BEFORE THE
SURFACE TRANSPORTATION BOARD

STB EX PARTE NO. 627

MARKET DOMINANCE DETERMINATIONS --
PRODUCT AND GEOGRAPHIC COMPETITION

COMMENTS OF
THE ASSOCIATION OF AMERICAN RAILROADS

INTRODUCTION AND SUMMARY

The Association of American Railroads submits these comments in response to the Board's April 29, 1998 Notice of Proposal to Eliminate Product and Geographic Competition From Consideration in Market Dominance Determinations. AAR represents the interests of the nation's major railroads. Its members operate 77 percent of the railroad route miles in the United States, employ 91 percent of the nation's rail employees and generate 93 percent of U.S. rail freight revenues.

AAR understands that the primary impetus for the Board's proposal in this proceeding is the perceived concern among shippers that it is unduly burdensome to litigate rate reasonableness cases before the Board and, in particular, that market dominance determinations are viewed as "major, undue litigation obstacles that discourage captive shippers from even seeking regulatory relief." Notice of Proposal at 4. We believe the shippers' concerns are overstated, and particularly as to product and geographic competition we do not believe that the need to litigate these issues has deterred the filing of rate cases. AAR nevertheless agrees that procedural obstacles and the cost of li

regulatory relief from the agency when such relief is warranted. Therefore, the Association and its member railroads stand ready to assist in the adoption of more efficient procedures that will make the statutory remedies afforded to shippers meaningful.

AAR does not believe, however, that elimination of product and geographic competition from consideration in market dominance determinations is a proper means of making rate reasonableness remedies more accessible to shippers. Elimination of what has been properly viewed as an important substantive component of the agency's market-based approach to rate regulation can only result in distortions in the regulatory process and arbitrary results in individual cases. Accessible rate remedies should be achieved through further reform and modification of the procedures governing rate reasonableness cases without violating the integrity of the statutory scheme that requires that effective competition, wherever it exists, should determine rail rates in the first instance.

It is beyond serious contention that product and geographic competition are effective constraints on rail rates in numerous markets. Under the Board's proposal, only competitive alternatives between the same origin and destination points as the issue traffic movement would be considered. This restriction is obviously irrational. Take the common example of a utility served by two railroads, where each railroad serves a different mine capable of providing coal to the utility. Under the Board's proposal, the source competition provided by the two railroads would be ignored, and <u>both</u> railroads could be found to be market dominant. Similarly, in a case where a utility previously served by a single railroad <u>actually</u> constructed a build-out to another railroad or barge to obtain coal from other mines, the Board's proposal could result in a finding of market dominance by either railroad. There is no sound rationale for establishing rules that would have such arbitrary results.

Since 1981, when the Interstate Commerce Commission (ICC) first included product and geographic competition in its market dominance guidelines, it has been a basic tenet of railroad rate regulation that "to exclude from consideration a priori any potential source of competition would be contrary to the intent of Congress as expressed in the Staggers Act." Market Dominance Determinations & Consideration Of Product Competition, 365 I.C.C. 118, 130 (1981). In market dominance cases decided in the intervening period, rail rates repeatedly have been found to be constrained by effective product and geographic competition. In addition, various exemptions from rate regulation have been based, at least in part, on the ICC's and the Board's finding of effective product and geographic competition.

There is no evidence that product and geographic competition have disappeared as factors in railroad markets. Indeed, the evidence indicates that product and geographic competition are becoming increasingly important. The electric power industry, in particular, is changing rapidly as a result of the deregulation of electricity generation and utility mergers. These changes are increasing the effectiveness of product and geographic competition in coal transportation markets. Global competition has intensified. As the testimony of railroad marketing witnesses attached to these comments demonstrates, shippers understand the strength of product and geographic competition and regularly use these competitive forces to discipline rail rates. It would be particularly ironic for the Board to do away with product and geographic competition at the very time that deregulation in the electric utility industry is making this an increasingly potent force.

To eliminate product and geographic competition from consideration in market dominance determinations would be to ignore commercial reality. It would also violate the logic of the economic principles underlying the market dominance standard. A core premise of the economics of competition is that market power can be constrained by a range of competitive forces, and it is well established that in transportation markets multiple forms of competition, often acting in concert with one another, can discipline railroad prices. This is hardly a controversial proposition. As Professors Kalt and Willig explain in their Verified Statement submitted with these comments, the arbitrary exclusion of entire categories of competitive forces in market dominance determinations would be contrary to the fundamental economics of competition.

Elimination of product and geographic competition from consideration in market dominance determinations also would be inconsistent with the regulatory scheme established by Congress in the Staggers Act. Congress made clear that while captive shippers would be protected by maximum rate regulation, there should be no regulation of rates in circumstances where the rates are constrained by effective competition. The Board should not decide -- for all cases and without regard to the facts -- to ignore this legislative mandate.

The Board should continue to give railroads the opportunity to meet their burden of showing that product and geographic competition effectively constrain their rates. It can do so and substantially reduce the burdens of market dominance determinations by simplifying procedures in market dominance cases. The Board's recent ruling in Docket No. 42022, <u>FMC Wyoming Corp. v. Union Pacific Railroad Co.</u> demonstrates that fair and effective procedural rules can be established to minimize litigation burdens. AAR believes that the discovery standards set out in that case are appropriate and it would support adoption of those rules as part of the Board's formal procedures governing rate reasonableness cases.

AAR will carefully review the comments of other parties for constructive procedural suggestions and it would hope in its reply comments to be able to endorse other suggestions for reducing the burden or cost of litigating issues relating to product and geographic competition.

* * *

AAR's Comments are supported by the following verified statements:

Professors Joseph P. Kalt and Robert D. Willig explain that the elimination of product and geographic competition from market dominance determinations would be wholly at odds with basic principles of economics and competition policy. They point out that these types of competitive forces are prevalent throughout the economy and they are especially important in many segments of the railroad industry. They acknowledge the Board's concern over the cost and efficiency of rail rate proceedings, but they explain that the Board should not establish substantive standards that ignore fundamental economic principles to deal with this concern, but rather establish procedures that permit expeditious and efficient adjudication of market dominance cases.

