Ex Parte No. 290 (Sub-No. 2)

RAILROAD COST RECOVERY PROCEDURES

Decided November 21, 1984

The Commission is adopting a substantially modified version of "all inclusive" index of railroad costs originally proposed by the Association of American Railroads (AAR). The modified all inclusive index replaces the interim indexing procedures currently being used. Modifications were made to AAR's original proposal after reviewing suggestions submitted by various parties. The Commission is also changing the timetable for submission and review of index calculations and lengthening the notice period under which rate increases filed under these provisions may become effective from 1 to 10 days.

DECISION

By the Commission:

Section 203 of the Staggers Rail Act of 1980 (Staggers Rail Act) (codified at 49 U.S.C. 10707a) requires us to publish a rail cost adjustment factor (RCAF) on, at least, a quarterly basis. That section requires the numerator of the RCAF to be the latest published index of railroad costs, as compiled or verified by the Commission. The current denominator is the index which was controlling (120.9) for the fourth quarter of 1982 rebased to 100.0. The RCAF must reflect the changing composition of railroad costs, including the quality and mix of materials and labor.

In Ex Parte No. 290 (Sub-No. 2) Railroad Cost Recovery Procedures, 364 I.C.C. 841 (1981), the Commission adopted the interim indexing methodology which is currently used. This interim index is a modified version of the input price index of the Association of American Railroads (AAR). It is compiled and submitted on a quarterly basis by AAR and is reviewed and analyzed by the Commission. The quarterly interim index is subject to our modification and is used to determine the RCAF. A railroad may, by filing a tariff, automatically increase its rates to no more than the RCAF on 1 day's notice under these general increase provisions. The railroads are, of course, free to exercise other pricing freedoms permitted under law. Although railroads may increase their rates by a percentage up to and including the RCAF, they are under no obligation to do so and, as a matter of record, some rates have not been increased when the opportunity has been available to do so.

In adopting the interim index methodology, we decided that the Producer Price Index (PPI) would be used for measuring the "all other" cost category only.
until AAR's "all inclusive" index became available. We further stated that we would consider developing and implementing our own composite index, if implementation of AAR's "all inclusive" index were not feasible within a reasonable time period.

AAR filed its "all inclusive" index on January 29, 1982. The new index made several changes in the methods of calculating the indices for wages, fringe benefits, fuel and materials and supplies. It also substituted alternative methodologies for calculating the indices in the "all other" category, which are now measured by the PPI.

In a decision served April 27, 1982 (47 F.R. 18012, April 27, 1982), we reopened Ex Parte No. 290 (Sub-No. 2), supra, for the purpose of soliciting public comments on AAR's proposed "all inclusive" index, the 1-day notice period, the use of a wage additive, AAR's proposed opportunity cost methodology and our auditing procedures. Comments were due July 9, 1982.

In a decision served June 20, 1983, we issued a Notice of Proposed Rulemaking (NPR) concerning the notice period for filing rate increases under the provisions of Ex Parte No. 290 (Sub-No. 2), supra, public participation in the computation of the RCAF, public audit and access to AAR's underlying data, the use of wage additives, and opportunity costs for funds collected but not yet disbursed. That NPR also proposed the adoption of a substantially modified version of AAR's "all inclusive" index of railroad input costs. The decision noted that the substantially modified index was no longer the work of AAR alone, but represented the input of AAR, Federal and state government agencies, individual shippers, shipper associations, trade associations and the Commission.

The decision also stated that, in our view, the Staggers Rail Act clearly mandates the establishment of one single nationwide index. We believe it was the intent of that Act to simplify the procedures for increasing rail rates and that the application of the single RCAF to all base rates best accomplishes that intent. The decision further stated that, given the complex and time consuming nature of index production, the compilation and publishing of regional or railroad specific indices is neither feasible nor desirable.

The decision also cited the establishment of another rulemaking proceeding, Ex Parte No. 290 (Sub-No. 4), Railroad Cost Recovery Procedures-Productivity Adjustment. In instituting this proceeding, we specifically stated that comments relating to the productivity issue would be considered separately from those comments directed to the April 27, 1982 Notice and Decision in Ex Parte No. 290 (Sub-No. 2), supra.

Comments were originally due August 23, 1983. In response to requests for an extension of the comment period, the due date for comments was extended to September 13, 1983.

The Notice Period

We also proposed a revised timetable for the submission and handling of RCAF rate increase proposals. AAR would file its RCAF submissions on or
within 10 days after the first day of the last month of the quarter, prior to the effective date of the proposed rate increase. We would expedite the handling of these RCAF submissions and render our decision within 15 days after the receipt of AAR's proposal. Railroads would file their RCAF increase tariffs effective on or after the first day of the quarter on not less than 10 days notice. Comments were invited.

Shipper parties generally support the revised timetable and the 10-day notice period although some contend that a longer notice period is necessary. AAR submitted a proposed revised timetable for the submission and processing of the index. It notes that the time required for calculating the index has been reduced and that an earlier filing date is now possible. AAR believes that its own revised timetable is preferable because it preserves the notice and review periods while adding certainty to the schedule.

Under AAR's timetable, the index would be submitted on the fifth day of the last month of each calendar quarter or on the closest business day to the fifth if the fifth were a Saturday, Sunday or holiday. Our decision would be due no later than 15 days after receiving the index. Tariffs containing RCAF increases could become effective on the first day of the quarter on 10 days notice.

We will adopt the AAR's revised schedule. The schedule preserves the benefits of our original proposal, assures the railroads a timely increase in their rates on the first day of a quarter, and provides shippers with 10 days notice of the new rates, as originally proposed. We do not agree with those shippers who seek more than the 10-days notice period of RCAF increase tariffs. The 10-days to be provided, an increase in the previous 1-day period, is ample notice for RCAF increases.

Public Access to Index Data—Audit of the Index

In our NPR, we observed that much of the data used in the compilation of the index is proprietary1 and cannot be released to either the public or, in the case of railroad price data, to other railroads. We also stated that both the integrity of the index and the confidential nature of the data which underlie it are protected by both the CPA's audit and our review of the CPA's workpapers and procedures.

