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February 26, 2007



Via HAND DELIVERY

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

ENTERED
Office of Proceedings
FEB 26 2007
Part of
Public Record

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 Supplemental Comments of the Association of American Railroads ("AAR") submitted in response to the Board's decision served July 28, 2006, and its pre-hearing order served January 22, 2007, in the above-captioned proceeding. Please date stamp the extra copy of this letter and return it with our messenger.

Sincerely,

A handwritten signature in black ink that reads "Samuel M. Sipe, Jr." with a stylized flourish at the end.

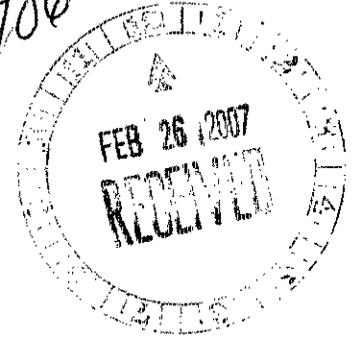
Samuel M. Sipe, Jr.
Counsel for Association of American
Railroads

Enclosures

cc: Parties of Record

218706

BEFORE THE
SURFACE TRANSPORTATION BOARD



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

SIMPLIFIED STANDARDS FOR RAIL RATE CASES

SUPPLEMENTAL COMMENTS OF THE
ASSOCIATION OF AMERICAN RAILROADS

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Michael E. Roper
BNSF Railway Company

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Of Counsel

Dated: February 26, 2007

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

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

SIMPLIFIED STANDARDS FOR RAIL RATE CASES

**SUPPLEMENTAL COMMENTS OF THE
ASSOCIATION OF AMERICAN RAILROADS**

I. Introduction

Pursuant to the Board's pre-hearing order, served January 22, 2007, the Association of American Railroads ("AAR") respectfully submits these supplemental comments in the captioned proceeding. AAR's comments address issues identified by the Board in its January 22, 2007 order and additional questions that arose during the course of the January 31, 2007 oral hearing in this proceeding.

II. Eligibility Criteria

A. Threshold Levels

Shipper representatives waited until the rebuttal round of comments to reveal what their prior assertions that thresholds must be revised dramatically upward meant. On the basis of exaggerated estimates of litigation cost and the assertion that eligibility thresholds must reflect a risk multiplier, the shippers proposed that, if the Board determines that a three-tier approach is called for, shippers with a maximum value of case ("MVC") up to \$10.5 million should be permitted to bring a rate case under the Three Benchmark approach, while shippers with an MVC between \$10.5 million and \$13.5 million should be permitted to use Simplified SAC.

These proposed thresholds are flatly inconsistent with the Board's objective of using the crudest simplified rate standards only in small cases and must not be adopted.

AAR has replicated Table 2 from the Board's July 2006 decision using the eligibility thresholds proposed by shippers:¹

**Eligibility Estimate
(2004 Revenue in Thousands)**

Description	All Regulated	Large Disputes		Medium-Size Disputes		Small Disputes	
Farm Products	942,701	0	0.0%	7,761	0.8%	934,940	99.2%
Metallic Ores	199,375	44,705	22.4%	3,253	1.6%	151,418	75.9%
Coal	3,168,171	1,096,705	34.6%	210,885	6.7%	1,860,581	58.7%
Crude Petroleum	2,403	0	0.0%	0	0.0%	2,403	100.0%
Non-metallic Minerals	111,508	0	0.0%	10,635	9.5%	100,873	90.5%
Ordnance	7,267	0	0.0%	0	0.0%	7,267	100.0%
Food Products	280,429	31,306	11.2%	0	0.0%	249,123	88.8%
Chemicals	2,534,099	64,119	2.5%	46,894	1.9%	2,423,086	95.6%
Petroleum Prod.	516,563	0	0.0%	0	0.0%	516,563	100.0%
Transportation Eq.	23,158	0	0.0%	0	0.0%	23,158	100.0%
Waste or Scrap	40,906	0	0.0%	0	0.0%	40,906	100.0%
Misc. Freight	103,195	13,667	13.2%	4,220	4.1%	85,308	82.7%
Misc. Mixed Freight	7,667	0	0.0%	3,776	49.2%	3,891	50.8%
Small Pkg. Freight	2,375	0	0.0%	0	0.0%	2,375	100.0%
Hazardous Waste	20,895	0	0.0%	0	0.0%	20,895	100.0%
Total	\$7,960,712	\$1,250,501	15.7%	\$287,424	3.6%	\$6,422,787	80.7%

