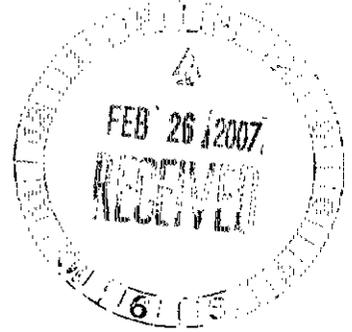


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**BEFORE THE  
SURFACE TRANSPORTATION BOARD**



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

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**SIMPLIFIED STANDARDS FOR RAIL RATE CASES**

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**SUPPLEMENTAL COMMENTS OF UNION PACIFIC RAILROAD COMPANY**

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**SUPPLEMENTAL COMMENTS OF UNION PACIFIC RAILROAD COMPANY**

Union Pacific Railroad Company (“UP”) is filing these supplemental comments pursuant to the Surface Transportation Board’s decision served January 22, 2007 (the “Notice”) to address issues raised in the Notice and at the Board hearing held on January 31, 2007.

We appreciate this opportunity to comment further on important issues pertaining to six areas: eligibility criteria, the Simplified-SAC approach, the Three-Benchmark approach, access to unmasked waybill data, mediation, and adjustments to URCS.

**I. ELIGIBILITY CRITERIA**

UP agrees with the Board’s basic approach to determining whether a case should be eligible for simplified procedures – that is, eligibility should depend on a shipper’s expected cost of pursuing relief and the value to the shipper of obtaining relief in the case at issue. We also agree that the eligibility threshold between full SAC and Simplified-SAC cases should be set no higher than \$3.5 million. We strongly oppose the proposal advanced by shippers at the hearing to set thresholds of \$13.5 million for Simplified-SAC and \$10.5 million for the Three-Benchmark method. That shipper proposal would make approximately 80 percent of regulated movements subject to the fundamentally unsound Three-Benchmark approach, as discussed in the supplemental comments of the Association of American Railroads.

In the Notice and at the hearing, the Board invited the parties to address several specific issues relating to eligibility. We address those issues below.

**A. Litigation Costs**

**1. The Board has overestimated the costs to litigate a full SAC case in light of the decision in Ex Parte No. 657 (Sub-No. 1).**

In the Notice, the Board asked whether it has overestimated the costs to litigate a full SAC case in light of its decision in Ex Parte No. 657 (Sub-No. 1). We believe that the Board has in fact overestimated the costs to litigate a full SAC case. The Board's \$3.5 million estimate is consistent with evidence regarding litigation costs *before* the decision in Ex Parte No. 657 – evidence submitted by the same shippers that are now trying to argue that costs will be higher.<sup>1</sup> However, the Board's decision in Ex Parte No. 657 will reduce costs in two important ways.

*First*, the Board's decision to rely on the Phase III model and unadjusted system-average URCS unit costs for variable cost calculations should produce savings of approximately \$1 million for each party, as the Board concluded in Ex Parte No. 657.<sup>2</sup> The Board's conclusion was supported by comments showing that UP spent well over \$1 million to file its three rounds of evidence in a coal rate case in which the parties litigated only variable costs.<sup>3</sup>

*Second*, the Board's decision should reduce the cost of litigating methodological issues on a case-by-case basis because it addressed long-standing disputes between railroads and

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<sup>1</sup> See Joint Written Testimony of American Chemistry Council, et al., submitted July 16, 2004.

<sup>2</sup> See *Major Issues In Rail Rate Cases*, STB Ex Parte No. 657 (Sub-No. 1), slip op. at 51, 59 (STB served Oct. 30, 2006).

<sup>3</sup> See Reply Submission of Union Pacific Railroad Company at 40, *Major Issues In Rail Rate Cases*, STB Ex Parte No. 657 (Sub-No. 1) (May 31, 2006) (discussing *Northern States Power Company Minnesota v. Union Pacific Railroad Company*, STB Docket No. 42059).

shippers regarding (i) which rate reduction method to use, (ii) which cross-over revenue allocation method to use, and (iii) whether and how to index operating costs.

We recognize that several parties, including UP, have appealed certain aspects of the Board's decision in Ex Parte No. 657. However, the \$1 million in savings from simplifying variable cost calculations would be largely unaffected if rigid adherence to the Phase III model and unadjusted URCS were relaxed modestly to allow recognition of some movement-specific characteristics and costs, which is all that UP seeks in its appeal. Moreover, parties' overall litigation costs should be lower regardless of which methodological approaches are ultimately adopted because parties will not expend resources arguing over questions that have been settled.

**2. The Board has *not* underestimated the costs to litigate a Simplified-SAC case, assuming no rerouting of issue traffic.**

In the Notice, the Board also asked whether it had underestimated the costs to litigate a Simplified-SAC case, assuming that it would not permit rerouting of issue traffic. We believe that the Board has likely *overestimated* the costs of Simplified-SAC.