- Robert L. Sansom, President of Energy Ventures Analysis, Inc., describes the implications of the Board's proposal as it relates to the transportation of coal. Mr. Sansom describes the evidence demonstrating that product and geographic competition have exerted substantial constraints on rail rates for coal movements. He also describes why it would be particularly inappropriate for the Board to eliminate product and geographic competition from market dominance determinations at this time, since deregulation in the electric utility industry is <u>increasing</u> the importance of those competitive factors for rail transportation of coal.

Senior marketing officers of four Class I railroads describe the significant influence of geographic and product competition on the pricing and marketing of rail transportation services.

I. THE ELIMINATION OF PRODUCT AND GEOGRAPHIC COMPETITION FROM MARKET DOMINANCE DETERMINATIONS WOULD BE INCONSISTENT WITH THE EXISTING STATUTORY SCHEME.

As the Board points out in its Notice, the ICC previously addressed the question whether to include product and geographic competition in market dominance determinations in a series of decisions beginning in 1976. Initially, the ICC decided that product and geographic competition would not be considered in applying the quantitative market share presumption contained in the first market dominance guidelines -- that is, market share would be calculated without reference to alternative product markets or origin/destination pairs other than those involved in the movement at issue. See Special Proc. For Findings of Market Dominance, 355 I.C.C. 12 (1976).[1] This original approach was adopted over the objection of several parties, including the Department of Justice, and the ICC soon had second thoughts. See Special Proc. For Findings of Market Dominance, 359 I.C.C. 735, 736 n.7 (1979).

After passage of the Staggers Act in 1980, the ICC formally reversed its earlier position, finding that "to exclude from consideration a priori any potential source of competition would be contrary to the intent of Congress as expressed in the Staggers Act." 365 I.C.C. at 130.

The ICC's understanding of Congress' intent is confirmed by the legislative history. When it enacted the Staggers Act, Congress made it clear that the objective of the new regulatory scheme was to allow market forces, not regulation, to establish railroad rates whenever possible: "[W]henever there is effective competition which will restrain rate increases by the railroads, such competition should continue to function as the regulator of the rate rather than the Commission." Report of Committee on Conference, H.R. Conf. Rep. No. 96-1430, at 89 (1980) (emphasis added). "[C]ompetition should be the determining factor in railroad rates wherever possible." Id. at 91-92 (emphasis added). Under the new regulatory scheme, the Commission had "jurisdiction to determine rate reasonableness only when there is no effective competition." Report of the House

Committee on Interstate and Foreign Commerce, H.R. Rep. No. 96-1035, at 33 (1980) (emphasis added).

Congress expressly stated this objective in the Rail Transportation Policy section of the Staggers Act:

> In regulating the railroad industry, it is the policy of the United States Government --
>
> (1) to allow, to the maximum extent possible, competition and the demand for services to establish reasonable rates for transportation by rail;
>
> (2) to minimize the need for Federal regulatory control over the rail transportation system . . .
>
> (6) to maintain reasonable rates where there is an absence of effective competition . . . .

Staggers Rail Act of 1980, 49 U.S.C. § 10101. In describing the new rail transportation policy, the House Committee on Interstate and Foreign Commerce noted: "This new section directs the Commission to encourage primary reliance on the marketplace rather than regulation, to limit regulation of railroads to those areas where there is an absence of effective competition." H.R. Rep. No. 96-1035, at 54.

Congress left to the ICC the task of developing rules and procedures to implement the new transportation policy, but the ICC's (and now the Board's) discretion was limited by the clear statement of Congress' objective: Rates should not be regulated where there is effective competition. The Board's current proposal to eliminate product and geographic competition from market dominance analyses would be directly contrary to this objective because it would result in the regulation of railroad rates that are effectively constrained by competition.

This departure from Congress' deregulatory objective would be especially inappropriate given that product and geographic competition are widespread in transportation markets. In its 1981 decision, the ICC concluded that:

> Geographic and product competition serve as effective constraints on the abuse of market power by a rail carrier. Therefore, they are

> relevant factors to be considered in determining whether a carrier is market dominant vis-a-vis certain traffic. Not to consider such factors may, in many instances, result in inaccurate determinations of market dominance.

365 I.C.C. at 127. Subsequent experience has borne out this observation. As discussed in more detail later in these comments, the ICC and the Board have repeatedly found since 1981 that product and geographic competition "serve as effective constraints" in diverse railroad markets. It is therefore beyond dispute that the elimination of product and geographic competition could "result in inaccurate determinations of market dominance" in numerous cases.

The ICC's 1981 decision to include product and geographic competition in market dominance analyses was appealed to the Fifth Circuit, which found the decision to be consistent with the deregulatory intent of Congress in the Staggers Act. Rejecting arguments that Congress intended that the ICC examine only direct -- intermodal and intramodal -- competition, the court stated:

> [I]f the ICC was required to ignore the effects of indirect competition, certain rates would become subject to regulatory intervention even though the rate is governed by market forces. Such a result flies in the face of Congress' stated policy of deregulation of rates subject to effective market control.

Western Coal Traffic League v. United States, 719 F.2d 772, 779 (5th Cir. 1983), cert. denied, 466 U.S. 953 (1984).

The ICC once again addressed the issue in its 1985 decision, Product & Geographic Competition, 2 I.C.C.2d 1 (1985). There, the agency adopted a proposal supported by the AAR along with several shippers and shipper groups imposing the burden of proving product and geographic competition on the defendant railroad rather than on the complaining shipper. A number of parties to that proceeding opposed any consideration by the ICC of product and geographic competition. Addressing their arguments, the ICC responded:

> We think that elimination of the basic product and geographic competition guidelines is unwarranted. As stated previously, these standards have been applied and challenged, and have stood the test of the courts.

Id. at 6.

In short, product and geographic competition have been included in market dominance determinations since 1981 because Congress, in passing the Staggers Act, intended that rates constrained by effective competition should not be regulated. Nothing has occurred since 1980 to suggest that Congress wishes to expand the scope of regulatory intervention. While the Board has the authority to modify its regulations if necessary to accommodate significant changes in the market, it does not have the authority to disregard Congress' intent or to establish rules that are inconsistent with the scheme established by Congress. As the ICC expressly acknowledged, the elimination altogether of product and geographic competition from the scope of market dominance inquiries would be contrary to Congress' intent and therefore it is not an action that the Board is authorized to take.

II. CONSIDERATION OF GEOGRAPHIC AND PRODUCT COMPETITION IN DETERMINING MARKET DOMINANCE IS MANDATED BY SOUND ECONOMICS AND PUBLIC POLICY.