Under the shippers' proposed thresholds, the rates on more than 80% of all traffic potentially subject to regulation could be assessed for reasonableness under the Three Benchmark approach. The only commodity for which rates on a significant volume of traffic would be evaluated under traditional SAC procedures would be coal, but even in the case of coal, nearly 60% of coal traffic would be subject to the Three Benchmark approach. Simplified SAC

¹ Table 2 appeared in *Simplified Standards for Rail Rate Cases*, Ex Parte No. 646 (Sub-No. 1), slip op. at 37 (served Jul. 28, 2006) ("646 NPRM"). The above is based on masked 2004 waybill revenue for traffic with an R/VC of greater than 180%.

would be used for almost no traffic. In other words, essentially all traffic except that of the very largest coal shippers would be subject to the Three Benchmark approach.

The Board is well aware that the Three Benchmark approach does not directly implement Constrained Market Pricing principles. As proposed, the test does not take into account the ability – and need – of railroads to price differentially in response to shipper demand. Instead, the Three Benchmark method is explicitly designed to cap challenged rates at an average level.

Neither the statute nor precedent permits the Board to subject a large portion of railroad traffic to rate regulation under the admittedly crude Three Benchmark approach. When in 1996 it adopted a more flexible benchmark approach than that proposed here, the Board recognized that “[b]ecause of their roughness . . . simplified procedures must be used as sparingly as possible, reserved for only those cases where CMP is not a realistic option.”² In that 1996 decision, the Board reasoned that the threat simplified procedures would pose to railroad revenue adequacy was minimal because “only a very small portion of rail traffic could be subjected to rate reasonableness review using such simplified procedures.”³

In its Notice of Proposed Rulemaking in this proceeding, the Board sought to dismiss the adverse effect of prescribing rates at average levels under the proposed Three Benchmark method, asserting that “only a small percentage of a carrier’s traffic would likely be eligible to use the Three-Benchmark approach under our eligibility criteria.”⁴ The Board also asserted that the Three Benchmark approach is not entirely divorced from CMP because “it would import that constraint by comparing the challenged rate against rates for other potentially captive movements

² *Rate Guidelines – Non-Coal Proceedings*, 1 S.T.B. 1004, 1021 (1996)(“*Non-Coal Guidelines*”).

³ *Id.* at 1008.

⁴ 646 *NPRM*, slip op. at 28.

that are constrained by some form of SAC test.”⁵ But as can be seen from the restated Table 2 above, almost no rates would be evaluated under Simplified SAC and only coal rates would be evaluated under traditional SAC under the thresholds proposed by shippers. Rates for other commodities would effectively be evaluated only under the averaging approach of the Three Benchmark method.

The railroads continue to believe that it is crucial to minimize the extent to which rates are evaluated under any methodology that departs significantly from CMP and fundamental principles of railroad economics. Shipper proposals, however, reveal that their goal is to make as much traffic as possible subject to review under the crudest, least accurate methodology – a methodology which is not grounded in rail industry economics.

B. Litigation Risk

Some shippers argue that eligibility thresholds should be increased to take account of the possibility that complainants in rate cases will not obtain the relief they seek. This proposal to incorporate a risk multiplier into the eligibility thresholds actually has nothing to do with mitigating risk for individual complainants. Litigation risk in any individual case is a function of the merits of the case. Thus, the litigation risk for a small shipper does not change when eligibility thresholds are raised to permit a large shipper with a bigger claim to bring a complaint under a cruder methodology. Moreover, if a small shipper thinks it has a particular likelihood of success when the eligibility threshold is \$200,000, it should perceive the same chance of success if the threshold were raised to \$10.5 million.

As AAR pointed out in its reply comments, it would be inappropriate for the Board to opine that any particular percentage of cases will have successful outcomes for shippers due to

⁵ *Id.*

the aura of prejudgment flowing from such an opinion. The eligibility standards should allow shippers to bring meritorious cases even if the value of the case is small. They should not encourage a mentality of litigation lottery. The only effect of raising eligibility thresholds by incorporating a risk multiplier would be to ensure that larger cases would be subject to less accurate maximum rate standards.

