MR. SMITH: You get mileage for that?

CHAIRMAN NOBER: I'm sorry?

MR. SMITH: We get mileage for the frequent testimony?

CHAIRMAN NOBER: You get welcomed back.

MR. SMITH: Chairman Nober, Members of the Board, good morning. My name is Paul Samuel Smith and once again it is my distinct privilege to represent the United States Department of Transportation. Some 20 years ago the Board's predecessor adopted rules to determine the reasonableness of railroad rates. These rules reflect the increased emphasis on competition found in the Staggers Act, in that they essentially require a shipper complaining about a railrate to construct a hypothetical railroad in an effort to approximate the intermodal competition which does not, in fact, exist.

Most of the rail industry would acknowledge the merits of the existing rules overall, even if none would proclaim their perfection. They permit rail carriers to price differentially as they must in order to survive without permitting shippers to be abused economically. In other words, they assist the Board in reconciling its often conflicting obligations to rely upon competition to the maximum extent possible, to maintain reasonable rates in the absence of competition and to allow railroads to earn adequate revenues.

Unfortunately, the task of constructing a stand alone railroad entails considerable data and analysis, and thus much time and money. The railroad result is that only cases involving large shippers and stable traffic patterns are brought to the Board under the guidelines decision. It may or may not be possible to do better, but after 20 years of certainly studying need to examine the ICC's decision. Changes in the rail industry have certainly occurred and perhaps in economic thought and other matters as well.

We at the Department of Transportation will listen attentatively to the views expressed today by interested parties, particularly those who actually ship or transport freight, for there is much we might learn. One change in the rail industry we very much hope to learn more about and that we urge the Board to examine in more detail is the prospect of a rail system approaching the limits of its physical capacity.

In classical economic theory, of course, when supply of a good or service cannot meet demand, the price goes up until the forces are again in equipoise. The potential implications for rail-rates and thus our rate reasonableness determinations are clear. The Secretary of Transportation, the Members of this Board and many others are well-aware of the existence of capacity constraints. All are similarly aware that railroads do not consistently earn the cost of capital.

Given the relevance of these subjects for the matter at hand, it is important to examine several factors. As a threshold matter, it is important to determine the real extent or the parameters of concurrent capacity constraints. In other words, are they of episodic nature only or are they persistent? Are they shared by many railroads in many areas of the country or they play only particular carriers or parts of particular systems and so forth?

It is also important to learn what the causes of these capacity constraints might be. Their expected duration and their cures. And with respect to potential cures, of course, the Board must focus upon those matters within its competence and jurisdiction. Railroad regulation is certainly one of those. This proceeding should concern itself with whether the answers to the above and other questions suggest changes to the guidelines decisions so as to mitigate capacity limits.

Do the current standards, for example, adversely affect rail incentives to expand

their capacity? And if so, how? If they discourage capital investment, modifications may well be in order. DOT looks forward to assisting the Board in future proceedings that seek once again to reconcile the need for rail-rates that both encourage capacity investment and that meet the standard of reasonableness. That concludes my prepared presentation. I'll be happy to try and answer any questions you may have.

CHAIRMAN NOBER: Okay. Vice Chairman Buttrey, do you have any questions? Mr. Mulvey?

COMMISSIONER MULVEY: I have a few questions. In your statement you quote from our Excel decision that one of the three main constraints on constrained market pricing is the revenue adequacy one. That is the revenue adequate constraint insures that the captive shipper will not be required to continue to pay differentially high rates when some or all of the differential is no longer needed to ensure that the carrier is financially healthy.

So my question is do you believe that railroads can no longer practice price discrimination if and when they are found to be revenue adequate?

MR. SMITH: I don't -- the Department has not taken a position on that and certainly does not in this proceeding. We're just generally very much aware of what appears to be an increasing problem. We're not sure of the dimensions of that problem and we think that because rail-rates have a connection to investment capabilities and incentives, we want the Board as it considers the very many factors that will probably be presented today and in the future, we want the Board to think carefully about how whatever it might do, whatever it might modify might affect rail incentives to invest in capacity.