The Board based its cost estimate on expert testimony from an earlier proceeding that it would be possible to conduct a simplified SAC analysis for between \$25,000 and \$85,000. *NPRM* at 36. The Board reasonably relied on that testimony because it addressed a simplified approach to SAC that would have required parties to perform analyses similar to those that would be required under Simplified-SAC.<sup>4</sup>

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<sup>4</sup> See Reply Submission of Union Pacific Railroad Company ("UP Reply") at 36-37.

The Board should give no credence to shipper claims that Simplified-SAC will cost millions of dollars, and perhaps even as much as a full SAC case.<sup>5</sup> Simplified-SAC will cost shippers a fraction of the cost of a full SAC case for at least three reasons.

*First*, Simplified-SAC will cost shippers much less than a full SAC case because the Board's proposal eliminates the most costly aspects of a full SAC case. As Commissioner Mulvey observed during the hearing, Simplified-SAC eliminates all of the costs associated with selecting traffic for the stand-alone railroad, designing an operating plan, and determining the optimal network configuration. It also eliminates the need to develop detailed evidence to calculate operating expenses, and it dramatically simplifies the road property investment analysis. In addition, Simplified-SAC eliminates disputes regarding traffic projections.

Simplified-SAC will cost even less than the Board initially anticipated if shippers are not allowed to reroute the issue traffic. If rerouting is allowed, parties will incur extra costs to analyze multiple routes and litigate the same sort of complex network configuration and operating issues that the Board has sought to eliminate from Simplified-SAC.

We have argued that the Board should allow parties to address special operating expenses in cases involving hazardous materials and road property costs when prior cases do not provide representative costs, but such modest flexibility would not undermine the significant cost savings inherent in the Board's approach to simplifying SAC.

*Second*, Simplified-SAC will cost shippers much less than a full SAC case because the railroad will bear most of the costs of the simplified procedure. In fact, the cost estimate upon which the Board relied included all of the costs necessary to obtain and process

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<sup>5</sup> See Joint Written Rebuttal Comments submitted by American Chemistry Council, et al. ("ACC Reb.") at 8-9.

the required data and perform the required analyses.<sup>6</sup> Under the Board's proposal, however, the shipper will bear almost none of those costs. The railroad will bear the cost of (i) identifying the traffic that moves on the stand-alone railroad, (ii) calculating operating and equipment costs for each movement, and (iii) calculating revenue divisions for cross-over traffic. The railroad will also bear the cost of producing the data used to develop road property investment quantities.<sup>7</sup>

The Board should not accept the claims made by shipper consultants that they will have to reproduce the railroad's work from scratch to test its accuracy. Most testing will involve simply ensuring that the correct formula was applied to the correct numbers on a spreadsheet. The parties should be able to resolve any perceived problems informally or through a Board-sponsored technical conference.

*Third*, Simplified-SAC will cost shippers much less than a full SAC case because parties will not allow their consultants to spend more than the value of the case. As UP observed at the hearing, parties can and will manage their litigation costs in view of the value of the case. Full SAC cases are very costly in large part because the stakes are so high. In Simplified-SAC cases, however, the stakes are not as high. Moreover, we have shown that the estimates prepared by shipper consultants (i) include a substantial amount of unnecessary work and (ii) presume that consultants will start each analysis from scratch rather than use the information produced by the

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<sup>6</sup> See Opening Submission of Union Pacific Railroad Company ("UP Op.") at 50 (citing Reply Comments of the Association of American Railroads, Reply Verified Statement of Craig F. Rockey & John C. Klick at 20-26, *Rate Guidelines – Non-Coal Proceedings*, STB Ex Parte No. 347 (Sub-No. 2) (Mar. 19, 1996)).

<sup>7</sup> See UP Reply at 28-32.

railroad.<sup>8</sup> No party with a small case would pay for such excessive and unnecessary work. The Board thus should give no weight to the cost estimates provided by shipper consultants.<sup>9</sup>

**3. The Board should not base eligibility thresholds on the combined litigation costs of both parties.**

In the Notice, the Board invited the parties to comment on the proposal by Arkansas Electric Cooperative Corporation that eligibility thresholds should be based on the combined litigation costs of both parties. The proposal appears to be a thinly veiled attempt to allow shippers with larger cases to invoke less precise rate reasonableness standards, and the Board should reject it.

The Board's stated objective in this proceeding is to achieve "the dual statutory goals of providing captive shippers meaningful access to regulatory remedies for rail rates that are unreasonable, while recognizing the need for railroads to earn a reasonable return on their investments." *NPRM* at 3. Doubling the eligibility thresholds to take railroad litigation costs into account is not necessary to achieve the first goal and would be inconsistent with the second.

The Board does not need to double the proposed eligibility thresholds to provide shippers with meaningful access to regulatory remedies. It has adopted a sound approach to the access issue by proposing to base eligibility on a shipper's expected cost of pursuing relief and the value to the complaining shipper of obtaining relief. A shipper has meaningful access when

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<sup>8</sup> See *id.* at 28-34.

