 1), *Major Issues In Rail Rate Cases* (hereafter, "*Major Issues*"), that do not bear any apparent relationship to the opening comments of parties to the instant proceeding. For example, BNSF criticizes the "maximum markup methodology (MMM)" adopted by the Board to allocate SARR savings, while AAR advocates continued use of the "percent reduction methodology (PRM)". Although these comments are styled as replies, they appear to address issues that the Board already considered in reaching its findings in *Major Issues*. Absent a clear showing that the circumstances of medium-sized and small rate disputes differ from large disputes in a manner that substantiates a need for a different methodology, the reply comments of this type basically seek reconsideration of arguments that the parties already made and the Board already rejected in *Major Issues*.

While the railroad parties may disagree with some of the Board's actions in *Major Issues*, any reconsideration of those actions should be obtained through appropriate procedures. Indeed, BNSF along with several other railroad (and some shipper) parties have petitioned for judicial review.² Reconsideration of such issues in the instant proceeding would improperly disadvantage the other parties in *Major Issues*, and would

² See STB Notices in Ex Parte 657 (Sub-No. 1) served Nov. 16 and Dec. 14, 2006.

impose improper burdens on the parties in the instant proceeding. The Board should therefore give no weight to such arguments in this proceeding.

A. Eligibility Criteria

AECC's opening comments noted how the proposed eligibility criteria may tend to deny shippers access to SSAC, since the "Maximum Value of the Case" ("MVC") may materially exceed the "actual" value of the case in circumstances where the prescribed rate is above the jurisdictional threshold. Several of the railroad parties, including AAR, BNSF and CSX/NS, have proposed a modification of the criteria that would permit a complaining shipper to specify a rate above the jurisdictional threshold that would serve as the basis for determining the value of the case (while simultaneously constraining the relief to which the shipper would be entitled).

In some limited circumstances, a complaining shipper may have sufficient information to develop an informed expectation regarding the outcome of an SSAC analysis that could support a rational decision to limit the relief sought in a case. For example, if the traffic at issue moves through a corridor in which a SAC analysis has previously been performed, a shipper may be able to develop an informed expectation regarding SSAC results. However, there is no reason to believe that such circumstances will prevail on any type of regular basis. In most circumstances, determination of an accurate value for use in the formula would essentially require that the case be litigated before it is begun.

More importantly, for a shipper in the circumstances described in the example developed in AECC's opening comments,³ the proposed refinement would not provide any meaningful relief from the ability of the railroad to quote an initial rate that captures

³ AECC Opening Comments at pp. 4-6.

the negotiating leverage associated with the shipper's prospective SAC litigation costs. In the original example, by setting an initial rate above \$21.40/ton the railroad could produce circumstances that would lead a rational shipper to settle at approximately \$21.40/ton rather than litigate. Under the proposed refinement, the railroad would simply need to ensure that the challenged rate exceeded the shipper's "indifference" rate by an amount sufficient to trigger the requirement to use SAC. Extending the prior example, an initial rate of over \$28.40/ton would ensure an MVC calculation of at least \$3.5 million.⁴ Ultimately, the proposed change in the formula may affect the factors the railroad will consider in setting the initial rate, but it provides no new protection for the shipper against the ability of the railroad to set the initial rate in a manner that fully captures the leverage afforded by the shipper's prospective SAC litigation costs.

Even with the proposed change, the formula leaves the railroad with negotiating leverage that commands rates above the level that provides a market return on the required capital. As was the case with the original formula, this violates the "principal objective" of the SAC constraint articulated by the Board, which is "...to restrain a railroad from exploiting market power over a captive shipper by charging more than it needs to earn a reasonable return on the replacement cost of the infrastructure used to serve that shipper."⁵ The railroad still would be able to rely on a shipper's litigation costs to exploit its market power beyond the level otherwise permitted.

To remedy this problem, the Board should adopt the proposal advanced in AECC's opening comments to credit the shipper in the rate prescription with some or all

⁴ The shipper would not have any discernible economic incentive to stipulate a rate floor above the \$21.40/ton it could expect to achieve by litigating a full-SAC case (at a cost of \$7.00/ton) to achieve a rate at the 180 percent R/VC level (\$14.40/ton), as assumed in the original example.