COMMISSIONER MULVEY: Okay. Most are concerned that we create perverse incentives that the railroads find themselves benefitted by the clearness of revenue inadequate in one environment and therefore on the other hand install the returns as improving on other environments. One other question, we speculate logically that constraint capacity and rising demand should lead to higher rates and profits that could be used to expand capacity or "to put to other uses depending upon the opportunities open to them."

But because of the criticality of the nation's railroads to our economy in general and to large numbers of shippers, should the decision as to where these economic profits are invested be left just to the railroads or should the decision be made in light of the broader public interest that requires that at least some of these profits address the capacity constraint?

MR. SMITH: I think that the incentives for the railroad to spend whatever profits it might obtain would be among the factors that the Board would be considering in this proceeding. Our inclination would, because of the Staggers Act, be to rely upon market place decisions or the participants. But we can't definitively say, certainly at this point, that regardless of any other circumstance consideration that ought to be the case. Again, we're just trying to understand more and see what disincentives there might be to invest in the system either caused by possible changes to the SAC rules or other matters.

COMMISSIONER MULVEY: Okay. But you would agree that the environment today of constraint capacity is very different from the environment of excess capacity in the late 1970s and early '80s?

MR. SMITH: Oh, yes. And since the economics are so different, we think it is, indeed, fit to reexamine the rail-rate standards.

COMMISSIONER MULVEY: Thank you.

CHAIRMAN NOBER: I'm as well concerned about capacity, but let me sort of ask you a question about that sort of looking at some of the submissions of the parties. The

carriers, I think, one of their points is that the sort of ceiling on rates that the SAC process provides means that the returns they are getting on their coal business, according to them, are not high enough to justify the kinds of investments they need to make in the future to expand the network. But that's one of the points that is made several times.

Whereas, some of the shippers are saying that the high rates that the SAC, in their view, process provides both are a tax on utilities and a disincentive to invest in more electrical generating capacity. And I guess my question to you is how should we look at this? I mean, how do you think the Department should have us look at this in light of what kinds of -- how could the SAC test take either of those kinds of concerns into account, which are what, I think, both parties are trying to make to us, other than to just say be mindful of them, which we already are? We clearly are.

MR. SMITH: You clearly are and we are generally aware of those kinds of arguments made in the cases to you, although as not a participant, we don't have the kind of up close experience that we would need to be able to advise you more expertly than we can now. That's a very hard question. It is one of those conflicting obligations that you have and so I cannot say generally or even in an individual case whether you should believe or disbelieve one or the other.

CHAIRMAN NOBER: Okay. Well, thank you very much. If there are no further questions, why don't we turn to our next Panel of some of the shippers. Flip back to my list. We have Michael McBride from the Edison Electric Institute, John Ficker and Nick DiMichael from the National Industrial Transportation League, Jason Frisbie and Mr. DeBord from the Concerned Captive Coal Shippers and Mark Schwirtz and David Laffere from the Western Coal Traffic League.

Would you all come on up to the dias? Just the whole Panel, whoever is testifying, come on up. Do we have eight chairs? I think that's how many witnesses we have. We should have an extra chair or two. Okay. Do we have a chair? We need a couple more chairs for the witnesses. Okay. Well, as usual, we'll go from my left to my right. So, Mr. McBride, you drew the short straw.

MR. MCBRIDE: Thank you very much, Mr. Chairman, Members of the Board and staff, good morning. It is my privilege today to speak on behalf of Edison Electric Institute. EEI's members are some of the largest customers of the nation's railroads and ship hundreds of millions of tons of coal as well as other materials by rail. EEI's members require safe, secure, reliable and timely rail transportation at reasonable cost to provide electric service to the nation.

In summary, I would like to say the most important thing seems to me is that the Staggers Rail Act of 1980 has worked, at least in part. Railroads, or at least most of them, are now revenue adequate in fact. But the SAC rate-making process does not work for nearly all shippers. It is, therefore, time to regulate railroads the way every other regulated industry is regulated. On the basis of their actual costs with an adequate return on equity or ROE.