<sup>9</sup> The Joint Shippers' response to criticism regarding excessive charges for URCS-related calculations appears to be that consultants would spend a substantial amount of time analyzing "an array of railroad movements" that might be subject to a complaint. ACC Reb., Rebuttal Verified Statement of Gerald W. Fauth III at 12. We believe that the relevant costs are those involved in pursuing one complaint about a specific rate, not those associated with such fishing expeditions. The Joint Shippers never explain how consultants could spend 45 to 110 eight-hour work days to "identify," "develop," and "analyze" cross-over traffic. See UP Reply at 34.

its expected cost of pursuing relief is less than the value of the requested relief. Railroad costs are irrelevant to the question whether a shipper has meaningful access to the Board.

Moreover, doubling the proposed eligibility thresholds would be inconsistent with the Board's obligation to ensure that rail carriers have the opportunity to earn adequate revenues. While doubling the thresholds would not facilitate access for shipper with small cases, it would allow shippers that would already have meaningful access under more precise standards to use standards that are further removed from the principles of Constrained Market Pricing ("CMP"). Such an outcome would be contrary to the Board's conclusion that CMP, "the only economically precise measure of rate reasonableness," must be "used wherever possible,"<sup>10</sup> and that the Benchmark method should be used "only as a last resort" once the Board has "exhausted reasonable measures to simplify the SAC analysis." *NPRM* at 11.

UP is concerned about litigation costs, but the Board should address the issue by adopting rules that encourage parties to negotiate resolutions of their disputes, not by allowing shippers to invoke less precise standards in larger cases. Our concern about litigation costs is why we support mandatory mediation. It is also an important reason why we have urged the Board to reject the Benchmark method in favor of Simplified-SAC. As we discuss below in more detail, Simplified-SAC will promote negotiated solutions because it will allow parties to estimate a range of likely outcomes. When parties are better able to estimate a range of likely outcomes, they are in a better position to resolve their differences without litigation. One of the most important practical problem with the Benchmark method is that it will provide parties with

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<sup>10</sup> *Rate Guidelines – Non-Coal Proceedings ("Simplified Guidelines")*, 1 S.T.B. 1004, 1021 (1996).

little guidance regarding the likely outcomes of their cases and therefore will encourage them to gamble on litigation, as we discuss in Part III.A.2.

**4. The Board should not increase eligibility thresholds to account for “litigation risk.”**

In addition to the proposal for doubling the eligibility thresholds discussed in the Notice, shippers have proposed doubling and even tripling the thresholds to reflect “litigation risk.” The Board should reject those proposals for at least three reasons.

*First*, the Board does not need to increase the proposed eligibility thresholds to reflect litigation risk in order to provide shippers with meaningful access to regulatory remedies. As discussed above, a shipper contemplating a rate case has meaningful access if the expected cost of pursuing relief is less than the value of the requested relief. A shipper that qualifies for the most simplified standard would not obtain improved access to relief if eligibility thresholds were doubled or tripled.<sup>11</sup>

*Second*, doubling or tripling eligibility thresholds would not actually address the issue of litigation risk. If shippers are reluctant to bring small cases because they are uncertain about whether they will prevail, the solution is not to increase eligibility thresholds, but rather to adopt standards that produce more predictable results. Increasing eligibility thresholds would merely allow shippers with larger cases to invoke cruder simplified standards; it would not make rate cases more affordable or predictable for shippers with truly small cases.

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<sup>11</sup> Shippers incorrectly claim that the Board has previously acknowledged a need to account for litigation risk in establishing eligibility thresholds. *See* ACC Reb. at 14 (quoting *Simplified Guidelines*, 1 S.T.B. at 1049). The language quoted by shippers actually reinforces the concept that a shipper has access to relief as long as its requested recovery exceeds the expected cost of pursuing a complaint. The Board recognized that a shipper will have less incentive to pursue relief if its requested recovery is only slightly above its expected cost, but some shippers will inevitably find themselves in that position no matter where the eligibility thresholds are set.

*Third*, the Board has no rational basis for assigning a particular probability of shipper success in small rate cases. There is nothing inherent in any rate reasonableness standard that would allow the shipper or railroad to prevail in a set percentage of cases. In fact, shippers are largely in control of litigation risk because they decide which cases to pursue. Accordingly, any adjustment the Board might make to account for litigation risk would be entirely arbitrary.

**B. The Aggregation Rule**

In the Notice, the Board invited the parties to comment on whether the Board should abandon the proposed aggregation rule and instead address on a case-by-case basis any claims that a shipper was manipulating the agency's processes by disaggregating claims. The Board should not abandon the aggregation rule entirely, but we would support a decision to modify the proposed rule into a presumption that shippers could rebut on a case-by-case basis.

The Board should not abandon the aggregation rule because the rule serves two important functions. First, the rule ensures that CMP is used whenever possible by preventing shippers from disaggregating claims that should be brought as a single case. Second, the rule deters shippers from filing frivolous cases as a negotiating tactic because it requires them to consider the consequences of filing a frivolous case for their ability to file future cases.