Shipper parties continue to argue for participation in the computation and verification of the index. They believe that auditing procedures and allocations of cost items inherently entail judgmental factors on which parties may reasonably differ. They argue that it is natural to expect that an auditing firm retained by AAR would resolve judgmental issues in favor of its client.

Alternative procedures are also suggested. One shipper party suggests that we permit disclosure of relevant data under an appropriate confidentiality order to an independent auditing firm retained by those shippers desiring an audit. This

1 Proprietary data is data which if divulged to customers or competitors could harm the railroad whose data is disclosed. A current example of proprietary data would be the specific conditions of a contract rate. Cf., 49 U.S.C. 11910 (Unlawful Disclosure of Certain Information).

1 I.C.C. 2d
audit, it contends, could be funded by interested shippers and supervised by the Commission, thereby insuring impartial results.

Another shipper party suggests the retention of a single qualified auditing firm sponsored jointly by AAR and interested shippers and subject to review by our Bureau of Accounts. Under this alternative, the control of the audit mechanism would be taken out of the sole control of AAR, and placed either with us or jointly in the hands of those carriers who compile the index and shippers.

Another shipper party believes that a logical alternative to a specific audit of the data used to compile AAR's index is to check the index against actual performance of the railroads. The suggested procedure is to compare the total costs produced when 1 year's service units are applied to Rail Form A unit costs for 2 consecutive years. The party believes that the Rail Form A applications used for this comparison should be calculated at the 100 percent variable level because the rail cost adjustment factor is based on the total of both fixed and variable costs. It also contends that the results of these comparisons can be used to correct overstatements in the index. As a specific example of this procedure, 1981 service units were applied to both 1980 and 1981 unit costs. The party's witness concludes that, on the basis of total dollars produced for each year, there was an 11.637 percent increase in costs from 1980 to 1981.

The party argues that its suggested methodology eliminates the change in traffic mix that flaws a simple ton-mile comparison because costs are related to various unit costs such as switch engine minutes and crew hours.

We reject this methodology because a comparison of the total dollars generated by the application of 1 year's service units to the unit costs of two consecutive years is meaningless and of no value. Unit costs, as developed in Rail Form A, are determined by traffic levels, traffic mix, and total freight expenses, rents, taxes and a cost of capital element.

AAR, after observing that the only element of the index not available to the public at large is the input prices of materials and supplies, argues that these price data are confidential and proprietary and the release of this information would be harmful to railroads, railroad suppliers and even to the general public. It contends that release of these prices would be anti-competitive. It believes that railroads would be adversely affected by the release of price data, because negotiated business agreements would be revealed to both railroads and competitors. Suppliers, it argues, would be pressured to match prices and competitive adjustments that would otherwise be offered to railroads would be eliminated.

AAR also believes that suppliers would be harmed by disclosing prices. It contends that disclosure of price data would tend to standardize prices and reduce the incentive of suppliers to be flexible in reducing prices to compete more effectively. It argues that the prices of materials and supplies would most likely rise and the railroads would incur increased costs which would result in higher transportation costs to the shipping community. AAR observes that similar information is not available from the Federal government agencies who construct the PPI, the Consumer Price Index or the Bureau of Labor Statistics Freight Rate Index.
Finally, AAR observes that throughout 1983 we have inspected working papers, procedures and data input to the index; and have examined, altered and approved every refinement of index instructions, documentation and statistical methodology. Additionally, the 1983 audit by Deloitte, Haskins & Sells was furnished to us. AAR concludes that public scrutiny and review of the index would serve no useful purpose and that the public interest is adequately protected.

We remain convinced that much of the data used in the compilation of the index is proprietary and cannot be released to either the public or, in the case of railroad price data, to other railroads. We are still convinced that the integrity of the index and the confidential nature of the data which underlie it are protected by both the CPA's audit, our review of the CPA's procedures and workpapers, and our own independent review and audit of the index. For these reasons, we still believe that the auditing of the index by more than one certified public accounting firm would serve no useful purpose and would unduly burden the railroad industry. Accordingly, the requests of shipper parties for an additional audit are denied.

We will, however, make available working papers and other underlying data which we do not consider proprietary. These include data used to develop labor costs, the largest single portion of the index. We think this approach will best balance the legitimate interests of all the parties here. Nonetheless, we will closely review any comments or petitions re-raising this issue, after an appropriate interval has passed to evaluate the effectiveness of this approach.

**Opportunity Costs**

Our NPR proposed the use of the 3-month Treasury Bill rate for funds collected by the railroad industry in anticipation of labor contract settlements. We proposed that, during a period of labor contract negotiation following the expiration of a contract, the wage portion of the index be constructed through the use of our wage forms, updated for the latest management offer. Funds collected in anticipation of a retroactive labor settlement would accrue compound interest at the 3-month Treasury Bill rate. At the time of a labor settlement, the total amount of the excess collections, plus any accrued interest, would be applied to the retroactive payments due to organized labor. Any excess funds collected in anticipation of a labor settlement, plus any interest retained by the railroads after retroactive payments, would be applied to future index adjustments. A similar procedure would be used in the case of undercollected funds.

Shipper parties contend that opportunity cost adjustments should be applied to all elements of the index rather than only to labor costs, arguing that there is an inherent incentive for the railroad industry to overestimate future costs in order to increase the RCAF. They argue that experience demonstrates that costs generally have been overestimated during the time that the RCAF increase procedures have been in effect. Specifically noted were the differentials between the first quarter 1983 index forecast of 101.0 and the second quarter 1983 forecast of 97.9. One
party argues that the result of excess collections has so far amounted to some $75 million per month, and the opportunity costs on those excess collections during a single calendar quarter amounted to about $4 million.

Another shipper party believes that the 3-month Treasury Bill rate is inappropriate, because it is lower than the cost of borrowing for either shippers or railroads. It argues that the appropriate rate would be the after tax cost of capital to the railroads and the mere fact the Treasury Bills are available to both shippers and railroads alike should be irrelevant.