C. Combined Litigation Costs

The proposal by Arkansas Electric Cooperative⁶ that eligibility thresholds should be based on the combined litigation cost faced by both shippers and railroads is similarly focused on arbitrarily raising eligibility thresholds rather than implementing the statutory directive to develop “a simplified and expedited method for determining the reasonableness of challenged rail rates in those cases in which a full stand-alone cost presentation is too costly, given the value of the case.” 49 U.S.C. § 10701(d)(3). The statute clearly contemplates balancing the value of a case from the shipper’s perspective against the shipper’s cost to bring the case, and the point of the statutory directive was to enable shippers with lower value cases to have an effective vehicle for seeking rate relief. The underlying logic is that developing an expensive full stand-alone cost presentation would not be worthwhile to the shipper if the expected gain from, or value of, the case was less than the cost of pursuing the litigation. The cost to a railroad of defending the case is irrelevant to the issue of value from the shipper’s perspective. In evaluating whether to bring a case, the shipper will consider only its own cost of litigation.

D. Other Eligibility Issues

AAR has attempted to be flexible where shippers have identified what may be legitimate concerns with the Board’s proposals. For example, at the January 31 hearing, AAR expressed

⁶ See Rebuttal Comments of Arkansas Electric Cooperative Corp. at 6-7.

support for an aggregation rule that created a presumption in favor of aggregation which could be rebutted by the shipper. Such a rebuttable presumption would prevent manipulation of the eligibility criteria while at the same allowing exceptions in suitable cases where aggregation does not appear to be warranted.

AAR also proposed in good faith that a shipper that does not believe that it would be able to recover the full MVC as calculated by the Board should be permitted to stipulate an R/VC floor below which it does not seek relief.⁷ Where such a stipulation is made, it would be appropriate to calculate the MVC on the basis of that stipulation and permit the shipper to use the simplified methodology that corresponds to the recalculated MVC. The proposal was intended to permit shippers with cases that were near an eligibility boundary to opt for a more simplified methodology if the maximum value of their case, objectively evaluated, did not justify resort to a more rigorous methodology.

The Board suggested a modification of AAR's proposed approach, which it referred to as a "small claims" model in its January 22, 2007 pre-hearing order. AAR could not endorse this approach in the abstract. Whether it could be acceptable to AAR depends at a minimum on the eligibility criteria adopted by the Board, which is precisely the issue that remains unsettled. Moreover, AAR has concerns that in application the small claims model might have nothing to do with small cases and everything to do with tactics.

Vice Chairman Buttrey properly reminded participants at the January 31 hearing that a principal concern underlying the development of simplified procedures was that small shippers should have access to rate relief. AAR believes that the Board should keep this concern in mind as it addresses eligibility thresholds and that doing so is in no way inconsistent with the statutory

⁷ See Reply Comments of the Association of American Railroads, at 11-12.

focus on small cases. Indeed, AAR's proposal concerning a stipulated MVC would enhance small shipper access, and would also include more rate disputes in the category of small cases.

The small claims model would not foster access for small shippers, nor would it necessarily facilitate the bringing of small cases. Instead, that model could encourage shippers to pursue limited rate relief under crude standards without reference to the actual value of their case. For example, under the Board's proposal, a large utility customer that ships millions of tons of coal a year could opt to bring a case under the Three Benchmark approach to achieve a quick and relatively painless – albeit modest – rate reduction. AAR believes that it would be contrary to the statute for a shipper of large amounts of traffic to attempt to obtain a minimal rate reduction under the Three Benchmark approach and thereby seek to insulate itself against any rate increases for a five year rate prescription period.

The Board also expressed interest during the January 31 hearing in the views of commenters concerning its proposal to index the eligibility thresholds. AAR does not believe that indexing would be appropriate at this time. It is reasonable to expect that the cost of litigating simplified cases will decrease over time as parties gain experience with the new methodologies. The Board should wait to until it has gained experience with the thresholds and the course of litigation under the simplified approaches before considering whether there is a need to adjust eligibility thresholds using an index.

AAR has generally supported the Board's proposed eligibility levels. Based on the evidence available, there is no compelling rationale for establishing higher thresholds. The Board must assure that eligibility thresholds not be set at levels that undermine CMP as the predominant approach to determining maximum reasonable rates. Such a result would threaten the financial health of the nation's railroads. AAR urges the Board to reject out of hand the

proposals by the shippers for eligibility thresholds that would have the effect of applying CMP principles only in the very largest coal cases.

III. Simplified SAC Methodology

Certain shippers have argued that the Board is not entitled to adopt more than one simplified approach to evaluating rates and that whatever simplified approach is adopted should not have any relationship to CMP. These positions cannot be reconciled with the statute and its legislative history. The relevant statutory provision states:

The Board shall, within one year after January 1, 1996, complete the pending Interstate Commerce Commission non-coal rate guidelines proceeding to establish a simplified and expedited method for determining the reasonableness of challenged rail rates in those cases in which a full stand-alone cost presentation is too costly, given the value of the case.