Despite our concern that shippers will attempt to disaggregate claims to take advantage of simplified standards, we would be willing to accept an alternative to the proposed rule: in situations that would otherwise trigger application of the aggregation rule, the shipper could rebut the presumption that the rule applies by proving that it could not reasonably have aggregated the claim at issue with a claim raised in a prior case. The Board should place the burden of proof on the shipper because the shipper will be in the best position to explain why it did not bring the claims in the same case.

If the Board modifies the aggregation rule, it should also recognize that it has eliminated a significant shipper objection to the proposed eligibility thresholds. In the *NPRM*, the Board estimated that 67 percent of regulated traffic would be subject to simplified standards under the proposed thresholds. Shippers have argued that this estimate does not account for the effects of the aggregation rule, but modifying the rule would remove any doubt that simplified standards will apply to a substantial percentage of regulated traffic.

**C. The “Small Claims” Model**

In the Notice, the Board invited the parties to comment on a model under which a shipper would be free to select the methodology under which its rate would be analyzed as long as it was willing to accept a limit on the rate relief that would be available under each method. The Board should not adopt such a model – at least not in this proceeding.

We recognize that the model described in the Notice has its roots in a railroad proposal to allow a shipper to stipulate to a revenue-to-variable cost (“*r/vc*”) ratio that would be used to determine the shipper’s eligibility for simplified standards and also establish a limit on the shipper’s maximum recovery. However, that proposal was a good faith effort to address concerns that shippers could be precluded from bringing legitimate small cases by unrealistic assumptions about the maximum value of their cases. The proposal was not intended to allow shippers with large cases to invoke less precise simplified standards in the hope of obtaining a small payout from the railroad, or more significantly, a cap on future rates.

We are pleased that the Board is carefully considering the railroad proposal for modifying maximum-value-of-the-case calculations. However, the Board should not adopt the model described in the Notice. The model does not advance Congress’s directive to establish a simplified 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). In fact, the model appears to run counter to the spirit of that directive, because it invites shippers to invoke less precise rate standards in order to obtain some limited payout from rail carriers when they could pursue rate relief using SAC. Such an outcome seems inconsistent with Congress's concern that simplified standards not be used to "erode the Constrained Market Pricing principles adopted by the ICC for full stand-alone cost presentations."<sup>12</sup>

Moreover, we would need more information about how the model would actually work before we could provide meaningful comments on its merits. For example, in addition to the basic conceptual concern outlined above, one of our most significant practical concerns is that a shipper with a large case might be able to invoke the model to obtain a rate prescription that would be many times more valuable than the rate reduction from the challenged rate. In other words, a shipper with a large case could argue that it is entitled to invoke the Benchmark method because it is seeking relief that would reduce its r/vc ratio by only a small percentage, but if the new r/vc ratio becomes the basis for a rate prescription, the carrier could be precluded from increasing the rate that applies to a substantial volume of traffic for several years. There may be ways to address this apparent loophole, but the Board must not move forward without a more detailed proposal and without giving interested parties notice and a full opportunity to comment on such a proposal's potential impact on rate regulation, railroad revenue adequacy, and the public's interest in a sound rail transportation system. *See* 49 U.S.C. §§ 10101(1), (2), (3), (4), (6) & 10704(a)(2).

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<sup>12</sup> S. Rep. No. 176, 104th Cong., 1st Sess. 8 (1995).

## II. SIMPLIFIED-SAC

UP continues to urge the Board to adopt Simplified-SAC, with modifications that we have proposed, and apply it to all small cases.

In the Notice, the Board invited the parties to address two specific issues relating to Simplified-SAC: (i) whether Simplified-SAC would satisfy Congress's directive in 49 U.S.C. § 10701(d)(3), and (ii) whether the reduction in litigation costs that would result from precluding shippers from rerouting the issue traffic warrants a variation from full SAC methodology. We believe that the answer to both questions is "yes," as we discuss in more detail below.

### A. Three-Tier Approach

#### 1. Simplified-SAC would satisfy Congress's directive to establish a simplified procedure for small rate cases.

In the Notice, the Board invited the parties to comment on claims by shippers that the Board's adoption of Simplified-SAC would not satisfy Congress's directive to establish a simplified and expedited method for determining the reasonableness of rates in small cases. Those claims are refuted by the statute's language and legislative history.

Congress directed the Board to establish simplified procedures for "determining the reasonableness of challenged rail rates in 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) (emphasis added). The only substantive limitation imposed by Congress is that the procedures must be something other than full SAC. Adopting Simplified-SAC, which is not "full SAC," would plainly satisfy Congress's directive.

The statute's legislative history also demonstrates that Congress did not oppose the adoption of a simplified form of SAC. While the legislation was moving through Congress, the ICC was considering a simplified SAC proposal by the Association of American Railroads.

Congress did not rule out such an approach. Instead, it simply required the Board to complete that proceeding within a year. In fact, the legislative history suggests that Congress may have supported such efforts to simplify SAC, because its stated intention was “not . . . to erode the Constrained Market Pricing principles adopted by the ICC for full stand-alone cost presentations.”<sup>13</sup>

**2. The Board may adopt a three-tier approach to small rate cases.**

The Notice also raises the issue of whether the Board may adopt a three-tier approach or whether it must adopt only one simplified procedure. We believe that the statute permits a three-tier approach, as long as each approach is economically sound.