Congress' decision to allow the market to determine railroad rates whenever possible was based on sound public policy. Where competition is effective, it disciplines the prices that customers pay for the products and services they desire and it ensures that prices do not rise above levels needed to induce sellers to bring their supplies to market. Competition also disciplines the efficiency of a firm's operations, since inefficient operators face elimination from the market by lower-cost, more efficient firms that can offer more favorable terms. Reliance on competition to discipline the conduct of market participants is far more efficient than reliance on regulation, which necessarily distorts efficient marketplace results.

But as the Board and its predecessor have frequently noted, competition and market forces cannot readily be forced into neat pigeonholes. Competition is a process defined by rivalry among various options that can potentially meet the needs of a purchaser. The specific options available to purchasers -- and the relative strength of those options -- turn on the characteristics of a particular market and the needs of purchasers. As Professors Kalt and Willig explain in their Verified Statement, in "evaluating whether competition is likely to be effective in regulating the price and quality offerings available to customers, there is no methodological or theoretical reason to examine only some of the available alternatives while deliberately ignoring others." Kalt/Willig V.S. at 7-8.

The sources of competition in rail transportation markets are diverse. Competition is clearly not limited to alternative ways to move a specific product between a specific origin and destination. Originating shippers often have alternative outlets for their product; receiving shippers can often source from alternative origins. If a utility served by two railroads can purchase coal from a mine served by one railroad or from a different mine served by the second railroad, it would be irrational to conclude that there could be no competition simply because the two railroads do not serve the same origin <u>and</u> destination. This is precisely the sort of anomaly that would arise if the Board eliminates consideration of geographic competition.

The rivalry that characterizes a competitive market can arise from a variety of circumstances. Indeed, in 1981 the ICC rejected the use of quantitative presumptions in market dominance determinations because they did not adequately take account of the variety of circumstances that create competitive pressure in rail transportation markets:

> [T]he use of rebuttable presumptions in market dominance determinations often placed too much emphasis on quantitative evidence which did not fully reflect the circumstances of any given

> movement. This quantitative evidence was frequently offered at the expense of other evidence which, though less subject to quantification, is more reflective of the degree of market power possessed by a rail carrier over certain traffic.

365 I.C.C. at 120. The market dominance guidelines adopted by the ICC in 1981 and applied (with some modifications) since then are based on the explicit recognition that competition can only be understood by evaluating "the total competitive situation."[2] While the market dominance guidelines identify four specific types of competitive pressure -- intramodal, intermodal, geographic or product competition -- other "forms of competition that are more case- specific" are given "due consideration."[3] Any one type of competition "acting alone, or in concert, [can] restrain a [carrier's] market power."[4] The purpose of the market dominance inquiry is to "consider <u>any</u> kind of competition from <u>any</u> source to see if it effectively constrains the . . . rates at issue."[5]

As Professors Kalt and Willig explain, this approach is consistent with the fundamental economics of competition. Like the Board and the ICC before it, the antitrust agencies regularly look at product and source competition in merger and other enforcement proceedings as part of the overall analysis of competition. Kalt/Willig V.S. at 8. And in 1985, the ICC rejected proposals from some shippers to eliminate product and geographic competition from the market dominance guidelines, noting correctly that those types of competition "are economically valid and are the basic antitrust tenet in determining market power."[6]

As a matter of standard economics, the issue is whether competition is effective and not what label is applied to the competition. If the Board arbitrarily excludes product and geographic competition from consideration, it would necessarily find market dominance in some cases in which effective competition exists, which is both an economically irrational result and one that "is antithetical to a regulatory system in which policy calls for competition to serve as the regulator of rates wherever and whenever possible." Kalt/Willig V.S. at 16.

III. PRODUCT AND GEOGRAPHIC COMPETITION HAVE BEEN AND CONTINUE TO BE FORMS OF EFFECTIVE COMPETITION.

When the ICC decided to include product and geographic competition within the scope of the market dominance guidelines, it did so because "[g]eographic and product competition serve as effective constraints on the abuse of market power by a rail carrier."[7] Subsequent decisions by the ICC and the Board in market dominance determinations and exemption and merger proceedings demonstrate the extent and potency of geographic and product competition in many different rail markets.

A. Rate Cases

In the following rate reasonableness cases, the ICC or the Courts concluded that geographic and/or product competition created sufficient options for the shipper to preclude a finding that the carrier was market dominant.[8]

Consolidated Papers, Inc. v. Chicago & North Western Transportation Co., 7 I.C.C.2d 330 (1991).

> The Commission found geographic competition constrained CNW because its Wisconsin paper manufacturer customers had options which permitted them to avoid CNW's services. These customers could obtain pulpwood and wood chips from local sources rather than via rail from Wyoming and Colorado. The customers' decreased reliance on distant sources stemmed in part from technological changes that permitted greater reliance on local supplies. This case highlights the relationship that often exists between geographic and product competition. While the local supply of raw material provided geographic competition for raw material originating at distant points and moving via rail, the manufacturers' changing reliance on alternative wood types in the paper-making process provided product competition.

Coal Trading Corp. v. The Baltimore & Ohio R.R., 6 I.C.C.2d 360 (1990).

> The Commission held that the railroads did not have market dominance over coal moved for Coal Trading Corporation ("CTC") because of the geographic competition inherent in dealing with brokers. As a

coal broker, CTC could supply its export customers from many coal mine origins throughout the United States, including mines exclusively served by either of the two defendant railroads or by other carriers.

Westmoreland Coal Sales Co. v. Denver & Rio Grande Western R.R., 5 I.C.C.2d 751, 758 (1989).

The Commission found that the defendant railroads lacked market dominance because, as a broker, the shipper had geographic alternatives to transporting coal destined for export via rail from Utah and Colorado to ports in California. As the Commission noted, Westmoreland Coal Sales "was not contractually committed to any particular coal origins or destinations." Thus, according to the Commission, Westmoreland was not captive to the railroads.

Amstar Corp. v. Alabama Great Southern Railroad, 1988 I.C.C. LEXIS (May 10, 1988).

The Commission held that geographic competition in the form of multiple sugar supply alternatives prevented the defendant railroads from having market dominance over shipments from certain Amstar sugar refineries to three destinations -- Buffalo, Cincinnati and Evansville. According to the Commission, Amstar had effective bargaining power with the railroads, because it could choose from three of its other sugar refineries to supply these destinations. When the different points of origin were considered, each destination was found to be served by more than one independent set of rail carriers.