⁵ See Section I.1.A of the Board's decision dated July 28, 2006 initiating the instant proceeding.

of the costs borne by the shipper in establishing the prescribed rate.⁶ If the shipper bears some of the costs of establishing a lawful common carrier rate,⁷ it is reasonable for the Board to provide it with a credit for doing so. To the extent that this credit corresponds to the shipper's costs, it would leave the shipper paying a total bill for rail transportation that corresponds to the rate called for under constrained market pricing (CMP), and would remove the railroad leverage associated with a shipper's SAC litigation costs that leads to rates above the CMP level. This would leave both parties with interests more commonly aligned towards finding a rate that's consistent with the statutory standards and the Board's practices with a minimum amount of unnecessary litigation.

B. Broader Availability of SSAC

In its opening comments, AECC argued that broadening the availability of SSAC would be consistent with the objective of mitigating the burdens imposed on shippers by the costs of SAC.⁸ Such broadening would not unduly jeopardize rail revenues, since SSAC approximates SAC, but tends to produce a looser rate constraint (i.e., because it systematically omits consideration of efficiency improvements that prospectively could be captured in SAC).

The railroads' collective response to AECC's position can best be described as schizophrenic. On the one hand, the railroads acknowledge SSAC is consistent with

⁶ AECC Opening Comments at p. 7.

⁷ For common carrier rates below the jurisdictional threshold, and common carrier rates above the jurisdictional threshold that are not challenged, the entire cost of establishing the rate is borne by the railroad.

⁸ AECC Opening Comments at pp. 6-7.

CMP, that SAC is costly and that that reducing the time and cost of litigation is beneficial.⁹ However, they nevertheless oppose any expansion of SSAC availability.

The incongruity of the railroads' positions is particularly evident in the assertions made by AAR, BNSF and UP to the effect that SSAC and SAC are not likely to digress very much due to efficiency considerations. It may well be true that in specific cases the two methods do not differ materially due to efficiency considerations, but if SSAC gives results that are closely comparable to those of SAC while costing less, there is no valid reason why its use should be tightly restricted.

What the railroads' position ultimately boils down to is that they are willing to subject themselves to the high costs of SAC in order to ensure that shippers remain burdened with high SAC litigation costs to the maximum extent feasible. It does not seem to concern them that their position on the eligibility criteria can compel the parties in a rate dispute to cumulatively spend in litigation costs double the amount at issue in the case.¹⁰ Likewise, they steer clear of any attempt to ensure that the accuracy advantage of SAC is sufficient to justify its higher cost.

There is no valid public policy goal that the Board would serve by adopting procedures that promote inefficient use of the parties' resources. Indeed, for the same reason that the Board can focus on resource cost reductions in rail merger cases (i.e., regardless of the beneficiary), it is important that the Board consider the impacts of its requirements on resource costs for both the shippers and the railroads. At an absolute

⁹ Reply Comments of BNSF Railway Company at pp. 16-17 (Nov. 30, 2006); Reply Submission of Union Pacific Railroad Company at p. 37 (Nov. 30, 2007) ("UP Reply Submission").

¹⁰ In developing the eligibility criteria, the Board relies on the estimate that a shipper faces SAC litigation costs of \$3.5 million. Assuming that the defendant railroad faces comparable costs, a case with an MVC of slightly over \$3.5 M would impose \$7.0 M in litigation costs on the parties.

minimum, the eligibility formula should provide for use of SSAC up to the point where the value of the case is less than or equal to the expected SAC litigation costs of both parties combined (\$7.0 million). Below this level, any required use of SAC would be guaranteed to consume resources greater than the total amount at issue in the dispute.

Even above this level, a Board requirement to utilize SAC instead of SSAC would be economically inefficient unless the incremental cost of the SAC analysis¹¹ exceeds the magnitude of the deviation between SAC and SSAC results. Put another way, to avoid squandering resources, the Board ideally should not require the parties to spend an extra \$6.6 million in litigation above the cost of SSAC unless the amount at risk of error through use of SSAC is at least that much.

At present, the record in this proceeding does not support the establishment of a specific threshold for SAC application that reflects such a balancing of cost and accuracy considerations. Nevertheless, as parties and the Board develop greater experience with SSAC and the revised SAC procedures, it is reasonable to anticipate that predictable differences in results between the two methodologies will become discernible.