49 U.S.C. § 10701(d)(3). The statute directed the Board to complete its then pending efforts to develop a simplified procedure for small cases by a date certain. Nothing in the statutory scheme limits the Board's ability to develop additional or alternative methodologies in the future or suggests that only a single simplified alternative to SAC would be permissible. Indeed, SAC itself is just one of multiple constraints that a shipper could choose to pursue in a case brought under CMP guidelines.

Similarly, there is no basis in the statute to assert that the simplified approach that is adopted must be disconnected from CMP and SAC. On the contrary, Congress made clear when it called for the development of simplified procedures that it did "not intend to erode the Constrained Market Pricing principles adopted by the ICC for full stand-alone cost presentations."⁸ The Board itself has repeatedly stated that CMP, which is the only judicially

⁸ S. Rep. No. 176, 104th Cong., 1st Sess. 8 (1995).

approved maximum rate standard,⁹ remains the most accurate and preferred methodology for evaluating the reasonableness of rates. It is fully consistent with congressional intent and sound regulatory policy for the Board to attempt to develop a simplified SAC procedure that retains as much of CMP as possible while at the same time reducing the cost of litigation to facilitate shipper access to rate relief in the limited circumstances where such relief might be required.

With respect to the particulars of the Simplified SAC methodology, AAR limits its comments to two issues that could have a significant impact on the cost and accuracy of the methodology. First, AAR believes that complainants should be precluded from rerouting issue traffic. AAR agrees with the statements of the U.S. Department of Transportation at the January 31 hearing that it is reasonable to assume that railroads route traffic as efficiently as possible given the operating constraints that they face. In addition, permitting rerouting would introduce a host of issues that would complicate and increase the cost of a Simplified SAC case.

Second, AAR believes that the Board should give parties the flexibility to propose adjustments to road property investment costs in cases where the SARR route and facilities would differ from those in prior SAC cases. A railroad configured to transport exclusively unit coal trains, as has been the case in most recent SAC cases, would likely not have all of the facilities required to handle other commodities.

IV. Three Benchmark Methodology

AAR's member railroads have expressed a range of views regarding the workability of the Board's proposed Three Benchmark approach. They concur on the following points.

First, AAR and its members believe that a mechanical reduction to an average rate, as the Board has proposed, does not adequately address railroads' need to price differentially and will

⁹ See *Consolidated Rail Corp. v. United States*, 812 F.2d 1444 (3rd Cir. 1987).

inevitably result in an overall ratcheting down of rates towards an average. The ratcheting effect inherent in the Board's proposed benchmark approach is not materially different from that criticized by the D.C. Circuit in its 1993 decision arising out of the *McCarty Farms* litigation before the ICC. *Burlington Northern Railroad Co. v. United States*, 985 F.2d 589, 596-99 (D.C. Cir. 1993). This problem with using an average rate was in part responsible for the court's decision to strike down the ICC's attempt in that case to set maximum reasonable rates by reference to the average rate charged to a supposedly comparable group of traffic.

At the January 31, 2007 hearing, a witness for the shippers, Thomas Crowley, argued that the Board should not be concerned about a ratcheting down effect because comparison groups from case to case would not be identical. This is not, in fact, an argument that ratcheting down will not occur, but instead an argument about how quickly that ratcheting down will happen. The undeniable effect of the Board's proposal is to drive high rates down to the average of rates in a given comparison group. Even if the traffic in comparison groups is not identical in successive rate cases, the effect of repeated iterations involving multiple comparison groups will be to force rates down.

Second, the Board should not include non-defendant traffic in comparison groups under the Three Benchmark approach. The cost structure of a defendant railroad and the demand characteristics of its shippers are not the same as those of other carriers. Nothing in the record of this proceeding supports the proposition that rate levels on a defendant carrier should be judged unreasonable by reference to rates on traffic moving on another, non-defendant carrier.

Third, as stated in AAR's Rebuttal Comments, at 10-11, competitive traffic should be excluded from comparison groups because rates on competitive traffic are not instructive as to what rates should be for traffic without competitive modal options.

Fourth, as detailed in AAR's Opening Comments, at 9-12, the Board should not change the method by which the RSAM is calculated. The function of the RSAM, which is to indicate the revenue levels that a railroad would need to achieve with respect to relatively demand-inelastic traffic in order to become revenue adequate, would be destroyed if the Board were to calculate the RSAM based on all traffic as it proposes.