General Chemical Corp. v. United States, 817 F.2d 844 (D.C. Cir. 1987).

The D.C. Circuit upheld the Commission's conclusion regarding product competition -- specifically, that effective end-product competition can constrain railroad rates for moving raw materials. General Chemical was a soda ash producer located in Green River, Wyoming, a location responsible for 80% of the domestic soda ash market. Railroads moved 95% of the soda ash from this region, thus the producers claimed to be captive to the railroads. A third of annual soda ash production was used to manufacture glass containers, an end product that competes with containers made of aluminum, paper and steel. The Court accepted the Commission's finding that the competition between the various types of containers had a "significant" disciplinary effect on the price of soda ash -- which could affect traffic volumes and, therefore, the rates the railroads would set to deliver this material.

In addition, the Court agreed with the Commission that two materials, cullet and caustic soda, are popular soda ash substitutes for the manufacturing of glass, and thus provided additional, direct product competition.

Salt River Project Agricultural Improvement & Power District v. United States, 762 F.2d 1053 (D.C. Cir. 1985).

> Evidence of effective product competition was found in Salt River's dramatic increase in the use of local gas at two of its electric generating plants in Arizona in lieu of oil transported via rail. In a two-year period, oil use declined from 100% to 18% at one of the plants, and from 18% to 1% at the other.
>
> The Court also found effective geographic competition as Salt River secured fuel oil for these plants from eighteen sources other than those served by Southern Pacific. In one year, Salt River received over two times more oil from competing alternatives than from Southern Pacific origins. The next year it received no oil from sources served by Southern Pacific, while continuing to receive oil from other sources.

Eli Lilly & Co. v. Burlington Northern R.R., I.C.C. Docket No. 38262 (served July 27, 1984) at 9.

> The Commission held that BN lacked market dominance over shipments of nitric acid from a supplier in Cosgrove, Missouri to an Eli Lilly plant in Lafayette, Indiana, in part, because of effective geographic competition. Eli Lilly also received nitric acid from four additional suppliers, in four different locations, none of which was served by BN. Since Eli Lilly admitted that it used these supply alternatives to restrain nitric acid producers from raising their rates, the Commission found that the company could just as easily "restrain the railroads' pricing by shifting the amount of its purchases among its various suppliers on different, competing rail lines."

Aluminum Co. ("ALCOA") v. Burlington Northern, Inc., I.C.C. Docket No. 37715S (served Apr. 11, 1983).

> The ALJ found that geographic competition existed in the transportation of aluminum sheeting from ALCOA's Warrick, Indiana plant to three destinations served by the defendant railroads. Customers at these three destinations received less than half of their aluminum via rail from ALCOA's Warrick facility, the remainder coming from nearly 30 separate suppliers of aluminum in almost 50 unique locations. Since ALCOA's customers could obtain aluminum from a multitude of competing sources, sufficient geographic competition existed to restrain rates.
>
> The ALJ also held that the railroads faced product competition. The ALJ determined that if the delivered price for aluminum sheeting was excessive, ALCOA's container customers could shift to plastic, and the railroads would experience a loss in traffic. In this connection, the ALJ noted that one ALCOA customer had instituted a process that would allow it to recycle its own cans -- thereby reducing its need for aluminum sheeting and rail transport.

Aluminum Ass'n, Inc. v. Akron, Canton & Youngstown R.R., 367 I.C.C. 475

(1983).

> The Commission found rail rates for movements of aluminum ingot from the West to destinations in the East, Midwest and South were constrained by product competition from recycled aluminum. Nearly 30% of the aluminum supply came from recycling, and almost 80% of this recycled aluminum was produced in close proximity to the destinations to which the issue traffic moved. Therefore, the Commission held that aluminum consumers had a realistic alternative to transporting aluminum ingot from the West. The Commission also held that aluminum is used in the highly competitive market for food and beverage containers, where steel, glass and plastic are ready substitutes.
>
> The Commission also found convincing evidence that the railroads faced effective geographic competition. First, it found that producers in the West accounted for less than one third of the U.S. capacity, and the three largest volume aluminum rail movements to the complaint destinations did not originate on the on the defendant carrier. Second, it found that producers could avoid the railroads -- and transportation costs entirely -- by engaging in swaps or trades, in the nature of barter transactions. Indeed, two of the aluminum customers received more in trade than they did via rail. Finally, the Commission found that imports, particularly into the destinations at issue, competed with the respondent railroads' shipments.

B. Exemption Proceedings

The Board's exemption authority is not an issue in this proceeding. However, the ICC's and the Board's prior exemption cases are relevant here because they discuss the extent and vitality of product and geographic competition in a variety of railroad markets, and in many cases they describe the dynamic by which product and geographic competition effectively constrain rail rates. The particular commodities covered by prior exemptions, of course, could not be the subject of rate reasonableness proceedings, but they illustrate the type and diversity of products and railroad markets that are affected by product and geographic competition. In light of its exemption precedents, the Board could not logically conclude that product and geographic competition are insignificant.

Some representative exemptions granted since 1990 are described below.

Ex Parte No. 346 (Sub-No. 34), <u>Rail General Exemption Authority -- Exemption of</u>

Hydraulic Cement, 1996 STB LEXIS 410 (served Dec. 17, 1996).

> The Board extended an exemption for the rail transportation of hydraulic cement to cover a particular shipper's traffic, rejecting the shipper's contention that its access to only one rail carrier (UP/CNW) made it captive: "That the Dacotah plant is physically served by only one carrier does not necessarily mean that there is an absence of effective competition." Id. at *6. The Board explained: "There is competition from other producers that inhibits the ability of the railroad serving Dacotah's cement plant to increase rates. Dacotah's relatively unfavorable geographic location (usually the most distant supplier in the market it supplies) puts it at a natural disadvantage vis-a-vis its competitors. The carrier serving Dacotah must establish rates that overcome this disadvantage in order to handle Dacotah's hydraulic cement traffic. If the rate is too high, the producer does not participate in the market and the carrier does not participate in its transportation to that market." Id. at *8.

Rail General Exemption Authority -- Exemption of Carbon Dioxide, 10 I.C.C.2d 359 (1994).