First, with respect to the SAC process. SAC does not work for most captive shippers, even for most large unit train coal shippers, although a few such complaints are still pending before the Board. Chairman Nober, you forthrightly told Congress that only about 75 shippers, many of whom are EEI members, could avail themselves of the SAC process. That number is now significantly less as a result of Board decision since that testimony was given. And there may be few, if any, SAC complaints filed with the STB in the future.

Moreover, as a result of the FMC proceeding, the only shippers thrown in the SAC process who has any chance of being useful as a practical matter are large unit train coal

shippers. Therefore, the SAC process no longer works for nearly all captive shippers. So what do we do? Mr. Chairman, Members of the Board, so much time has past since Coal Rate Guidelines nationwide were adopted in 1985. But some might forget that SAC was not the only rate reasonableness methodology approved in that proceeding.

The ICC actually said it was approving two methodologies, one based on the revenue adequacy and management efficiency constraints, the other based on SAC. So we needed another rate reasonableness methodology to flesh out the revenue adequacy and management constraint approach. Now, to answer a question that Commissioner Mulvey has already asked, EEI members have not challenged and do not challenge the so-called jurisdictional threshold in the statute, which is what permits differential pricing.

But methodologies other than SAC can, by definition, produce rates that ensure that railroads are revenue adequate. EEI is not here advocating use of fully allocated costs or any other specific method for setting rail-rates. Instead, our point is that SAC is not necessarily the only method that would make railroads revenue adequate. EEI supports rate regulation based on the railroads actual cost, in addition to the continued availability of the SAC methodology.

EEI in particular supports an effort by the railroads to raise rates on lower rated traffic, so as to more rationally price the railroads effective capacity, rather than to continue to raise rates on high rated traffic, such as coal. Such is required by the Long-Cannon amendment for the Staggers Act. If railroads rationally price their scarce capacity so that higher rated traffic were ensured access to it, they would be conducting their business following rate regulatory principles that FERC applies under the Interstate Commerce Act to regulate oil pipelines, in which FERC and other agencies apply under other analogous statutes and they would not need to raise rates on high rated traffic.

What has changed to justify the use of a cost-based rate methodology as a supplement to SAC? Three things at least. One, SAC is not workable for most shippers. So to rely on it exclusively is to fail the statutory obligation "to maintain reasonable rates where there is an absence of effective competition and where rail-rates provide revenues which exceed the amount necessary to maintain the rail system in to attract capital" and " to provide for the expeditious handling and resolution of all proceedings required or permitted to be brought under this part."

Two, railroads or at least most of them, most of the time are now earning demonstrably adequate revenues. They have no difficulty attracting capital and railroad analysts typically rate them as a strong buy over perform or the like. The ICC itself said when it established Coal Rate Guidelines nationwide that if railroads were revenue adequate, a standard lower than SAC would be appropriate.

Three, as every railroad has been saying for a few years now, there are capacity constraints throughout the U.S. Rail Network. SAC was a methodology adopted at a time when there was excess capacity in the U.S. Rail Network as Commissioner Mulvey has already pointed out. In such circumstances it may have made sense to carry traffic that barely covered the variable costs of carrying it and made only a tiny contribution to fixed cost.

Today, however, carrying such traffic often means that other high rated traffic will not be carried due to congestion. And may I point out to the Board that just yesterday in the publication Coal Transportation the lead headline is "Coal Stockpiles Remain Low," railroads say with fear of what could happen this summer if it is hotter than expected. So we have a problem.

Today, carrying other traffic, low rated traffic, means that other high rated traffic will not be carried and that makes no sense. Therefore, another rate reasonableness methodology is now appropriate, given the changed circumstances now prevalent. Because railroads do not need to recover nearly all their fixed costs from their high rated traffic.