The statute literally does no more than require the Board to complete the then-pending ICC proceeding to develop simplified procedures within one year of the date the statute took effect. 49 U.S.C. § 10701(d)(3). The Board fulfilled that obligation by issuing its decision in *Simplified Guidelines*. The statute does not preclude the Board from modifying its procedures in light of experience, including modifying them by adopting a multi-tier approach.

**B. Rerouting Of Issue Traffic**

**1. The reduction of litigation costs warrants precluding complainants from rerouting the issue traffic.**

In the Notice, the Board invited the parties to address whether the reduction in litigation costs from precluding the rerouting of issue traffic warrants such a variation from full SAC methodology. We believe that the reduction in litigation costs warrants the variation. The reduction in litigation costs would be substantial, and shippers would not be disadvantaged because railroads have strong incentives to use efficient routes in the first place.

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<sup>13</sup> S. Rep. No. 176, 104th Cong., 1st Sess. 8 (1995).

As we have discussed in prior comments, precluding complainants from rerouting the issue traffic would result in significant cost savings for shippers and railroads by eliminating the need to litigate disputes about route selection. Such disputes would require parties to engage in extensive discovery to address the question of whether the route the shipper would select has sufficient existing capacity to handle the additional traffic, and then to litigate a two-month-long case within the larger rate case, with three rounds of evidentiary submissions devoted to route selection. This mini-proceeding would be expensive for both parties and would be inconsistent with the Board's objectives in proposing Simplified-SAC.<sup>14</sup>

Shippers have expressly complained about the costs associated with the potential rerouting of issue traffic.<sup>15</sup> Their comments show that they expect to incur substantial costs not only when they litigate actual disputes, but also when they explore the possibility of rerouting in each case.<sup>16</sup> In other words, shippers will incur significant costs related to rerouting even in cases in which route selection issues are never litigated. The Board can eliminate all of these costs by precluding complainants from rerouting the issue traffic.

Precluding complainants from rerouting the issue traffic may also produce time savings. Under the Board's proposed schedule, routing disputes are to be addressed one month after discovery begins and one month before railroads provide their second disclosure. However, shippers have argued that they cannot make informed routing decisions until after the railroads

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<sup>14</sup> One of the Board's main reasons for proposing Simplified-SAC was to eliminate disputes about whether the stand-alone railroad would have sufficient facilities to serve the traffic group. Allowing shippers to reroute the issue traffic would insert that issue into Simplified-SAC.

<sup>15</sup> See Joint Written Comments submitted by American Chemistry Council, et al. ("ACC Op.") at 26-27 & Verified Statement of Thomas D. Crowley at 18-19.

<sup>16</sup> See ACC Op., Verified Statement of Gerald W. Fauth III ("Fauth VS"), App. 2 at 1, 2 (estimating consultant time and costs with respect to evaluating and litigating rerouting issues).

provide the type of discovery slated for the second disclosure,<sup>17</sup> and some railroads have stated that the schedule does not afford them sufficient time to produce their second disclosure after the route is selected.<sup>18</sup> Precluding complainants from rerouting the issue traffic eliminates any need to extend the procedural schedule to address those concerns.

Finally, as we have discussed in prior comments, the savings in time and cost outweigh the likely benefit to shippers from rerouting the issue traffic. Shippers are unlikely to improve their case by rerouting the issue traffic. Railroads' incentives are to use efficient routes to minimize operating costs and maximize existing capacity. Shippers have acknowledged this point, observing that "carriers have re-routed substantial amounts of traffic in recent years to increase traffic densities . . . and increase efficiencies."<sup>19</sup> As the Board has recognized, the adoption of Simplified-SAC will not alter these incentives. *NPRM* at 12.

**2. The Board could not permit complainants to reroute the issue traffic without allowing defendants a fair opportunity challenge that effort.**

As the Board considers whether to allow complainants to reroute the issue traffic, it should also consider that litigation costs associated with routing disputes may be higher than the Board originally anticipated. We will not belabor this point, but as we explained in detail in our prior comments, the Board cannot simply assume that any route that the issue traffic used in the prior twelve months has sufficient infrastructure to accommodate the permanent rerouting of the issue traffic, or that system-average operating costs would appropriately reflect the operating costs after rerouting. If the Board allows the shipper to select a route other than the predominant

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<sup>17</sup> See ACC Op., Fauth VS at 37.

<sup>18</sup> See Opening Comments of Norfolk Southern Ry. & CSX Transportation Inc. at 10.

<sup>19</sup> Joint Written Reply Comments submitted by American Chemistry Council, et al. at 17 n.14.

route used to handle the issue traffic, it must allow the defendant the opportunity to demonstrate that the route does not have sufficient capacity to handle that traffic efficiently on a consistent basis or that additional investment or operating costs would be required to do so.<sup>20</sup> The Board can avoid this problem altogether by precluding complainants from rerouting the issue traffic.