> The ICC exempted rail transportation of carbon dioxide, noting the widespread existence of geographic competition due to the fact that carbon dioxide plants and processing facilities were dispersed across the United States. "If a railroad were to raise its rates to one carbon dioxide shipper, either the shipper could send the carbon dioxide to another market, or the receiver could buy its supply from another producer, or both situations could occur." Id. at 363.

Rail General Exemption Authority -- Exemption of Rock Salt, Salt, 10 I.C.C.2d 241 (1994).

> Rail transportation of rock salt and common salt was exempted because of the broad geographic dispersion of salt mines and processing plants and the presence of substantial volumes of imported salt. The ICC concluded that shippers had alternative markets for their product and receivers had alternative sources of supply.

Petition to Exempt from Regulation the Rail Transportation of Scrap Paper, 9 I.C.C.2d 957 (1993).

> The ICC granted a partial exemption from regulation for the rail transportation of scrap paper in this proceeding, retaining jurisdiction for products subject to the statutory rate cap for non-ferrous recyclables. Id. at 958. There was substantial geographic and product competition due to the fact that scrap paper is generated throughout the United States and "there is no difference between recycled fibers originating in the various regions." Id. at 960.

Rail General Exemption Authority – Used Motor Vehicles, 9 I.C.C.2d 884 (1993).

> The ICC found that there was "intense rail-to-rail and geographic

competition because shippers have numerous options in selecting origin and destination points for used motor vehicle traffic and thus need not limit rail transportation to only one carrier."

Rail General Exemption Authority – Petition of AAR to Exempt Rail Transportation of Selected Commodity Groups, 9 I.C.C.2d 969 (served Oct. 15, 1993).

The ICC concluded that effective geographic and product competition existed for lard and meat products because (a) brokers play a key role in the market by representing smaller producers, (b) major producers and brokers have multiple locations served by different rail carriers, and (c) major producers have the ability to shift production from one facility to another. Id. at 976. Transportation rates for wallboard were constrained by product competition from previously exempted substitute commodities. Id. at 977. Geographic or product competition was also cited as a basis for exempting primary forest or wood raw materials, coke produced from coal, and cinders, clay, shale, and slate. Id. at 976-79.

Rail General Exemption Authority – Transportation Equipment, 9 I.C.C.2d 263 (1992)

The ICC granted an exemption for rail transportation of motor vehicles and motor vehicle parts and accessories, noting the existence of "motor carrier competition, geographic competition generally, and various shipper options and powers." Id. at 265. The ICC's notice instituting the proceeding described in detail the vibrancy of geographic and product competition in this market, noting that (a) the industry is widely dispersed; (b) parts can be obtained from numerous sources; (c) finished cars can be sent to a variety of destinations; (d) shippers of motor vehicles are major corporations with the ability to negotiate hard for concessions from the railroads; and (e) automobile manufacturers, related automotive firms, and automobile importers are able to reconfigure and relocate their operations.

Rail General Exemption Authority – Lumber or Wood Products, 7 I.C.C.2d 673 (1991).

The ICC granted an exemption for the rail transportation of various lumber, plywood, and treated wood products noting the existence of geographic and product competition. Id. at 678. In addition, the ICC rejected the request of some parties to retain competitive access regulation for long-haul lumber movements, stating: "Geographic competition is particularly relevant for this lumber traffic because any attempt by a rail carrier to abuse market power by refusing to enter competitive joint rates or reciprocal switching agreements with other rail carriers would leave that carrier vulnerable to competition from other regions." Id. at 680-81.

C. Merger Proceedings

The Board has also recognized the importance of product and geographic competition in recent merger cases. As a general matter, the Board and the ICC have acknowledged that even where the number of routing options decreases from two originating or terminating carriers to one as the result of the merger, "geographic or product competition may be sufficient to act as a constraint to prevent competitive harm." Union Pacific Corporation, et al. – Control and Merger – Southern Pacific Rail Corporation, et al., Decision No. 44, F.D. No. 32760 at 100 (served August 12, 1996) ("UP/SP"); Burlington Northern Inc., et al. – Control and Merger – Santa Fe Pacific Corporation, et al., Decision No. 38, F.D. No. 32549 at 55(served August 23, 1995) ("BNSF"). In particular,

> source competition can be an effective competitive restraint on rail rates when sources of supply are numerous, cost conditions of alternative sources of supply are homogenous, transport costs from alternative sources are similar, delivered products are close substitutes, and the share of transport costs in the delivered price of the product is high.

UP/SP, at 125. In the UP/SP merger, the Board specifically addressed the effectiveness of these competitive factors in the context of several transportation markets. See, e.g., UP/SP at 126, 132. See also BNSF at 68 (acknowledging the importance of these competitive factors in electric utility markets).

D. Marketing Testimony

The verified statements of railroad marketing officers submitted with these comments establish that product and geographic competition continue to be widespread and effective. As the individual witness statements illustrate, railroads are forced to set their rates to reflect the product and geographic competition they confront. Sometimes, if they fail to heed the competitive forces or decline to meet the competition, they lose the business altogether. A few of the examples set forth in the verified statements of the geographic and product competition that railroads face in today's marketplace are described below.

1. Geographic Competition

Mr. Richard Peterson, Senior Director of Interline Marketing of Union Pacific Railroad Company ("UP"), notes that UP is the only railroad serving most of the grain elevators located on its system. However, if UP does not charge competitive rates from those grain elevators that it exclusively serves, farmers and merchants will truck the grain to elevators located on other railroads. He notes as well that because individual grain products (i.e., wheat, barely, corn) are largely fungible commodities, UP's grain shippers will lose business and, consequently, so will UP, unless it sets rates to allow grain moving on UP to compete effectively with grain produced elsewhere.

Douglas J. Babb and Gregory T. Swienton are Senior Vice Presidents of the Burlington Northern and Santa Fe Railway Company. They describe the geographic options enjoyed by American Electric Power's ("AEP") Rockport Plant, situated on the Ohio River. While AEP receives its coal primarily via barge, three major railroads have the ability to deliver coal to the river. As a result, the rates quoted by BNSF to deliver Powder River Basin Coal to AEP are influenced by UP's ability to deliver coal from Powder River Basin mines, as well as mines in Wyoming and Colorado, and by CSXT's ability to deliver coal from Appalachian mines to the Ohio River. Messrs. Babb and Swienton also point to the leverage exercised by utilities which have multiple plants, even where each individual is exclusively served by a single carrier. The leverage results from the ability of these utilities to alter the production levels at their various sites to take advantage of the most favorable rates for delivered fuels. For example, Union Electric's Labadie plant is supplied by UP from the Powder River Basin, while its Rush Island and Sioux plants are supplied by BNSF from the Powder River Basin and Illinois. If BNSF's rates to the Rush Island and Sioux plants are too high, Union Electric can generate more power from the Labadie plant served by UP.