Other shipper parties and AAR believe that the Treasury Bill rate is the most appropriate measure of risk-free interest rates that can be applied to calculate opportunity costs. They observe the Treasury Bill rate is clearly superior to other return values, such as the railway industry’s estimated cost of capital, because these measures reflect tax and capital structure considerations which have no bearing on inflationary cost recovery. AAR has also proposed the use of an 80 percent “realization rate” to compensate for rate increases authorized under the RCAF conditions but not taken either in full or in part by the railroads.

We remain convinced that, because of the self-correcting nature of the index, we need not adopt an opportunity cost adjustment for items other than anticipated labor costs collected but not yet paid. By self-correcting we mean the effects of overstatements in the index are offset by corresponding understatements. Since the forecasted index tracked well when compared with actual historic data, an opportunity cost adjustment in areas other than labor is not necessary. We note that a quarterly AAR exhibit titled “Forecasting Experience,” shows that both overestimates and underestimates of the index’s actual performance have occurred and the forecasted index has compared favorably with actual data. The weighted index, as forecasted, was seven-tenths of one percent under actual performance on a cumulative basis, at the first quarter of 1984.2

The funds collected by the railroads in anticipation of a yet to be settled labor increase are different because these funds are not paid immediately but are available for use until the time a retroactive wage payment is made. To not apply an opportunity cost adjustment in this unique situation would be giving the railroads an interest-free loan. As we have previously stated, our methodology pending the settlement of a new contract calls for the computation of the wage element of the index on the basis of the latest management offer. During such a period, the railroads would collect a portion of the wage element of their expenses

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2The following are the cumulative forecasted index compared with the index computed using actual data (overstatements and understatements of the index) from the second quarter 1981 through the first quarter 1984; second quarter 1981, 1.6 percent understatement, third quarter 1981, 2.2 percent understatemnt, fourth quarter 1981, 3.0 percent understatemnt, first quarter 1982, 1.0 percent understatemnt, second quarter 1982, 1.0 percent overstatemnt, third quarter 1982 0.5 percent overstatemnt, fourth quarter 1982, 0.1 percent overstatemnt, first quarter 1983, 0.8 percent overstatemnt, second quarter 1983, 0.1 percent overstatemnt, third quarter 1983, 0.5 percent understate-

1 I.C.C. 2d
from shippers, and then pay that portion to labor on a retroactive basis after settlement at some unknown future date.

We agree with AAR and some shippers that the 3-month Treasury Bill rate is the proper rate to use in the computation of opportunity costs. The 3-month Treasury Bill is a standard risk free investment rate used by our Commission and by numerous other entities. This rate shall be used on a compounded basis, as the various 3-month Treasury Bill certificates mature during a period of unsettled labor contracts. During a period of labor contract negotiations following the expiration of a labor contract, the wage portion of the index shall be constructed through the use of a straight time hourly wage rate, computed from our wage forms and updated for the latest management offer. Funds collected in anticipation of these wage increases would accrue interest at the 3-month Treasury Bill rate. At the time of the labor settlement, the total amount of the excess collections, plus any accrued interest, would be applied to the retroactive payment due to organized labor. Any excess amount of funds collected in anticipation of the labor settlement, plus any interest retained by the railroads after a retroactive payment, would be applied to future index adjustments. The same procedures would be used in the case of under collections.

We have considered AAR’s proposed use of a realization rate to adjust the opportunity cost for rate increases which are authorized but not taken in full by the railroads. Although we realize that the maximum rate increases authorized under these cost recovery provisions will not be taken on all traffic, we will not establish a realization rate adjustment. We note that railroads are free to adjust rates upward to the maximum permitted levels. The fact that the maximum increase is not always taken is merely a reflection of the railroad exercising business judgment in adjusting its rate levels. Furthermore, general rate increases prior to the Staggers Act were lengthy and involved proceedings conducted under different rules. One of the purposes of the Staggers Act was to enable the railroads to achieve timely rate increases to cover inflation. Finally, we observe that there are other provisions of the Staggers Act which permit a railroad to increase its rates beyond the maximum inflationary levels permitted under our general increase provisions.

AAR’s proposed methodology is adopted with the exception of its proposed use of a realization rate. AAR is ordered to amend its procedure to eliminate the use of a realization rate in computing the opportunity cost of funds collected in anticipation of unsettled labor contracts.

*Correction of The Index For Negative Quarters*

One party contends that there is an excessive reimbursement to the railroads because of quarters in which the index shows a decline from a previously higher level and either the lack of a corrective adjustment in a subsequent quarter or an ordered decrease in the maximum rate levels permitted under these conditions. It
proposes the use of a holddown to offset the over reimbursement occurring because of negative quarters.

While we recognize that over reimbursements to the railroads have been possible because of the decline in the index from a previously higher quarter, corrective adjustments will not be ordered.

One of the purposes of the Staggers Act was to assure the railroads of a timely and simple means of gaining inflationary rate increases. We have previously observed that the law does not provide for rollbacks, and described the related problems of equity and jurisdiction. The law does not provide for holddowns either. The potential for problems related to corrective holddowns as a routine item appear to be as great. The index of railroad costs is an integral part of our current general increase procedures which replaced a lengthy procedure involving complex testimony and delays in achieving inflationary increases. We believe that the addition of a corrective adjustment to the index would complicate our simple process and the intent of the indexing concept.

We do observe that we recently adjusted the maximum increase permitted under these procedures downward by 0.1 percent to correct a similar overstatement in a prior quarter. That adjustment was made on an ad hoc basis to correct a computational error and was endorsed by all parties. Had the parties disagreed, our action may have been different.

*Discounting The Index for A Profit Element*

One party observes that in our NPR we decided that the issue of discounting the index for a profit element concerned the issue of productivity which is specifically addressed in Ex Parte No. 290 (Sub-No. 4), *supra*. In that NPR, we stated that all issues relating to discounting of the index would be addressed in that proceeding.

The party believes that it is not exactly clear how all of the suggestions concerning the discounting of the index relate to productivity. It contends that some aspects of discounting the index could, if left for consideration in Ex Parte No. 290 (Sub-No. 4), *supra*, be omitted from consideration in either proceeding.