Revenue adequacy. The current revenue adequacy standard further prevents the rail-rate regulatory process from being useful to shippers. The standard is based on return on investment or ROI, that is net income divided by a complex controversial measure of "investment." The "investment denominator is so flawed, it's to be considered meaningless," by Professor Alfred E. Kahn, the father of deregulation and the author of the "Economics of Regulation."

Wall Street relies on ROE not ROI. ROE is what determines whether the railroads can "attract capital," in the words of the statute. Financial institutions are certainly willing to invest in the railroads. ROE is the type of indicators used by railroad executives themselves to determine whether the railroads are earning sufficient revenues to award themselves bonuses or other compensation. ROE is, therefore, what the Board should use to determine revenue adequacy or inadequacy, because it determines whether railroads can attract capital and is sufficiently reliable to be relied on by the railroads themselves to measure whether their returns are adequate.

Indeed, the railroads are increasing their investments in their systems, which is additional evidence that the Class I railroads are earning adequate revenues. EEI submits that the time has long since arrived to treat railroads as they treat themselves and as Wall Street treats them as revenue adequate. If (a) railroads were treated as if they were revenue adequate, which EEI believes that at least some of them are, (b) the Board were to expect railroads to get as much revenue as possible from their lower rated traffic instead of from their higher rated traffic as the Long-Cannon amendment requires and (c) the Board were to regulate rail-rates on the basis of the railroads actual cost.

Rail-rate regulation might well be practical and, therefore, useful for many shippers. At the present time, however, rate regulation is not practical or useful for nearly all shippers for the reasons stated in EEI's comments and those stated in the joint statement of subscribing shippers.

In conclusion, EEI urges the Board to recognize that circumstances have changed and that at least some railroads revenue adequate using the standards Wall Street applies to them and that they apply to themselves. It is time, therefore, to regulate railroad rates based on actual costs, not base solely on the hypothetical costs of a hypothetical competitor. If the Board were to do so, it would be implementing its existing Coal Rate Guidelines, which call for a methodology other than SAC if the railroads are revenue adequate. Thank you, Mr. Chairman.

CHAIRMAN NOBER: Well, thank you. Mr. Ficker, Mr. DiMichael?

MR. FICKER: Thank you, Mr. Chairman, Commissioner Mulvey and Vice Chairman Buttrey, it's a pleasure to be here this morning. It's an honor and privilege to represent over 600 member companies of the National Industrial Transportation League at these hearings.

As many of you may know, I bring a slightly different perspective to this whole environment and maybe some of my associates up here on the Panel. I spent 20 years as a shipper, actually negotiating and dealing with railroads, trucklines, ocean carriers and even airlines when occasion called for it. And it dawns on me that the world that we are facing today and the hearing that we are hearing about today, the discussion we are having, doesn't really hit

the mark for the vast majority of people who use the rail network in this country. And that way I'll direct my comments.

The league's members are some of the largest users along with Mike McBride's constituency, some of the largest users of rail services in this country. Many of our members spent close to a billion dollars a year in rail transportation service costs. On February 16th this year the Board issued a notice it would hold this hearing to express views on the Stand Alone Cost methodology or SAC used by the Board in evaluating reasonableness of large rate cases. And I'm happy to be here.

As we look at the Board, one of the primary statutory responsibilities we see is to ensure reasonable rates for captive shippers. The Board is the sole forum for captive shippers and the believe that a rate is unreasonable. The league understands that the Board SAC procedure one method that the Board has developed for administering this important function, but the Board has also developed small case procedures for determining reasonableness of rates where the SAC procedures are not available, because the value of the case is not large enough.

And to our knowledge, that has never been utilized. The league believes the Board's procedures of standards for adjudicating large rate cases have, because of their cost, complexity and length, evolved to the point of practical irrelevance. And this is echoed to a degree by Mr. Smith's comments and by Mr. McBride's comments.

Indeed, the Board has come to this conclusion itself, as testified in Congress last year, which we referred to already, where Chairman Nober and your comments to Congress in 2004 stated that "A stand alone rate case can cost as much as $3 million to prosecute, $5 million to defend and generate more than 700,000 pages of material." Well, that might be a great benefit to my previous employer, a paper company. I see little value to anyone else. In a speech later that year you indicated that $3 to $5 million figures could even go higher.