John Anderson, Executive Vice President of Sales and Marketing at CSX Transportation, describes a situation involving a CSXT processing customer, located in Alabama, for which CSXT ships product to manufacturing plants in South Carolina. A competitor of CSXT's customer sought to expand its business by planning to build a new processing plant near the South Carolina manufacturer, thus avoiding a rail move. In the face of this competitive pressure, CSXT and its customer forged a partnership resulting in the reduction of the delivered price of the product and the retention of the business.

Donald Seale and J.W. Fox of Norfolk Southern describe an instance of geographic competition from the merchandise side of NS's business. They report that Georgia is a destination market served by NS for the movement of caprolactam, a chemical used in textile manufacturing. NS felt compelled to reduce the rates it charged a South Carolina shipper of this product in order to meet competition from a competitor of their customer based in Georgia and served by CSXT.

2. Product Competition

Messrs. Seale and Fox of NS also provide a variety of examples of product competition, noting that NS's rates for many products are constrained by their customers' ability to substitute alternatives. Beet sugar and cane sugar are interchangeable, as are kaolin clay and calcium carbonate, and talc and industrial sand. If NS's rates are out of line, manufacturers using raw materials shipped via the NS will switch to alternatives moved by a competitor or produced locally.

John Anderson of CSXT offered another example of product competition, discussing the transportation of grain to lots. He reported that North Carolina feed mills frequently replace the corn delivered by CSXT from Ohio with locally grown wheat in their mix of grains. If CSXT wants to continue to deliver Ohio corn, it must offer rates which make the corn moved by rail more attractive than the wheat available locally.

The BNSF marketing officers, Messrs. Babb and Swienton, discuss product competition in the context of one of BNSF's utility customers. Houston Lighting & Power operates gas, coal, lignite and nuclear plants -- all supplying electricity to the same region. If the delivered price of the Powder River Basin Coal moved by BNSF is too high, HL&P has the ability to shift incremental coal generation to its gas-fired plants, which have significant excess capacity. This flexibility has been frequently raised during rail negotiations with BNSF.

Finally, in another utility related example, NS witnesses Fox and Seale describe the phenomenon of coal tolling, a practice whereby a high cost utility will divert its coal supply to a nearby generator and then purchase that second utility's electricity to supply its customers. Carolina Power & Light, which received coal via Norfolk Southern, employed this option by having its coal sent via CSXT to Appalachian Power and then purchasing the electricity. Carolina Power & Light stressed its ability to enter into such a transaction in its subsequent rate renegotiations with NS.

The evidence is irrefutable that product and geographic competition are a fact of life in the contemporary marketing of rail transportation services. The Board's proposal simply to disregard product and geographic competition entirely in rail rate cases would ignore this reality.

IV. MOST UTILITY COAL SHIPMENTS ARE SUBJECT TO INTENSE AND INCREASINGLY EFFECTIVE GEOGRAPHIC AND PRODUCT COMPETITION.

The implications of the Board's proposal can be seen most starkly in the context of rail transportation of coal. Indeed, electric utility shippers of coal obviously understand the potent force of geographic competition since one of the specific objectives of certain of the complaining shippers in the consolidated Bottleneck proceeding was to obtain the benefits of geographic competition -- i.e., transportation service from a second railroad serving different mines from those served by the bottleneck carrier. It would be ironic for the Board to eliminate from consideration a form of competition that coal shippers have so vigorously pursued. It would be doubly ironic for the Board to eliminate product and geographic competition from market dominance determinations at the same time that deregulation in utility markets is making those competitive forces all the more powerful as constraints on rail rates.

Coal is the most significant commodity transported by U.S. railroads, both in terms of ton-miles and total revenues.[9] The vast majority of this coal traffic moves under rail transportation contracts mutually agreed to by shippers and railroads. A small percentage of coal traffic moves pursuant to common carrier rates; a very small number of these shipments result in rate litigation. Nonetheless, these few coal rate cases constitute a majority of the rate complaints that have been brought before the Board in recent years. Thus, the Board's proposal to eliminate consideration of geographic and product competition must be evaluated in light of its likely effect in these coal rate cases. Perversely, this approach to regulation would be likely to increase the burdens of coal rate litigation -- on the parties and the Board -- by permitting, perhaps encouraging, needless and unwarranted expansion of the Board's jurisdiction to include cases involving rail transportation that is clearly subject to effective competition.

As described in the accompanying Verified Statement of Robert L. Sansom, rail rates for coal transportation have fallen dramatically (about 50 percent in real terms) over the past decade. This decline has occurred whether or not a coal shipper has either direct intramodal or intermodal transportation alternatives (i.e., alternative rail or nonrail carriers providing competitive service between the same origins and destinations). Shippers deemed not to have either intramodal or intermodal competition, as the Board and the ICC have defined these terms, benefit from intense and effective geographic competition, in which a competing carrier offers to (and often does) transport the shipper's coal to a different destination, or from a different origin. In fact, more than half of the rail-served coal-fired power generating capacity in the U.S. is represented by power plants that also receive competitive rail service from other carriers and other modes of transportation. The fact that many coal shippers currently enjoy effective geographic competition explains, at least in part, the significant drop in rail rates for coal transportation over the past decade. Indeed, as Dr. Sansom explains, the remarkable decline in rail rates for coal transportation in recent years has extended to electric power generating plants served only by a single rail carrier.

Electric power is a quintessentially fungible commodity, whether it is produced from coal, natural gas, nuclear reactors, or hydroelectric plants. The market for electric power is rapidly becoming even more competitive, in response to recent, fundamental changes in the industry. These recent changes include the FERC's Order No. 888 proceeding, in which that agency adopted transmission rules designed to facilitate expansion of the competitive bulk power market,[10] along with other fundamental regulatory initiatives, such as the deregulation of electric power generation, the expansion of regional energy markets administered by independent system operators ("ISOs"), and soon, the introduction of retail competition in some states. See Sansom V.S. at 26-28. Thus, electricity increasingly is generated, dispatched, conveyed by transmission lines and distribution facilities and, ultimately, bought, sold and traded in a competitive marketplace on the basis of the relative cost of production. Competition in the market for electric power inevitably constrains electricity prices, as well as the costs of all necessary inputs, including railroad transportation of coal. Id.