We remain convinced that the issue of discounting the index for a profit element is properly a part of Ex Parte No. 290 (Sub-No. 4), *supra*. That proceeding also involves the propriety of adjusting the index and the detail for making adjustments. The issue of discounting the index for a profit element will continue to be addressed in Ex Parte No. 290 (Sub-No. 4), *supra*. As to the concerns expressed about our ability to recognize adequately all aspects of this issue, we will take notice of the comments in this proceeding when considering the issues in that proceeding. If it is necessary, we will seek additional comments in resolving this issue.

*The All Inclusive Index*

Our NPR proposed the adoption of a substantially modified version of AAR's "all inclusive" index. We observed that, because of the many modifica-
tions, our proposed index was no longer the work of AAR alone, but represented the input of AAR, Federal and State government agencies, individual shippers, shipper associations, trade associations and the Commission. Comments on the proposed “all inclusive” index were requested. After reviewing and carefully considering those comments, we are adopting the following indexing scheme, which we believe best serves as the index of railroad costs envisioned by the Staggers Act.

**Labor and Fringe Benefits**

**A. Labor**

In our NPR, we observed that, because labor costs are the largest single part of the index, care must be taken to develop the labor component. We concluded that the proposed “all inclusive” index methodology may have overstated the actual cost of labor, and proposed that a straight time hourly rate be developed on the basis of projected annual railway wage payments. These wage payments would be computed using national contract provisions, adjusted for exceptions, such as union agreements to accept less than national contract increases, and management salary increases of a lesser percentage than union contract salaries. We also proposed including Conrail’s labor costs at national contract levels in order to comply with certain provisions of the Northeast Rail Service Act of 1981.

In our NPR, we observed that section 1159 of the Northeast Rail Service Act of 1981, Public Law 9735 (NERSA), provided that cost reductions resulting from certain provisions of that Act should not be used to limit the maximum level of Conrail’s rates. To reconcile this NERSA provision with section 10707a of the Staggers Rail Act, which requires an index of railroad costs applicable to all railroads, we proposed the application of “national contract” wage provisions to determine Conrail’s portion of the wage component of the index.

Effective with the index for the first quarter of 1984, the labor portion of the index was computed to include Conrail at “national contract” levels with all other railroads included at their actual labor costs. This change was fully explained in a decision served March 21, 1984, Ex Parte No. 290 (Sub-No. 2), *Railroad Cost Recovery Procedures*, appeal docketed *sub nom. Edison Electric Institute v. ICC*, Nos. 84-1044, et al. (D.C. Cir. filed February 9, 1984).

AAR argues that, although differentiating between union and nonunion compensation rates appears to have some theoretical merit, in practice, differentiating between these two groups of employees is demonstrably unnecessary. It argues that its own study shows an extremely close relationship between the wage rate increases of union employees and those of all employees combined. AAR contends that while the incremental increases from year to year are virtually identical for many of the periods, the slight differences that do exist do not exhibit any pattern. It faults the shipper-sponsored study which developed the difference
between union and nonunion wage increases, observing that it was based on only 3 of the 128 divisions shown on the wage forms, those being (1) executives, general officers and assistants, (2) division officers and assistants, and (3) staff assistants and professional and sub-professional assistants. AAR contends that nonunion railroad employees clearly are not restricted to these three employee divisions. It developed straight time hourly rates for the last 13 years for both the 95 union employee divisions and the total 128 divisions. AAR believes that the 95 divisions are the traditional categories recognized by both union and management as the union employee base for the purpose of labor contract negotiations, and that the remaining 33 employee divisions are comprised of nonunion employees or a mixture of nonunion and union personnel.

The shipper party sponsoring the differential study between union wage and nonunion wage increases believes that there is invalid data reported on Wage Forms A and B for the years 1971, 1972, 1978 and 1982. It also provides a revised effective wage factor which it contends takes into account both wage rate adjustments attributable to lower wage increases for management-level employees and wage settlements lower than the national agreement.

We are not convinced that there is a measurable differential in the percentage wage increases of management and union railway employees. We believe AAR’s study showing an extremely close relationship between union employees and all employees combined is more convincing than the shipper’s argument. We also support AAR’s contention that Wage Forms A and B show either union employees or a composite of union and nonunion employees. We conclude that these forms cannot be used to compute a differential in the relative wage increases granted to union and nonunion railway employees. We are revising our rules to provide for a single straight time hourly rate for both union and nonunion employees.

B. Fringe Benefits

In our NPR we observed that, because many railroad employees are at the monthly ceiling for railroad retirement payments, contributions to the railroad retirement fund system should be computed on an average “effective rate”. This effective rate would represent the average percentage of wages represented by employer railroad retirement payments. Shipper parties support this concept and one party notes that the utilization of a so-called effective rate will produce results more nearly reflective of the actual experienced cost increases of the railroad industry’s railroad retirement payments.

AAR in its comments observed that it has used an “effective rate” methodology for the computation of both Tier I and Tier II railroad retirement payments and its proposal continues the use of this methodology. Our recent review of AAR’s index working papers confirm the continued use of an effective rate methodology.
After our review of both shipper and AAR comments we remain convinced that an effective rate methodology is the proper way to compute the employer’s payments to the railroad retirement fund. The term “effective rate” means the average of all payments to the fund as a percentage of total wages paid regardless of whether the wages were subject to railroad retirement employer contributions.

**Fuel**

In our NPR, we proposed the adoption of AAR’s “all inclusive” index methodology for the calculation of the cost of diesel fuel consumed by railroads. We also observed that, although there had been data problems in the past, we believed that revision of the instructions to the reporting railroads, retention of a certified public accounting firm by AAR and our monitoring of the accounting firm’s audit procedures would ensure the integrity of the fuel data component.

AAR observes that Bureau of Labor Statistics’ fuel indices measure fuel consumption by users other than railroads. It believes there should be a small difference between fuel figures reported in the R-1 Annual Report and the index because, for example, the R-1 is historic and the RCAF index is forecasted. AAR further believes the RCAF fuel index and other fuel indices track well when they are compared.