The league believes that if it costs a potential complainant $3 to $5 million for a SAC complaint, then it's large enough in itself to disqualify virtually all shippers from the practical use of a SAC case. And I would from my personal experience if I had ever taken a comment to my management in the previous organizations I worked in suggesting that I bring a case before the STB about rate unreasonableness, and I told them how much it was going to cost and how long it would take and what the chances of success were, I probably would have been asked to leave the employ of that company.

At least as problematical as the cost of the SAC case is the length and complexity. It appears that the minimum time for a SAC case is two years and some are longer than that, three to four years. The league has previously testified to the Board that most non-coal shippers transport their products in a series of destinations that often change every few years or even less often in some cases. It is clear to us that SAC process taking two to three years to adjudicate does not move at today's business speed.

And so in another way, it becomes irrelevant to the vast majority of shippers in the United States. And I think Mr. Smith and his comments alluded to that same thing. The economic environment that most shippers face today is changing so rapidly that to be able to adjudicate a case over two years, those customers would be gone and those movements probably would no longer exist.

The Board has publicly recognized that SAC procedures are, in fact, useful only to a very, very, very, very small portion of the possible universe shippers. In your comments, Chairman Nober, in March of 2004 in a speech you declared "If no small rate cases are brought, this means that in practice only 75 coal shippers have meaningful opportunity to challenge

rail-rates and this is unacceptable."

And Mr. McBride alluded that that's even less than the 75 today after some of the decisions over the last year. The league agrees. Indeed, the league believes that SAC cases have increased in length, complexity, cost and a number of shippers with a meaningful opportunity to challenge rail-rates is significantly less. Whatever the exact number of is almost irrelevant. It is clear that the percentage of all shippers that can practically utilize SAC is so small as to be insignificant.

In short, a large case litigation process costs the shipper well over $3 million and rising, extends three to four years and longer and results in a huge record of over 700,000 pages that can be understood only by a small cadre of lawyers and consultants, many of whom are here today, for the extremely uncertain results. It is useless to the vast majority of members and, indeed, the vast majority of shippers.

Recognizing that the Agency's large rate case procedures in reality provide an effective regulatory forum for a very limited number of shippers, the Board has, over the past two years, recognized that it must change and reform its small case procedure. Thus, in March of 2004, in testimony before Congress the Board indicated that its top priority going forward would be to "establish a meaningful process for deciding small rate cases."

Indeed, the Board indicated that its next step would be to improve the Agency's small rate case procedure. In giving that testimony, Chairman Nober, you declared and I quote "The Board has to remain an effective regulatory backstop when a dispute over rates and service is formally brought before the Board. No cases have ever been brought under our Small Rate Case Guidelines and we must work to change that."

The Board took written testimony from the industry and held a hearing in April 2003 on the small rate case issue. It sought additional comments from shippers that were submitted in July of 2003, the following year, and the Board asked for further written comments in July 2004 and held a hearing in September 2004. It appeared we were on the road to significant progress. However, despite the activity over the past two years, the related reform of small rate case procedures and despite its stated importance, the Board has issued no proposal for a rule-making on small case procedures.

The Board stated last year that it was focusing on "catching up" with its docket after the appointment of Commissioner Mulvey and Buttrey. But a full compliment of Commissioners has been in place now for over eight months and the Board has cleared away several months ago several large rate case decisions on reconsideration. Nevertheless, there has been no apparent activity to initiate reform of the small rate case procedure. The inactivity is of great concern.

But now, that concern has multiplied by the Board's seeming desire to initiate a long and complex proceeding on the various aspects of Stand Alone Cost methodology. At the very time the Board and this staff should be focusing on the reform of small rate case procedures, the Board seems to be losing its focus and diverting its limited resources towards some undefined review of large rate cases instead of focusing its attention on its stated top priority.