Other continuing developments in the electric utility industry are likely to cause these competitive constraints to become even more intense and more pervasive. First, new technology, including combined-cycle gas turbine generators, will increase competitive pressures, and inevitably will decrease coal volumes consumed by old-fashioned coal burning steam generation plants. Sansom V.S. at 38-41. These state-of-the-art generation systems are not only highly efficient; they have lower capital costs than conventional steam generation plants, and are quicker to build, easier to permit and easier to locate. Id. These factors make natural gas combined-cycle plants the predominant choice for new electric generating capacity, including traditional "baseload" generation, and make these plants increasingly competitive with existing coal-fired generating capacity. Id.[11]

Second, natural gas-fired plants will become far more competitive relative to steam-fired plants as a series of newly promulgated and proposed additional environmental constraints take effect in the near future. For example, significantly more restrictive sulfur dioxide emission limitations will be imposed on coal-fired power plants when Phase 2 of the Clean Air Act Amendments of 1990 takes effect on January 1, 2000. Under these restrictions, essentially all large coal-fired generating plants will realize a significant increase in their generating costs, while combined-cycle gas plants, which emit virtually no sulfur dioxide, will experience no additional costs, thus enhancing their competitive position relative to coal-fired plants. Sansom V.S. at 41-45.

Moreover, newly proposed regulatory initiatives by the Environmental Protection Agency ("EPA"), including new controls on ozone production, and national ambient air quality standard for fine particulates, also would impose substantial additional penalties on coal-fired generating plants while leaving natural gas-fired plants relatively unscathed, further enhancing their competitive position. Id. In addition, the United States' commitment to reduce emissions of global-warming gases seven percent below 1990 levels, undertaken in the Kyoto accord signed in December, 1997, essentially would require electric utilities to reduce coal-fired generation by half in the next decade. Id. If ratified and enforced, these restrictions would drastically reduce coal volumes transported by railroads and improve the competitive position of natural gas-fired generating capacity via-a-via coal-fired plants. Id.

Third, increasing concentration in the electric utility industry resulting from a series of mergers will expand the geographic scope of several major electric utilities, facilitating their ability to shift power production from plants served by one carrier to those served by its competitors, effectively rewarding carriers that charge lower coal transportation rates, and punishing those whose rates are relatively higher. Id. at 43-44.

All of these factors will combine to increase the bargaining power of domestic electric utilities vis-a-vis railroads in the near future, by a substantial margin. Indeed, Vice Chairman Owen reached precisely this conclusion in his separate opinion in the recent West Texas coal rate case.[12] While concurring in the Board's decision to reject a claim of effective electricity product competition based on the specific circumstances of the case, Vice Chairman Owen pointed to recent developments in the electric utility industry as warranting "careful analysis" of future claims of such competition in utility coal cases. West Texas at 36. Further, Vice Chairman Owen predicted that future utility coal complaints would properly be dismissed on grounds of effective electricity product competition:

> Sometime in the future, it should be expected that a rate complaint will be

> brought before this agency by an electric utility that has as a feasible alternative the ability to obtain an adequate supply of lower-cost electric power from sources other than its own generating plant.

It would be particularly inappropriate for the Board to decide to ignore product and geographic competition at the very time that those forces are emerging as potent forces to discipline the rates of the most important commodity handled by rail.

The effectiveness of the competitive constraints discussed above may vary to some degree in individual cases, and AAR does not contend that these constraints would compel a finding of no market dominance in every coal rate case that might be brought. By the same reasoning, however, it cannot rationally be concluded a priori that evidence of geographic and product competition, no matter how compelling, can never suffice to establish "effective competition" within the meaning of the statute.

V. THE BOARD CAN SUBSTANTIALLY REDUCE ANY BURDENS ASSOCIATED WITH DEVELOPING AND PRESENTING EVIDENCE ON GEOGRAPHIC COMPETITION WITHOUT ELIMINATING THESE FACTORS FROM CONSIDERATION IN MARKET DOMINANCE CASES.

The written comments filed with the Board in Ex Parte No. 575 do not reflect a widespread concern with product and geographic as substantive standards. Of the 90 written statements filed in Ex Parte No. 575, only three specifically take issue with the Board's consideration of product and geographic competition in market dominance determinations.[13] Significantly, several commenting parties acknowledged the potency of these forces in the marketplace. For example, an economist submitting testimony on behalf of the Attorneys General of Ohio, Illinois, Texas and Iowa, discussed the interchangeability of coal and fuel oil for some utilities, of various nitrogen fertilizers for farmers, and of different grain products for feed producers, concluding

> [i]n those instances in which a substitute input can be obtained via an alternative rail carrier or through the use of an alternative transport mode, the availability of product substitutes can discipline rail pricing practices.[14]

A spokesman for Dow Chemical described the advantages shippers can have if they operate several plants served by different origin carriers, acknowledging that

> One of the options that chemical companies have historically attempted to use for negotiating leverage at captive plants has been to shift product sourcing or production to facilities not captive to that railroad. [15]

A witness for FirstEnergy described the potency of geographic competition at the source, stating that

> FirstEnergy's fuel needs could be met through coal from a variety of sources, which coal could be transported by a variety of origin carriers. This source diversity, of course, presents the opportunity for competition between both coal suppliers and origin rail carriers to earn FirstEnergy's business.[16]

And the Department of Transportation generally criticized attempts at "artificially barring" particular forms of competition, commenting that ". . . approaching deregulation in the electric utility industry may introduce more geographic and product competition into coal transportation than exists today."[17]

There is no broad consensus that product and geographic competition are insignificant and should be ignored. The more pervasive concern, as the Board observed in its Notice of Proposal, is that the complexity and burdens involved in rate reasonableness proceedings constitute an impediment to obtaining relief and perhaps a deterrent to bringing cases in the first place.[18] AAR does not believe the burdens associated with litigating market dominance issues, including issues relating to product and geographic competition, are substantial and we think it is unlikely that any shipper has been deterred from filing a rate complaint on this ground.