Certain shipper parties proposed various alternative means of measuring the fuel portion of the index. One suggestion is the use of the Middle Distillates to Commercial Consumers Index rather than actual railroad price data. One shipper party believes that there are inconsistencies in two separate AAR fuel indices contending that over the period from 1980 through the first quarter of 1982, the RCAF index produced an increase almost twice as great as that published by the AAR in the RCR-2.\(^3\) When properly compared, the RCR-2 index and the RCAF index produce the same increase. Some difference should be expected because the RCR-2 is an actual historic index while the RCAF index is forecasted. Additionally, the major part of the basis for this party’s argument is not appropriate since the RCR-2 index report used for the comparison was incorrect and was subsequently reissued by AAR.

Another shipper party suggests that we use the Diesel Fuel to Commercial Consumers Index as a ceiling for the fuel portion of the index believing that the establishment of a ceiling would contribute to curbing unnecessarily inefficient fuel purchasing policies by the railroads.

We have reviewed these alternative methodologies and find that they do not measure the cost of railway diesel fuel as well as AAR’s survey of actual prices. The Middle Distillates to Commercial Consumer’s Index, for example, is produced by the Bureau of Labor Statistics and is not a measure of railway fuel cost but rather a composite of a number of different users. We also conclude that use of the Diesel Fuel to Commercial Consumers Index as a ceiling for the fuel portion

\(^3\)RC-2 is an index of railway expenses compiled and issued by AAR.
of the index is improper because it is a measure of the cost of diesel to a broad range of purchasers and not just to railroads.

We are persuaded that AAR’s proposed methodology best measures the cost of diesel fuel to railway users. Alternative methods of indexing this component measure prices for a composite of consumers and are therefore less appropriate for measurement of railway fuel costs. Additionally, we believe the quality of the data used for the computation of the fuel index has improved because of revised instructions and audit procedures. We will continue to use AAR’s methodology for measurement of the fuel portion of the index. We will also continue to both audit the actual fuel purchase data of the individual railroads and the compilation of fuel data by AAR. If we find significant problems in the accuracy of fuel data either as reported by the individual railroads or as compiled by AAR, we will consider a change in the method of computing the fuel component of the index.

**Materials and Supplies**

In our NPR, we said we believed AAR’s market basket adequately measured the materials and supplies component of the index. We recognized that, although there were difficulties inherent in the use of a judgment sample, we believed it would be neither necessary nor cost effective to use probability sampling. This is because the market basket consists of frequently used railroad materials and accounts for over half of the materials and supplies purchases of the sample railroads.

We also stated we were aware of the problems disclosed by both our own audit and by the more recent audit conducted for AAR by the certified public accounting firm of Deloitte, Haskins and Sells. We noted that instructions for reporting railroads had been revised and that AAR had conducted a seminar to train the railway staff responsible for the preparation of this portion of the index. Additionally, we have continued to monitor the material and supplies portion of the index to insure that the market basket is properly reported and measured.

Shipper parties continue to cite the same problems with the materials and supplies market basket contained in their reply to the ANPR. However, they furnish no new reasons why the existing market basket procedures should not be continued. The use of probability sampling for determining the composition of the market basket and the exclusion of outlier data are again suggested. The use of price quotes rather than actual prices is again questioned.

The construction of the market basket and the collection and verification of market basket data use generally accepted procedures. We fully expect the

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4 The market basket is a proportionally weighted selection of railroad material and supplies purchases.
5 An outlier is an extremely high or extremely low value showing significant difference from the main data grouping.
6 The procedures separate railroad materials and supplies into both functional and compositional categories. A wooden cross tie, for example, falls into the forest products compositional category and the maintenance of way function category. Items are ranked in each category from highest to lowest. The market basket is prepared to insure adequate representation in both compositional and functional categories. AAR’s newly revised market basket (effective third quarter 1984) achieves an overall representation of 65 percent of all material and supplies expenses. A copy of AAR’s newly revised market basket and instructions is attached as appendix “A”.

1 I.C.C. 2d
revised instructions and the increased auditing of this component to result in improved accuracy of this component.

We will continue to use the market basket for the materials and supplies portion of the index. We will not specify a standard, for excluding outlier data at this time because improvements in both the specifications for reporting market basket data and the accuracy of data reported have virtually eliminated the outlier problems which formerly existed. The problem of outliers will be monitored as part of our audit process and corrective action taken as the need arises. We will also continue to accept price quotes for market basket items. We observe that actual invoice prices are used if available. In the absence of an actual invoice item a contract may be used. Price quotes are used only when invoices or contract prices are not available. As with any market basket, changes in the purchasing patterns of the railway industry may necessitate changes in the composition either in the market basket itself or the market basket data. Any changes must be approved by our Bureau of Accounts.

Equipment Rents

Our NPR proposed a two-phased system for indexing equipment rents. Car hire rates would be indexed through use of the rates found in the Universal Machine Language Equipment Register (UMLER) while the index for lease rentals would use actual data. We observed that UMLER car hire rates are legitimate expenses of conducting business and are established using our mandated procedures, in conformance with provisions of the Interstate Commerce Act.

We also said there were no relevant data for the measurement of lease rental data, but saw no reason why such data could not be assembled. We proposed the collection of lease rental data on either a modified Form D40 or on another form designed for that purpose. The data collection form, the instructions for completion of the form, and the procedures for collecting and computing lease rental data would require approval by our Bureau of Accounts.

AAR agrees with our belief that car hire rates are best indexed through the use of the rates from the UMLER system, and believes that these rates are legitimate business expenses established using procedures which we mandate.

AAR states that it has conducted a survey of railroads to determine the availability of lease rental data and found that although these data, as reported in Schedule 410 of the R-1 Annual Report, are available on a quarterly basis, information on the physical units to which these rentals are attributed is not. AAR suggests that, if lease rental rates are to be provided on a quarterly basis, an alternative deflator is required. AAR believes that a logical locomotive lease

\textsuperscript{7}The Universal Machine Language Equipment Register (UMLER) is a computerized listing of the car hire rates and other data for all freight cars suitable for interchange service.

\textsuperscript{8}A deflator is a factor used to equate a dollar amount which otherwise would fluctuate because of influences such as changes in volume. An example of the use of a deflator is the measurement of fuel consumption on a miles per gallon basis.