To foster development of reliable information regarding the amount at risk of error, the Board should leave open the opportunity for parties to develop and submit information regarding the accuracy of SSAC as a proxy for SAC. For example, the results from SAC cases decided under the recent methodological changes could be compared to SSAC results developed for the same issue traffic.

¹¹ To illustrate using the Board's estimated SAC litigation cost of \$3.5 M per party and SSAC litigation cost of \$0.2 M per party, the incremental cost of SAC litigation is \$3.3 M per party (\$3.5-\$0.2), or \$6.6 M total. To the extent that actual litigation costs are found to differ from the Board's estimates, or if those estimates are otherwise changed, the incremental cost of SAC litigation would need to be recalculated accordingly.

When sufficiently reliable information of this type is available, the Board should allow parties to utilize SSAC in situations where the prospective error associated with use of SSAC is lower than the incremental cost of SAC. In the meantime, the Board should amend its formula to account for the combined litigation costs of both parties, and take appropriate steps to mitigate the reliance by railroads on the prospective SAC litigation costs of shippers to achieve rates above statutory levels.

C. Disaggregation Of Data From Past Cases

BNSF attempts to rebut AECC's observation that use of data from past cases could have greater accuracy and validity if appropriate partitioning is used to separate past results from more versus less comparable situations. Specifically, AECC's opening comments identified instances in which geographic ("East" vs. "West") factors appeared to account for much of the variation observed among past SAC analyses.¹² In these cases, use of geographic partitioning would appear to reduce the magnitude of any imprecision associated with reliance on the available selection of past SAC analyses.

While BNSF characterizes AECC's suggestion as "cherry-picking", BNSF ironically then advances a proposal that would enable parties to hand-pick the past results they would like to employ (based on submission of "limited additional evidence"). To an extent, BNSF appears to be agreeing with the general proposition that some subsets of past results are likely to be more relevant than others for specific SSAC analyses.

The Board must decide whether the prospective attainment of greater accuracy is worth the effort that will be required to justify selection of a specific subset. In most circumstances, the geographic partitioning suggested by AECC would not leave much room for discretion, and thus would tend to create few (if any) opportunities for disputes.

¹² AECC Opening Comments at p. 8.

It would capture broad differences that may exist between the eastern and western operating environments, but would not “fine tune” the selection of comparable analyses.

A potential refinement of this approach would allow parameters to be drawn from a specific prior SAC analysis when an SSAC would utilize the same facilities. For example, if a SAC analysis covered movement over a given line, an SSAC that replicated all or part of the SARR in the SAC analysis could prospectively rely on data from (only that SAC analysis (rather than a combination of that analysis with analyses from other movements)).

D. Treatment Of Depreciation in SSAC

AECC’s opening comments pointed out the apparent inconsistency between the Board’s proposal that the SARR pay the full book value of the defendant carrier’s equipment and the fact that SSAC provides no method to credit the SARR with efficiency improvements associated with purchase of new equipment.¹³ UP’s reply alludes to AECC’s comments in this area,¹⁴ but does not offer a discernible criticism. This leaves intact AECC’s position that the SARR should be permitted to benefit from reliance on used equipment to the same degree as does the defendant railroad, and should pay no more (or no less) than the depreciated values of the defendant railroad’s equipment.

E. Economic Power Of Large Shippers Vs. Railroads

The reply comments of BNSF include an assertion to the effect that large shippers, particularly those with multiple plants, possess sufficient market power to protect themselves against the actions of (comparatively smaller) Class I railroads. It is certainly true that shippers with multiple plants may possess a degree of countervailing

¹³ AECC Opening Comments at p. 9.

¹⁴ UP Reply Submission at p. 20, footnote 57.

market power not available to other shippers. What the BNSF argument fails to mention is that the effectiveness of this countervailing leverage results primarily from the opportunities such a shipper may have to shift output to plants served by other railroads. In the long wave of rail mergers, such leverage has been systematically lost. For example, a shipper who previously could shift output between plants served exclusively by Burlington Northern and ATSF now has no such option. Similarly, a shipper who previously could shift output among plants served exclusively by UP, MP, WP, MKT, CNW, SP and/or DRGW now has no such option. If anything, the BNSF argument brings attention to a form of competition that has been weakened or lost in the merger cases that created the current rail mega-carriers. It reinforces the importance of the Board's rate reasonableness procedures for shippers of all sizes.