Even if the burdens imposed by rate cases were substantial, those burdens do not justify jettisoning an important component of the substantive standards. Moreover, consideration of product and geographic competition does not contribute disproportionately to the time and expense of rate cases. With the revisions to the evidentiary standards adopted in Ex Parte No. 320 (Sub-No. 3), 2 I.C.C.2d 1 (1985), railroads already have the burden of proof on product and geographic competition. Therefore, shippers need not come forward with any evidence on this subject unless and until railroads have submitted evidence on these factors.

To the extent railroads have sought inappropriate and unduly broad discovery from shipper complainants, such excesses can and should be addressed. Specifically, the Board could adopt as part of its formal rules the limitations on discovery imposed in STB Docket No. 42022, FMC Wyoming Corp v. Union Pacific Railroad Co. Those rules would require a carrier seeking discovery in a rate reasonableness proceeding to identify with specificity the product and geographic competition it asserts is effective, to explain the basis of that assertion to avoid fishing expeditions and to tailor its requests narrowly to elicit only the information needed to prove the effectiveness of the specific competition it identifies.

There may well be other procedural changes that are warranted. AAR would welcome constructive suggestions for reducing the burdens associated with market dominance discovery

and evidence in rate cases and looks forward to working with other parties to achieve this objective.

Respectfully submitted,

LOUIS P. WARCHOT
KENNETH P. KOLSON
Association of American Railroads
50 F Street, N.W.
Washington, D.C. 20001

SAMUEL M. SIPE, JR.
F. MICHAEL KAIL

Of Counsel:

JEFFREY R. MORELAND
RICHARD E. WEICHER
The Burlington Northern and Santa Fe Railway Company

JEAN PIERRE OUELLET

Canadian National Railway Company

MARCELLA W. SZEL
TIMOTHY MULCAHY
Canadian Pacific Railway Company

TIMOTHY T. O'TOOLE
CONSTANCE L. ABRAMS
Consolidated Rail Corporation

P. MICHAEL GIFTOS
DOUGLAS R. MAXWELL
CSX Transportation, Inc.

RONALD A. LANE
MYLES L. TOBIN
Illinois Central Railroad Company

RICHARD P. BRUENING
WILLIAM J. WOCHNER
Kansas City Southern Railway Company

JAMES C. BISHOP, JR.
GEORGE A. ASPATORE
Norfolk Southern Railway Company

JAMES V. DOLAN
ARVID E. ROACH II
Union Pacific Railroad Company

ANTHONY LaROCCA
Steptoe & Johnson, LLP
1330 Connecticut Avenue, N.W.
Washington, D.C. 20036-1795
(202) 429-6486

G. PAUL MOATES
VINCENT F. PRADA
Sidley & Austin
1722 Eye Street, N.W.
Washington, D.C. 20006
(202) 736-8175

Counsel for the Association
of American Railroads

May 29, 1998

[1] The D.C. Circuit upheld the ICC's 1976 rules, but expressed skepticism about the ICC's interpretation of the 4R Act. Atchison, T. & S. F. Ry. Co. v. I.C.C., 580 F.2d 623, 634 (1978). After passage of the Staggers Act, the ICC repudiated its prior interpretation. See 365 I.C.C. at 128.

[2] Arizona Public Serv. Co. v. Atchison, Topeka & Santa Fe R.R., ICC Docket No. 38088, slip op. at 12 (1987).

[3] Market Dominance Guidelines, 365 I.C.C. at 131; Westmoreland Coal Sales Co. v. Denver & R.G.W. Ry., 5 I.C.C.2d 751, 757 (1989).

[4] Westmoreland, 5 I.C.C.2d at 756-57.

[5] Dayton Power & Light Co. v. Louisville & N.R.R., 1 I.C.C.2d 375, 379 (1985) (emphasis added).

[6] 2 I.C.C.2d at 6.

[7] 365 I.C.C. at 127.

[8] In addition to the cases described below, the Board recently concluded that UP had "made a prima facie case of geographic competition" in Southwest Railroad Car Parts Co. v. Missouri Pacific Railroad Co., ICC Docket No. 40073 at 9 (Served Feb. 20, 1998), noting that the complainant had conceded that it had "relocat[ed] its facilities in order to avoid unreasonable transportation costs." Id.

[9] See, e.g., Surface Transportation Board, Office of Economics, Environmental Analysis, and Administration, Rail Rates Continue Multi-Year Decline (Feb. 1998) at 4-5 (coal traffic accounted for 22.5 percent of total rail industry revenue in 1996, at average rates per ton- mile substantially lower than any other commodity group).

[10] Promoting Wholesale Competition Through Open Access Non-Discriminatory Transmission Services, Order No. 888, FERC Stats. & Regs. ¶31,036 (1996), order on rehearing, Order No. 888-A, FERC Stats. & Regs. ¶31,048 (1997); see also Open Access Same-Time Information System & Standards of Conduct, Order No. 889, FERC Stats. & Regs. ¶31,037 (1996), order on rehearing, Order No. 889-A, FERC Stats. & Regs. ¶31,049 (1997).

[11] See Transcript of Hearing, Ex Parte No. 575, Review of Rail Access and Competition Issues at 316 (April 2, 1998); see also id. at 329 (noting that at HL&P "They go back and forth between gas and coal").

[12] STB Docket No. 41191, West Texas Utilities Co. v. Burlington Northern Railroad Co., (served May 3, 1996), aff'd sub nom. West Texas Utilities Co. v. STB, 114 F.3d 206 (D.C. Cir. 1997).

[13] Comments Of Consumers United For Rail Equity, March 26, 1998, at 4; Comments Of The Fertilizer Institute, March 26, 1998, at. 4-5; Comments Of Potomac Electric Power Company, March 26, 1998, at 12-13.

[14] *Assessing the Need for Competitive Reforms in Rail-Served Transport Markets: The Question of Access***,** Mark L. Burton, March, 1998, Prepared for the Attorneys General of Ohio, Illinois, Texas and Iowa, p. 20.

[15] Written Statement Of The Dow Chemical Company March 26, 1998 at 3.

[16] Comments Of FirstEnergy Corp., March 26, 1998 at 4.

[17] Statement of the United States Department of Transportation March 1998 at 4.

[18] See, e.g., Comments Submitted On Behalf Of The National Industrial Transportation League, March 26, 1998 at 34, and Comments Of Wyandot Dolomite, Inc., March 26, 1998 at 2- 3.