1 I.C.C. 2d
rental deflator is locomotive horsepower, contending that this is probably the ultimate indicator of physical capacity. It also proposes that freight car capacity be used as a deflator for freight car lease rentals. Under AAR’s proposed “all inclusive” index methodology, data for both deflators would be collected.

Certain shipper parties disagree with AAR and argue that there is no reason why car hire rates cannot be determined by the use of actual data rather than through the UMLER system. They believe that UMLER contains numerous distortions and includes factors unrelated to lease rental rates and contend that we have acknowledged this.

One shipper argues that extracting the car rental data from the UMLER file, as outlined by AAR, would lead to a series of inaccurate estimations. It observes that UMLER gives no indication of the amount of or type of cars that actually incur rental payments; and that UMLER reports only the rates for those cars, asserting that there is no indication of which cars actually incurred rental payments and which cars did not. The party also notes that UMLER includes cars that generally receive no mileage allowance credits, and believes that inclusion of these cars would tend to distort the reported charges in car rental payments.

Another shipper agrees with our proposal, observing that the carriers could provide both quarterly information of aggregate lease rental charges by equipment category, and capacity information for those equipment categories which could then be used to estimate appropriate deflators.

Another shipper party believes the use of UMLER rates and lease rental charges in the equipment rents section of the index results in a “double count” because the labor and material items used to develop these rates and charges are also included in other portions of the index. The same party also contends that equipment rents are overstated because a return element is a part of the car hire rate and this results in revenue to the railroad industry.

Another suggests use of a railway equipment factor from the PPI for the locomotive portion of other rents but provides no support for use of this specific surrogate.

We remain convinced that our original proposal to index car hire rates through use of the rates found in the UMLER system is the best way of practically indexing car hire. The UMLER system is the only comprehensive source of car hire information. It produces the car hire rates which apply to all cars that move. When rates apply, and to which specific cars, is largely a matter of chance and other external factors.

AAR’s methodology uses UMLER only to measure changes in car hire rates. Inclusion of labor, material charges and the return element neither distort nor inflate the index. On the contrary, these elements are some of the basic building blocks used to establish the proper level of the car hire rates. Accordingly, they are essential to the proper measurement of change in the rates from one period to the next. To omit any of these elements would truly distort the index.

In the application of a weighting factor to the index we must remember that car hire rates are regularly used in determining the cost underlying any freight
rate. Furthermore, the return element (as well as labor and materials) is included in the car hire rates by law and is a legitimate cost of doing business to the car users. This return element is frequently passed through to the nonrailroad car owners by the leasing railroad which acts as no more than a middleman. To the extent that this does not occur, the payment by the using railroad is offset by the credit to the receiving railroad leaving only the net cost to be included in the indexing process. The car hire component shall be indexed using UMLER.

We are also convinced that our original proposal to use actual data for indexing lease rentals, as amended by AAR, is an accurate way of indexing lease rental payments. Rental payments will be indexed through quarterly data, as reported in Schedule 410 of the R-1 Annual Report, using actual locomotive horsepower and freight car capacity rented as deflators.

**Purchased Services**

In our NPR, we proposed that the purchased service component either be measured through data collection in the same manner as prescribed for lease rentals or that AAR demonstrate, to our satisfaction, that there is a parallel between railway labor and material costs and purchased services expenses. Any form used for the collection of purchased service data, together with the instructions for that form, must be approved by our Bureau of Accounts.

AAR responded that although the railroads were able to supply purchased services expense data on a quarterly basis, there were two problems in using actual data. It contends there are conceptual difficulties in developing a deflator that would serve for the wide variety of services included with the purchased services category and that there is a shortage of quarterly data points from which to forecast. In order to be consistent with the data collected on depreciation, interest, and taxes, it would be necessary to collect data over a period of several years. As an alternative, AAR proposes use of the Bureau of Labor Statistics Employment Cost Index for Compensation to Private Non-Farm Workers.

Shipper parties note that our NPR is critical of AAR's recommended procedures. One shipper party observes that AAR's methodology draws no distinction between the various components of purchased services expenses, noting that these components could be separated on the data form. It believes that purchased services expenses consists primarily of equipment, repair and maintenance costs and various other items, such as office equipment rentals and professional services. It contends that where services are purchased from affiliate companies, subsidiary companies or other railroads, the expenses should be clearly identified and removed from the calculation of the purchased services index. The party agrees that an increase in purchased services expenses for one railroad represents additional revenue to an affiliate, subsidiary or another railroad. The party alleges that this is a type of double counting which occurs through the use of AAR's all inclusive indexing methodology.

1 I.C.C. 2d
Another party, observing that the purchased services expense group covers an array of specialized services that are difficult to trace to specific activities, believes the majority of these expenses relate to revenue generation and facility maintenance. It suggests the use of a deflator revenue factor, such as revenue ton-miles. It also believes that, over the 1978 to 1981 period, the AAR indexing methodology is upwardly biased and recommends we adopt the Monthly Construction Cost Index published by the "Engineering News Record." Another shipper suggests the use of a broad measure of the general economy such as the Implicit Price Deflator of the Department of Commerce.

Another shipper party believes that AAR's logic assumes purchased services have exactly the same characteristics as the labor and material costs incurred directly by the railroads. It contends that, because these services are purchased rather than internally produced, they are different from rail labor and materials. It argues that the use of these items as a basis for the purchased services index gives railroads alone the benefit of improvements and supplier productivity, while no benefits accrue to the shippers. The party contends a measure which reflects the economy as a whole, rather than the railroads' own costs, is more appropriate and suggests the use of the Implicit Price Deflator for the Gross National Product published by the United States Department of Commerce.

We do not find AAR's arguments persuasive. It has not proven that there is a relationship between purchased railway services and either the AAR index of material prices, wage rates and supplements combined, excluding fuel, or the Bureau of Labor Statistics Employment Cost Index for Compensation to Private Non-farm Workers.

We see no reason why AAR could not collect quarterly data from its participant railways back to the year 1977, consistent with the data collected and furnished on depreciation, interest and taxes.