The league well-appreciates the Board may believe an effective reform of the small rate case procedure may be difficult and we expect it would be, but unexpected difficulties will not be resolved by diverting the Board's attention and resources by concentrating on a SAC case.

Moreover, if it is true that the Board has been unable to deal with the reform of small rate case procedures, because it has been dealing with the backlog of SAC cases, then it is

equally true that the Board will be unable to deal with the reform of small rate case procedures by diverting its attention to a long complex proceeding about SAC.

Even a cursory examination of the testimony submitted in this case so far and even the comments made prior to my statements indicate that the Board, and if the Board initiates a broad reexamination of SAC, will get the Agency into a very long and protracted proceeding. The key here is that such a proceeding will have no practical relevance to virtually all shippers in this country and will consume a major portion of the Board's time, attention and limited staff resources.

Frankly, the league sees no possibility of reformation of the large rate case procedures that would be fundamental enough to be of any use to the vast majority of the shippers over any realistic time period. In fact, the results of a rule-making may well be to make the SAC process even longer, more complex and more expensive than it is now. In its March 2004 Congressional testimony, the Board indicated that many shippers do not have full confidence in the Board as a fair and impartial regulatory body.

The league believes that the Board's development of a fair, impartial, clear and expeditious and inexpensive process for adjudicating small rate cases would materially improve the Board in restoring that full confidence. The development of an effective small rate case rule would help the Board make a meaningful and -- make the Board more meaningful to the vast majority of rail users.

Moreover, the league strongly believes that development of a clear and effective and expeditious procedure for small rate cases would advance the prospects of private sector solutions that the Board so clearly desires. If the parties know the rules and are convinced that the dispute will be heard expeditiously, then they will be more willing to negotiate within the boundaries of those rules.

Inversely, if there are no rules known by the parties, then the prospects of private sector solutions diminish, as the parties become more convinced that their position is justified. The league is, therefore, opposed to any of the version of the Board's resources in the review of the large rate case procedure until the Board initiates and completes a review and reform of the Board's procedures for small rate cases.

The Board should not proceed any further with this proceeding, but should instead immediately initiate a complete rule-making on the reform of small rate case procedures as requested in the joint written testimony of numerous associations submitted to the Board on July 2004 in Ex Parte 646. Thank you for your time and I'll be happy to answer questions when it's appropriate.

CHAIRMAN NOBER: Mr. Schwirtz?

MR. SCHWIRTZ: Good morning, Chairman Nober, Vice Chairman Buttrey, Commissioner Mulvey. It's good to see you again and appreciate the opportunity for the league to be able to talk today on the very important issue to not only my company, but the Western Coal Traffic League. For the record, my name is Mark Schwirtz. I'm the Senior Vice President and Chief Operating Officer of Arizona Electric Power Co-Operative in Benson, Arizona. I'm appearing here this morning on behalf of the Western Coal Traffic League, which I currently serve as President.

The league is the only national trade association whose exclusive focus is on western coal and its transportation. Our membership consumes over 140 million tons annually. Fortunately, most of our members enjoy competition for their coal transportation business. However, a significant minority, in which, unfortunately, my own company falls, rely on rail

movements which are captive to one or more railroads.

While my appearance today is on behalf of WCTL members, I see my primary mission as that of a spokesman for our members with captive movements. These members, in addition to my own company, include Arizona Public Service, Kansas City Power and Light, Minnesota Power, Texas Municipal Power Agency, Westar Energy, Western Fuels Association and Excel Energy.

The mood of these members is one of discouragement. Discouragement with our perception of how the Board has administered the SAC process since 2002. I note that our colleagues at Edison Electric Institute have confided to the Board in their written comments that for the most part they are no longer inclined to avail themselves to the statutory rights to insist upon reasonable rates before this Board.

I can understand Edison's despair. I can't say whether or not our members have reached this point. I know personally I have and it is not because of any inherent defects in the SAC methodology itself, but rather because of the way that I believe the Board has administered the methodology since 2002. Our written comments detail our specific problems with the way SAC has been administered. I will not belabor them here.