### **III. THREE-BENCHMARK APPROACH**

UP opposes the Board's proposal to adopt the Three-Benchmark method or any formulaic benchmark-based approach, but we have tried to make constructive contributions to the dialogue by addressing specific practical issues raised by the Board's proposal.

In the Notice, the Board invited the parties to address the issue of whether it may use the Benchmark method at all, as well as three practical issues raised by the Board's proposal. We discuss those issues below.

#### **A. Ratcheting**

- 1. The Board may not use its Benchmark approach, as modified in the *NPRM*, even after the Board has exhausted all reasonable means of simplifying a full SAC presentation.**

In the Notice, the Board invited the parties to address whether it may use the Benchmark method once it has exhausted all means of simplifying SAC. We do not believe that the Board's Simplified-SAC proposal has exhausted all reasonable means of simplifying SAC, but even if it has, we do not believe that the Board could use the Benchmark approach.<sup>21</sup>

As we have discussed extensively in prior comments, the fundamental problem with the Benchmark method is that it does not provide an economic principle or a theoretically

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<sup>20</sup> See UP Op. at 14-19.

<sup>21</sup> UP has offered several additional suggestions for reducing the costs of Simplified-SAC, including eliminating one round of evidentiary filings and developing standardized discovery. See UP Reply at 37-38.

definable test against which a rate can in principle be objectively be assessed. Instead, it caps challenged rates based on mean r/vc ratios of movements with different demand characteristics. This fundamental problem exists even if the Benchmark test is applied only after the Board has exhausted all reasonable means of simplifying SAC. Notably, not one party in this proceeding has stepped forward to address our arguments and defend the Benchmark method as a valid method of regulating maximum rates.

The Benchmark method has the same fundamental problem as the r/vc benchmark test that the D.C. Circuit addressed in *McCarty Farms*.<sup>22</sup> One manifestation of that problem is the “ratcheting” effect described by the court: rates can be reduced for no other reason than repeated application of the test.<sup>23</sup>

At the hearing, one of the shipper witnesses argued that ratcheting should not be a major practical problem because movements with rates that have been reduced by application of the Benchmark test would be unlikely to appear in comparison groups used in subsequent tests. He explained that that the criteria for defining the comparison groups would be different from case to case and that the movements used to form comparison groups will change from year to year. But that was also the situation in *McCarty Farms*, and as the court explained in that case, that “practical defense” to ratcheting concerns “does nothing to give [the test] any glimmer of supporting principle or intellectual coherence.”<sup>24</sup>

Practical defenses to ratcheting of the type offered at the hearing and in *McCarty Farms* are irrelevant because the ratcheting effect is merely a manifestation of the larger problem

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<sup>22</sup> *Burlington N.R.R. v. ICC*, 985 F.2d 589 (D.C. Cir. 1993).

<sup>23</sup> *See id.* at 597.

<sup>24</sup> *Id.*

with using formulaic r/vc comparisons to regulate rates: in any collection of similar movements, there will be lawful pricing differences because railroads are expected to use differential pricing – that is, to set rates based on each movement’s demand characteristics – and no principled basis exists for holding that a rate is unlawful simply because it produces an above-average r/vc ratio, or even the highest r/vc ratio, in a comparison group.

**2. Adopting the Benchmark method would be bad policy because parties will have more difficulty resolving disputes through negotiation under the Benchmark method than under Simplified-SAC.**

In addition to our concern that the Benchmark method will produce results that are flawed, we oppose adoption of the Benchmark method because outcomes of rate challenges will be unpredictable. We want to set lawful rates. We have no interest in litigating rate cases. However, when railroads and shippers are not able to estimate the range of likely outcomes to rate cases, there will be more cases, and the parties will find it more difficult to resolve their differences through negotiation.

Parties will be unable to estimate a range of likely outcomes under the Benchmark method because the criteria for defining comparable traffic are vague. The Board’s catalogue of potentially relevant factors provides almost no practical guidance to parties for developing their comparison groups, and the Board’s final offer selection process will not provide the parties or future litigants with any information about how the Board actually assessed and weighed those factors. Indeed, it is impossible to offer meaningful comments on the substance of the Board’s approach to selecting comparison groups because the criteria are so vague.

Parties will also be unable to estimate a range of likely outcomes under the Benchmark method because the composition of comparison groups may change significantly from case to case. As discussed above, one shipper witness at the hearing described how the composition of comparison groups will be in constant flux because of changing traffic patterns

and changes in which movements are selected for inclusion in the Waybill Sample. The Board has also observed that in a case involving a 400-mile movement and a case challenging a 500-mile movement, the “comparison group would almost certainly be different.” *NPRM* at 27 n.47. In practical terms, the shifting nature of comparison groups means that results of earlier cases will not provide parties with useful information about likely outcomes in future cases.