Purchased services expenses will be indexed, at this time, using the Producer Price Index for Industrial Commodities Less Fuel and Related Products and Power. We believe such a general measure of inflation is superior to the use of a revenue ton-mile deflator. Revenue ton miles are not a good measure of railroad traffic volume. Further, it is not likely that the volume of purchased services varies directly with traffic volume.

While we fully realize that the use of actual purchased services data in the index will include some payments to affiliated companies, the index will not be distorted because of the inclusion of affiliate data. The examination of affiliate transactions has long been a part of our audit process. Material transactions with affiliates are examined to insure that the charges recorded in a railroad's books are not in excess of what the railroad would have paid a nonaffiliated company for the same service. Any form or forms used for the collection of purchased services data must be approved by our Bureau of Accounts.

**Depreciation**

In our NPR, we proposed the adoption of AAR's suggested depreciation methodology. We stated that the Form D-40, the instructions for completing that
form, and the procedures for collecting and computing depreciation data, must be approved by our Bureau of Accounts. Additional comments including suggestions for alternative methods of indexing depreciation were requested.

Shipper parties contend that when we included depreciation as a part of the cost index in Ex Parte No. 411, Complaints Filed Under Section 229 of The Staggers Rail Act of 1980, we used a factor of 1.0. This, they observe, has the effect of holding the depreciation component constant.

Parties also question whether increases in depreciation reflect cost inflation alone or a composite of both cost inflation and plant improvements. Examples are cited, such as the installation of a signaling system with reverse signaling capacity as a replacement for a directional signaling system. Under AAR's indexing scheme, this change would be treated as a depreciable capital cost, while these parties believe it would reflect upgrading the quality of the railway line. The alternatives of either indexing depreciation at 1.0, to conform to the methodology adopted by the Commission in Ex Parte No. 411, supra, or adjusting depreciation to account for quality changes are suggested.

Shipper parties also argue that in Ex Parte No. 411, supra, we found that the PPI should not be used to index depreciation because of the lack of any data connection between many of the elements of depreciation and the PPI. They argue that proceeding concluded that no support was given for the position that depreciation may be properly indexed at all. They argue that depreciation should be treated in the same manner as Loss and Damage and be indexed at a figure of 1.0.

After observing that we requested specific comments on recognizing current or replacement costs in the index, two parties contend that replacement cost accounting is inappropriate for determining inflationary cost increases. They argue that replacement values relate to expected investment actions and not the historical in-place investment base. They conclude that a hypothetical replacement cost base should not be used to measure the actual inflation expenses of the railroads.

We are convinced that Depreciation Expense should be indexed. Maintaining a given level of capacity through replacement of depreciated capital goods in a period of generally rising prices results in Depreciation Expense increasing even though capacity does not. Thus, we adopt for use at this time the Producer Price Index for Railroad Equipment for indexing Depreciation Expense.

However, we note that, if we eventually were to adopt the replacement cost accounting proposed in Ex Parte No. 393 (Sub-No. 1), consistency would require us to apply a similar indexing methodology here.

Loss and Damage

In our NPR, we proposed indexing loss and damage with a factor of 1.0 until a suitable methodology is proposed and adopted. Additional suggestions for indexing the loss and damage component were requested.
AAR, in commenting on the Commission's suggestion, stated that although it has not identified a relationship between loss and damage expenses and the PPI, this is not because such a relationship does not exist. It argues that the unit cost of paying loss and damage claims depends largely on the value of the commodities being transported and the cost of transportation, and that both elements are affected by the general rate of inflation. AAR argues that it is vital to an inflation index to not assume changes do not take place simply because common elements of unit measure are difficult to identify. They contend that loss and damage payments are affected by inflation in exactly the same manner as other railroad expenses. AAR argues that the PPI-All Commodities is a proper measure to index loss and damage payments because virtually all items in the PPI can be carried by railroads. It admits that the relative importance of an individual commodity in the PPI and the percent of total loss and damage payments accounted for by that commodity varies. However, contending that an aggregate measure is more appropriate to the index, it proposes the PPI measurement scheme. In conclusion, AAR states that the railroad industry will continue to explore other ways to measure inflation in loss and damage payments.

Shippers generally agreed with our proposal, observing that the indexing of loss and damage expense involves both determining a proper expense base and calculating a cost increase percentage. They contend there is no stable or supportable basis to develop either of these factors, and that the only logical approach is to use the factor of 1.0 proposed by the Commission. They also allege that railroad loss and damage expenses have actually decreased while the PPI has moved in the opposite direction.

AAR's assertion that virtually all commodities included in the PPI can be transported by railway supports use of a broad measure of inflation. The assertion that Loss and Damage has decreased suggests that the volume of goods lost or damaged decreased which will be reflected in revisions to the weights. We, therefore, adopt for use at this time Producers Price Index for Industrial Commodities Less Fuel and Related Products and Power Index for indexing Loss and Damage.

Casualties and Insurance

Our NPR proposed indexing this component using the PPI, less fuel, until an alternative methodology could be adopted.

AAR proposed an alternative methodology using a modified version of Norton Masterson's Claims Cost Indices, (Masterson's Index) adjusted for social inflation to represent first and third party losses. It contends that the railway industry is basically self-insured and covers its losses through the combination of a fund to cover predictable losses and the purchase of catastrophic insurance to cover extraordinary losses.

AAR believes this approach is proper for the casualty and insurance component expense, and contends that Masterson's index measures the changes in economic costs which would enter into accident claims. The Masterson index,
AAR claims, is based on several publicly available cost indices weighted to reflect the composition of insurance industry claims costs. It is a composite of 14 separate indices of which only two categories, other bodily injury and other property damage, are relevant to the costs incurred by the railroad industry.

AAR further contends that research concerning the study of hazardous material movements showed that, in most accidents, bodily injury losses outweighed property damage losses, and suggests using a ratio of 80 percent, other bodily injury, and 20 percent, other property damage. AAR also contends that recently incidents of multi-million dollar judgments have risen greatly and that judgments of a million dollars or more, which averaged one per month during the early 1970’s, averaged four per week during 1982. It argues that, although inflation has been a factor in these increases, over half were due to larger real dollar awards, and, in addition to higher dollar awards per judgment, the number of litigants arising from a single incident has also risen. AAR believes this trend is substantiated by the steadily rising case load at both the State and Federal levels which has far outstripped the increase in aggregate population.