Results of what we view are one-sided rulings, which we detail in our comments, are rail- rates which are either uncapped or unprecedently high levels. If the Board has read the various comments of the shippers parties, what I am telling you will not be new or surprising. What might be new to you, however, is something to which you may be unaware. It certainly is not discussed in decisions and that is the fact that in most situations the real parties of interest in the SAC cases are the electric light customers, many of whom absorbed the increases which you have authorized directly on their monthly light bills. It has been so noticeable in Arizona that the State Legislature recently passed a memorial asking the Arizona Congressional Delegation to address these abuses.

Since 2002, the pendulum has swung so far in favor of the railroads that the electric utility companies are becoming unwilling to commit millions of dollars to what now has become a futile effort. And as Mr. Ficker stated, I think the dollars have gotten even higher than what was estimated before, at least from a personal experience they have. I hope you can appreciate the impacts of recent Board decisions on the U.S. economy and the concerns that utilities now have about what the future holds for our customer's electricity rates.

In closing, I believe the Board needs to be more even handed in the administration of SAC. In this regard, no useful purpose is served by rule- making cases. The Board has before it in pending cases solid records on seminal issues we have outlined and we urge the Board to address these issues in the records before it. Thank you and I'll be happy to answer any questions when it is appropriate.

CHAIRMAN NOBER: Mr. Laffere?

MR. LAFFERE: Chairman Nober, Vice Chairman Buttrey and Commissioner Mulvey, it's good to be here. I'm also the Treasurer for the Western Coal Transportation League and am responsible for the procurement of transportation services for Kansas City Power and Light. Kansas City Power and Light has consumers in the Kansas and Missouri area. We have four coal-fired generating stations to which we transport, approximately, 13 million tons of low-sulphur PRB coal annually.

Two of our plants have effective competition and access to the BNSF and the UP, while our Iatan Plant is captive to the BNSF and our Montrose Station is captive to the UP. Since the 1980s, KCPL has transported coal to the generating stations under a series of private

contracts. For our captive plants, and in particular Montrose, the STB Coal Rate Guidelines have provided an important negotiating tool for benchmarking our rates for the captive movements and to evaluate the reasonableness of the railroad proposals for -- when made.

As Mark stated, since 2002 we have concerns. We have heard that the BNSF and the UP continually call for higher and higher rates on captive movements. And more recently, both carriers have embarked on programs of public pricing turning away from contracts in favor of higher tariff type rates and service provisions and have expressed a reluctance or even a refusal to negotiate a private contract. Because of that, we are very concerned about our ability to work with the railroads in the future to come to reasonable rates and service terms when our current contract expires.

We are typical of many coal shippers whose only recourse will be to the Board if, as we fear, the railroads impose unreasonably high monopoly prices on the captive traffic. In this environment, the need for meaningful regulation of railroad pricing on market-dominant traffic is the most acute it has been since the 1970s. At the same time, there is uncertainty over the Board's commitment to meaningful protections for captive utility coal consumers and their rate payers.

With all due respect, it appears the STB coal rate decision since 2002 have uniformly favored the railroads and have sanctioned some of the highest rate increases in over 25 years. WCTL's written statement traces the path that has led us to where we are today. It summarizes the elements of the Board's current application of the Coal Rate Guidelines that have skewed recent decisions in the railroad's favor.

In administering the guidelines, the Board seems to have accepted the railroad's claim that they must increase revenues earned from coal to support infrastructure and replacement expansion. As Commissioner Mulvey stated earlier, however, there is no additional oversight from the Board that those revenues will be used for the construction of facilities in the movements to alleviate the congestion that we have in our areas.

While we are not specifically here to talk about revenue adequacy, we agree with the EEI that the major railroads are financially healthier than the Board's current standards admit. Each of the problems with the implementation of the guidelines that WCTL discusses in its statements arose from decisions made by the Board in individual rate cases. None is the product of a Congressional directive or general rule-making procedure. Therefore, it is WCTL's position that all of these problems can be solved and should be solved by the Board in individual rate cases.