When parties are unable to estimate a range of likely outcomes, railroads cannot set rates so as to avoid challenges because shippers cannot know whether a given challenge is likely to fail. Moreover, parties may adopt more divergent positions in the initial stages of rate negotiations because they will have no objective check on their own beliefs. And without clear standards or reliable precedent to guide them, parties will have little reason to depart from their initial positions because they will not have an objective framework for forging a compromise. The inevitable result will be more rate cases with fewer negotiated settlements.

By contrast, parties will be able to estimate a likely range of outcomes in cases under Simplified-SAC. Simplified-SAC results will be based on factors that can be estimated using basic data about a railroad’s network, traffic flows, and URCS costs. Moreover, parties will be able to rely on precedent – cases involving similar routes will produce similar results. Parties will understand the range of likely outcomes and thus will be able to work towards a compromise without the need to file a case. This has been our experience with SAC. In fact, railroad and shipper consultants should be able to apply to the tools they have developed for pre-litigation analysis of SAC cases to Simplified-SAC cases. There can be no guarantee that parties will be able to avoid litigation regardless of what rate standard is adopted, but the adoption of a

standard that produces predictable outcomes creates the best chance that the parties will reach a solution on their own.<sup>25</sup>

**B. Equal Access To Unmasked Waybill Sample**

**1. The Board should not give shippers access to confidential contract rates.**

In the Notice, the Board invited the parties to address whether the need to protect confidential contract rates outweighs concerns created by the information asymmetry that would exist if railroads were able to use unmasked revenue information to develop comparison groups and shippers were not. The Board does not need to address this issue because it should exclude contract traffic from comparison groups, but if it does not exclude contract traffic, it should reject shipper arguments about information asymmetry as a red herring.

**a) The Board should exclude contract traffic from comparison groups.**

UP and other railroads previously have submitted detailed comments explaining why contract rates will rarely be comparable to common carrier rates challenged by shippers. At the Board hearing, the U.S. Department of Transportation also expressed the view that contract traffic should not be included in comparison groups. Moreover, the witness for the consultant group Snively King Majoros O'Connor & Lee, which represented the shipper in two cases filed under the current small case guidelines, asserted that contract rates are "quite different" from

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<sup>25</sup> At the hearing, during a discussion about mediation, some skepticism was expressed about the likelihood of resolving SAC cases through negotiation. We believe that many parties resolve their disputes negotiation before they come to the Board's attention because the parties understand the likely result based on past cases. For an example in the public record, the Board should consider *Northern States Power*: UP recognized, based on the results of *Wisconsin Power & Light*, that it would not be worthwhile to litigate stand-alone costs, and the parties agreed to litigate only the jurisdictional threshold. As another example, in *Arizona Electric Power Cooperative*, the complainant and UP settled the portions of the complaint involving coal originating in Colorado and the Powder River Basin.

common carrier rates and that shippers find the “certainty” provided by contracts to be “quite appealing.” The testimony at the hearing reinforced our position that contract rates should be excluded from comparison groups because they typically include terms that affect the overall economic value of the parties’ arrangements (such as multi-year commitments) and will often reflect outdated judgments about market conditions (because of multi-year commitments).

The Board hearing also highlighted another reason to exclude contract traffic from comparison groups: basing the analysis and outcome of rate proceedings on confidential contract information keeps consultants and outside counsel in the driver’s seat of rate litigation. All parties agree that contract rates would be subject to a protective order. But because contract rates must remain confidential, shippers will have little choice but to hire outside consultants and counsel and rely on them to evaluate the likelihood of success and the appropriate range for a negotiated settlement. Railroads will be in the same position if shippers are permitted to use confidential contract rates charged by non-defendants. The parties will have more control over their cases and will be able to reduce their reliance on outside consultants and counsel if confidential contract information is excluded from comparison groups.

**b) Information asymmetry is a red herring because comparison groups would be based on non-rate factors.**

Even if the Board allows parties to include contract traffic in comparison groups, shippers do not need access to confidential contract rates to develop their comparison groups. As the Board has stated, comparability will be determined by factors other than rates. *NPRM* at 20. If the Benchmark method has any validity, rate information will be irrelevant. And if the Board fears that the Benchmark method is as subject to manipulation as shippers’ arguments suggest, that is just one more reason why the method should not be adopted.

Moreover, even if railroads had some minor advantage because they know their own contract rates, that advantage would be offset by the information advantage that shippers have over railroads. Shippers will generally know more about their product and markets than railroads, and thus they will often have an advantage in explaining why particular movements have comparable or different demand characteristics. This shipper advantage would be more significant than any railroad advantage because it involves market information that is actually relevant to selecting comparable traffic and arguing about comparability issues before the Board.

**2. The Board's standard protective order is insufficient to protect the confidential rate information in the Waybill Sample.**

In the Notice, the Board also invited the parties to address whether the agency's standard protective order would adequately protect confidential contract rate information in the Waybill Sample. We believe that the standard order would not provide adequate protection if rate information would be revealed before parties submit their final offer comparison group.

We recognize that confidential contract rate information is subject to discovery in SAC cases and would be subject to discovery under Simplified-SAC, but the risk that shippers would learn competitively sensitive information about their competitors' rates would be much higher in a Benchmark case than in a full SAC or Simplified-SAC case.