F. SSAC Route

Railroad parties including CSX/NS and UP argue that the route used in an SSAC analysis should correspond to the primary route normally used by the subject traffic. As addressed in further detail in AECC's reply comments,¹⁵ this argument overlooks the critical fact that the SSAC methodology is only applied in circumstances where the defendant railroad possesses significant market power. Especially in light of the Board's determination to apply the "maximum mark-up methodology" in the computation of prescribed rates, neither a shipper nor the Board can be confident that the carrier-selected routing for high-rated traffic will be the most efficient. Indeed, if the defendant carrier possesses enough market power for the Board's rate procedures (or the threat thereof) to provide a binding constraint, the carrier would appear to have a financial incentive to

¹⁵ Reply Comments of Arkansas Electric Cooperative Corporation at pp. 7-8 (Nov. 30, 2006) ("AECC Reply Comments").

employ inefficient routings. The ability of shippers to specify an alternative route removes the profit potential from such strategies. It is therefore important for the Board to preserve a meaningful capability for the shipper to specify the route.

G. Need for Revenues to Support Rail Infrastructure

Railroad parties including AAR and CSX/NS cite rail revenue adequacy and infrastructure needs as if such considerations should cause the Board to refrain from constraining rail rates. As addressed in further detail in AECC's reply comments,¹⁶ this line of reasoning promotes a cross-subsidy that is contrary to the entire purpose of CMP, as well as to the public interest. Under CMP, the revenue from a given subset of a railroad's traffic is limited to that needed to cover the costs of efficient operations and provide a market return on the capital assets required to serve that traffic. As long as the constrained market-based rates ensure that the subject traffic provides a market rate of return on the assets it uses, constraints on high rates cannot be the source of any overall revenue or capacity inadequacy on the part of the defendant carrier. Such considerations should not prevent the Board from implementing meaningful constraints on differential pricing.

H. Capacity Constraints, Price Levels and Market Power

Railroads parties including UP and CSX/NS attempt to argue that it is consistent with elementary economics for railroad prices to rise relative to variable costs as demand for rail services increases. According to this reasoning, such increases do not reflect an undesirable increase in railroad market power, and should not be of concern to the Board.

¹⁶ *Id.* at pp. 2-4.

As addressed in greater detail in AECC's reply comments,¹⁷ this argument reflects a nearly complete perversion of the economic principles upon which it purportedly rests. In economic terms, market power is defined as the degree to which a supplier is able to command a price in excess of (marginal) cost. When a railroad is able to increase the R/VC ratio on a given traffic flow through an increase in price, it is by definition exercising increased market power. The fact that a railroad can achieve increased R/VC ratios by rationing scarce current capacity also may reflect a diminution of competitive conduct by other current suppliers and/or barriers to entry faced by potential new entrants. It further suggests that railroads no longer possess economies of scale, undermining the entire rationale for many past merger decisions and the Board's competitive access policies.

Contrary to the railroad posture that everyone should relax and enjoy their systematic rate increases, the Board should give careful consideration to the degree to which the railroads are, to borrow the phrase popularized by Ned Beatty's character in the motion picture "Network" (1976), "tampering with the primal forces of nature". The Board should take a concerned view of any systematic increase in the exercise of rail market power, and should consider carefully the possible need for relaxation of past Board/ICC limitations on competitive forces that may no longer be warranted.

¹⁷ *Id.* at pp. 4-5.

AECC appreciates this opportunity to respond to the reply comments of other parties in this proceeding.

Respectfully submitted,

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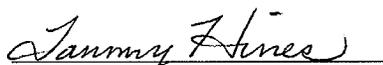
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January 11, 2007

Certificate of Service

I, Tammy Hines, a secretary in the law firm of Keller and Heckman LLP, hereby certify that a copy of the foregoing Rebuttal Comments of Arkansas Electric Cooperative Corporation have been sent, first class mail, postage prepaid, to all Parties of Record on this 11th day of January, 2007.



Tammy Hines