AAR argues it is also necessary to reflect the element of social inflation in the construction of a casualties and insurance index. It contends the effects of social inflation can be computed through the application of a 5-percent compound growth rate, applied to the modified Masterson’s index. AAR believes its 5-percent growth rate is a conservative estimate, given the growth of product liability cases and the incidence of million dollar verdicts. Since the index is available only on an annual basis, AAR suggests updating the index only once a year and holding it constant for the other three quarters of the year.

Shipper parties generally agree that our proposal is an acceptable interim method of indexing this component but believe that actual data should be used as a final solution.

We are not convinced that AAR’s alternative is an acceptable means of indexing the casualties and insurance component of the index. It has not shown that the Masterson index adjusted for social inflation is a measure of the actual casualties and insurance expenses of the railway industry.

Although it was not specifically suggested, we believe that, because the Industrial Commodities Less Fuel and Related Products and Power Index is prepared monthly by the Bureau of Labor Statistics, it is a better surrogate than our original proposal. We further observe that although a broad measure of inflation is the best alternative at this time, the use of actual data would be preferable. Parties are requested to submit alternative methods of indexing this component. The casualties and insurance component of the index will be measured by the Industrial Commodities Less Fuel and Related Products and Power Index until actual data becomes available.

Interest

In our June NPR, we noted that interest, like any other expense, is subject to inflation and proposed indexing of this element with the PPI, less fuel, until an acceptable alternative methodology could be developed.

1 I.C.C. 2d
AAR contends its proposed methodology for the calculation of interest expense deflates total interest cost through the use of a composite measure of changes in the size and capacity of plant and equipment. It believes these are the assets on which there is existing debt and on which interest is being paid. AAR contends its proposal achieves the equivalent of an interest cost per unit in order to be consistent with other components of the index, each of which represents a price per unit. Cited as examples are wages per straight time hourly the price per gallon of diesel fuel. AAR argues it would be inconsistent to use undeflated total interest costs in a price index. It contends its deflator is a satisfactory measure of changes in the physical asset base, because it considers changes in miles of track, aggregate locomotive horse power and aggregate freight car capacity.

AAR also believes that if we adopt a surrogate, such as the PPI, the proper Bureau of Labor Statistics index should be used. It believes this proper index is the Industrial Commodities, Less Fuel and Related Products and Power Index.

We still believe that interest, like any other expense, is subject to inflation, Interest Expense rises due to inflation because the funds needed for a given level of activity rises as prices rise and because interest rates themselves rise. Given the complexity of measuring this, we adopt, for now, as an alternative to indexing Interest Expense directly, the removal of this category from the weighting scheme (i.e., recalculating the weights assuming zero interest expense). This, in effect, treats Interest Expense similar to profits.

General and Administrative

In our NPR, after observing that the General and Administrative category is the smallest component of AAR's proposed "all inclusive" index (accounting for only two-tenths (.2) of 1 percent of the total) we proposed use of the PPI, excluding fuel, for indexing this component.

AAR agrees with the Commission but suggests use of the Bureau of Labor Statistics Index for Industrial Commodities, Less Fuel and Related Products and Power. AAR observes this index is a special commodity grouping, published monthly and contains all products included in the PPI except farm products, processed foods, feeds and fuels and related products and power.

A shipper party agrees with our proposal noting that this component represents a very small portion of the total index and further refinement would produce little improvement in quality.

We believe AAR's suggestions has merit because this element is extremely small and the Index of Industrial Commodities, Less Fuels and Related Products and Power is prepared regularly by the Bureau of Labor Statistics. We have amended our proposal and will use the Industrial Commodities less Fuel and Relaxed Products and Power Index to measure the general and administrative component.
RAILROAD COST RECOVERY PROCEDURES

Taxes

In our NPR we stated that until either an acceptable method of indexing the tax element of the index is proposed and adopted or the use of AAR's proposed miles of track deflator is adequately supported, we would index this component using a factor of 1.0.

AAR disagrees. It contends that property taxes, just as any other cost element contained in the index, are subject to inflation or deflation. It argues that since property taxes represented only 1.2 percent of operating expenses plus interest in 1982, a surrogate would be an alternative to the calculation of another component. AAR suggests combining taxes with general and administrative expenses and using the Index for Industrial Commodities Less Fuels and Related Products and Power of the Bureau of Labor Statistics.

We agree that taxes are subject to inflation and adopt, for use at this time, the Producer Price Index for Industrial Commodities Less Fuel and Related Products and Power as acceptable for this expense category.

The following portions of Title 49, Part 1135, Section 1135.1 are amended to read as follows:

Section 1135.1, Railroad Cost Recovery Procedures

(a) Rail carriers may adjust rates and charges quarterly in order to compensate for inflationary cost increases. The quarterly adjustment shall not exceed the percentage change in the all inclusive index of railroad costs as proposed by the Association of American Railroads and modified by the Commission. The Commission will make modifications or revisions to the index as necessary.

(c) The Association of American Railroads must file the actual index calculations with the Commission on the fifth day of the last month of the prior quarter (or the closest business day if the fifth is a Saturday, Sunday or holiday). The index is to be calculated for the mid-point of the next quarter.

(d) Tariffs containing adjustments under the provisions of this rule may be filed to become effective on not less than 10 days notice.

CONCLUSION

This decision will not significantly affect the quality of the human environment or conservation of energy resources.

We certify that these final rules will not have a significant economic impact on a substantial number of small entities because only Class I railroads and their trade association, AAR, are directly involved in the furnishing of data and the calculation of the index. The Association of American Railroads may submit an index calculated according to the revised methodology beginning with the first quarter of 1985.


1 I.C.C. 2d
By the Commission, Chairman Taylor, Vice Chairman Andre, Commissioners Sterrett, Gradison, Simmons, Lamboley and Strenio. Chairman Taylor dissented in part. Commissioner Lamboley did not participate.

1 I.C.C. 2d