Under the Benchmark method, the focus of every case will be the development of a comparison group comprised of non-issue traffic. Consultants likely will work closely with the complaining shipper to select comparable traffic from the universe of potential comparables because the shipper will have valuable knowledge about its product and markets. In such a situation, the shipper could not help but obtain competitively sensitive information about its competitors' rates because it knows that its consultants have access to that information. For example, if the consultants exclude a movement from the comparison group that the shipper had

described as comparable, the shipper could not help but conclude that the r/vc ratio for the excluded traffic is higher than the r/vc ratio for the challenged movement. Similarly, if the consultants include a movement in the comparable group, the shipper could not help but conclude that the r/vc ratio for the included movement is lower than the r/vc ratio for the challenged movement.

We do not question the good faith of the consultants and counsel that represent shippers. The problem is that shippers and consultants could not work together in an effective manner without the shipper acquiring competitively sensitive information.

### **C. Non-Defendant Traffic**

In the Notice, the Board invited the parties to address railroad arguments that non-defendant movements should be excluded from comparison traffic. We and other railroads have explained that the maximum rate a railroad may charge for a particular movement depends not only on the movement's characteristics, but also on the characteristics of the railroad, including its revenue needs, its cost structure, its network, and its mix of traffic. We also have explained why the Board's proposal to apply a carrier-specific revenue-need adjustment factor to the r/vc ratios of comparison group traffic is not a substitute for taking the appropriate characteristics into consideration when making comparisons between rates charged by different railroads. We have thus maintained that if the Board wants a low-cost, simplified approach, it should exclude non-defendant traffic altogether rather than try to account for those variables.

We are also concerned that allowing a shipper to challenge a railroad's rates based on rates set by a non-defendant would promote unwarranted litigation. Railroads are expected to set their rates based on their own characteristics; indeed, they have no practical

alternative.<sup>26</sup> Allowing a shipper to challenge a railroad's rates based on the rates charged by other railroads would not promote sound ratemaking; it would invite opportunistic litigation.

#### **IV. MEDIATION**

In the Notice, the Board invited the parties to address whether it should adopt the suggestion of a 20-day mandatory, non-binding mediation period at the commencement of any case. We strongly support such a mediation period because it will provide parties with an opportunity to resolve their dispute before expending substantial resources on litigation.

At the hearing, several shipper witnesses expressed concern that mediation might prolong cases unduly. We believe that a 20-day mediation period is appropriate. Our experience in both the recently settled *Williams Olefins* case and the pending *Kansas City Power & Light* case is that mediation did not delay the resolution of either matter. The potential savings from a mediated resolution far outweigh the cost of a short pause at the beginning of a case.

#### **V. ADJUSTMENTS TO URCS**

The Board's Notice did not seek comments from the parties on any aspect of the Board's proposals to use system-average URCS costs to calculate the jurisdictional threshold in all small cases and to calculate operating costs under Simplified-SAC. However, the Board's URCS proposals were an important topic at the hearing, particularly in connection with Canadian National Railway's testimony regarding the problems with using unadjusted URCS in cases involving movements of hazardous materials.

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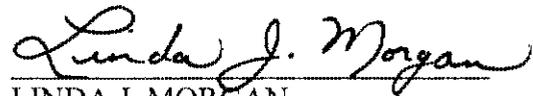
<sup>26</sup> *Cf. Az. Elec. Power Coop., Inc. v. Burlington N. & Santa Fe Ry.*, 6 S.T.B. 322, 328 (2002) ("When the purpose of the SAC exercise is taken into consideration, it becomes clear that a defendant carrier's ability to recover reasonable costs and earn adequate returns should not be limited by the inclusion in our rate reasonableness analysis of another carrier's traffic and revenues that do not or could not reasonably be expected to pay for the defendant carrier's costs.").

Our prior comments have discussed in detail the importance of making limited exceptions to the Board's proposals to use unadjusted URCS. We have explained why the Board should permit parties to adjust URCS costs to account for the special operating costs of moving hazardous materials and high/wide traffic. We have also explained why the Board should allow limited departures from its proposal to calculate jurisdictional thresholds using unadjusted URCS and the Phase III model to ensure that those calculations reflect the special costs of handling hazardous materials and high/wide traffic and better reflect costs that would otherwise be significantly under- or over-stated, or excluded entirely, such as payments to third parties.

These issues remain vitally important to UP. We ask the Board to consider carefully our prior comments and proposals, as well as Canadian National's testimony at the hearing regarding the need to account for the costs of handling hazardous materials.

Respectfully submitted,

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February 26, 2007

## CERTIFICATE OF SERVICE

I, Michael L. Rosenthal, hereby certify that on this 26th day of February, 2007, I caused a copy of the Supplemental Comments of Union Pacific Railroad Company to be served by first-class mail or a more expeditious method of delivery upon all persons who have filed a notice of intent to participate in STB Ex Parte No. 646 (Sub-No. 1).



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Michael L. Rosenthal