Fifth, the Board must develop a method for bringing waybill sample rates used in the comparison group calculations up to date so that there is temporal equivalence between comparison group traffic and the current issue rate being challenged. Otherwise the outcomes of Three Benchmark cases will reflect outdated market conditions.

Sixth, shippers' lawyers and consultants should not be given access to unmasked waybill data for purposes of evaluating and preparing complaints. Granting such access to unmasked waybill data would encourage fishing expeditions involving highly sensitive confidential data which the Board has recognized as inappropriate. Recently, the Board rejected a similar request for access to unmasked waybill data on behalf of North Dakota grain shippers. Citing its 1996 *Non-Coal Guidelines* decision, the Board stated that permitting access "would be an inappropriate use of the Waybill Sample for a non-regulatory purpose."¹⁰

Nor is there any justification for loosening the strictures governing release of unmasked waybill data once a complaint has been filed. The Board has already stated that revenues should not be a consideration in selecting traffic for a comparison group. Moreover, the Board should be extremely wary of promoting a regime of small rate cases in which the shippers themselves are forced to watch from the sidelines. Under the statute, the shippers who would actually authorize and pay for the filing of cases under the Three Benchmark approach would not be

¹⁰ See March 10, 2006, Letter from Leland L. Gardner to Nicholas J. DiMichael, at 2.

entitled to the unmasked waybill data due to its commercial sensitivity. *See* 49 U.S.C. § 11904(b).

V. Use of System-Average URCS

As AAR has noted in prior rounds of comments, the Board's proposal to adhere strictly in all cases to the use of system-average URCS costs is not workable because URCS does not accurately capture or grossly understates actual costs for some types of traffic. Hazmat movements, high/wide shipments and payments to railroads and other third parties are examples for which use of system average costs would clearly be inappropriate. AAR continues to urge the Board to permit sufficient flexibility to allow substitution of actual costs under these circumstances.

VI. Mandatory Mediation

In its Opening Comments, at 6-7, AAR proposed that the Board establish a mandatory mediation period at the commencement of each case. There appears to be considerable support for (and no principled objection to) mediation. Indeed, mediation has been used successfully to settle the only two cases brought in the last two years under the existing *Non-Coal Guidelines*. Given the amounts at issue in individual small cases, mediation offers an excellent prospect for resolution. Moreover, mediation costs are modest and the mediation process can be tailored to suit individual cases.

VII. Exempt Traffic

Although the Board did not request further comment on treatment of exempt traffic at the January 31 hearing, the issue of how to deal with prior exemptions in rate reasonableness cases is an important one. The Board properly recognized in its recent fuel surcharge decision that it would be inappropriate to depart from prior exemption determinations without satisfying the

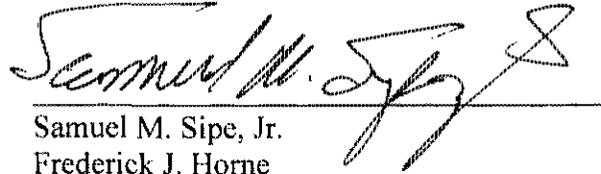
statutory standards for revocation.¹¹ In the rate case context, the Board should rule on petitions to partially revoke an exemption before requiring parties to engage in rate case discovery.

VIII. Testing

The U.S. Department of Transportation has proposed that the Board should test its Simplified SAC methodology to determine how close the results are to those produced by a full SAC analysis, and has also suggested that the Board demonstrate how a Three Benchmark case would unfold. AAR does not oppose some form of testing and/or demonstration if the Board should determine that it is useful, but does not believe that the Board should delay adoption of new rules pending such testing and/or demonstration.

¹¹ *Rail Fuel Surcharges*, STB Ex Parte No. 661, slip op. at 12-13 (served Jan. 26, 2007).

Respectfully submitted



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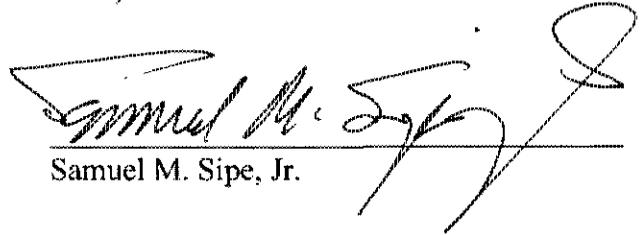
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CERTIFICATE OF SERVICE

I, Samuel M. Sipe, Jr., hereby certify that on this 26th day of February, 2007, I caused a copy of the Supplemental 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).



Samuel M. Sipe, Jr.