Some of the issues identified by WCTL can be corrected by the Board taking a more balanced approach in its evaluation of the evidence under the SAC test. In these cases, no changes in the SAC methodology itself are needed. Where the problem is with actual component of the SAC test, such as the Equal Percentage Reduction Rule where the inconsistency in the indexing of stand alone revenues and operating costs, solutions have already been proposed in pending cases, which can be adopted or modified by the STB in its discretion.

New rule-making proceedings are not needed to address the issues of concern to the WCTL. Based upon our experience over the last 25 years rule-makings will mean delay, increased public cost and will have no assurance of producing meaningful reform. Additionally, whatever does result from the rule-making would end up in court adding additional delays.

We urge the Board to move swiftly to tackle the problems with the current SAC test in the cases that are now before it and restore a more even handed approach to the regulation of coal captive shipper movements. And I thank you for the opportunity to be here this morning

and I will answer any questions when appropriate.

CHAIRMAN NOBER: Thank you and, Mr. DeBord?

MR. DEBORD: Yes, good morning. My name is Mike DeBord. I am the Vice President of Transportation Combustion Services for American Electric Power Service Corporation. AEPSC acts as an agent to secure rail transportation services required by a number of affiliated American electric power companies. AEP with more than 5 million customers is one of the country's largest investor-owned utilities serving parts of 11 states. Our service territory covers 197,500 square miles in Arkansas, Indiana, Kentucky, Louisiana, Michigan, Ohio, Oklahoma, Tennessee, Texas, Virginia and West Virginia.

We own and operate about 80 generating units in the United States with the capacity of more than 36,000 megawatts. Coal-fired plants account for about 73 percent of our generating capacity. The service corporation secures rail transportation services for more than 35 million tons of AEP's coal supply annually at a cost of more than $350 million. One AEP electric generating company, AEP Texas North Company, is the complainant in Docket No. 41191, which is currently pending before the Board.

Therein, AEP Texas North is challenging BNSF Railway Company rates for service to the Oklaunion Station at Vernon, Texas. The vast majority of AEP's coal-fired generating stations enjoy some form of competition in terms of coal transportation service. As a result, we are not a traditional captive shipper with respect to the vast majority of our traffic. In those situations in which our plants are captive, however, we are very exposed to the revenue demands of our market-dominant rail carriers, notwithstanding the size and scope of our operations.

Like all other captive coal shippers, we need an effective rate-making methodology to be in place at the STB to protect against unreasonably high rate levels. The existence of a firm right of recourse at the STB permits captive shippers to engage in meaningful negotiations with rail carriers regarding commercial arrangements for the transportation of coal where the rate regulation process is viewed as ineffective though or where parties are no longer able to evaluate with any reasonable degree of reliability, the rates and application of the Board's rate-making methodology would produce.

In a given situation, shippers and rail carriers are placed in a difficult position in which each side lacks a reasonable benchmark to guide its actions and to evaluate proposals or demands made by the other party. As the Board is aware, AEP Texas North Company is currently involved in a SAC case before the Board regarding our Oklaunion Station.

From our perspective as a complainant, we have found the SAC process to be very complex, very time consuming and very expensive. Also, as we have followed the results in other SAC cases that have been decided while our case has been pending, we have grown increasingly concerned about our situation. As a litigant in an individual case, we would hope that the Board would decide in our individual case each one of the issues that has been presented by the parties, rather than to defer consideration of those issues to some form of generalized rule-making process.

Having shouldered the burden of litigating a SAC case at this point in time, we believe that we should not be forced to bear the additional expense of an entirely new proceeding in which we would be required to represent each of our arguments regarding the most significant SAC issues. Such a proceeding would take months if not years to complete and we fear it would deprive us of a timely ruling on our complaint. Thank you and I, too, will take questions.

CHAIRMAN NOBER: Mr. Frisbie, you have a statement?

MR. FRISBIE: Yes, sir, I do.

CHAIRMAN NOBER: Go ahead.

MR. FRISBIE: Good morning. I am Jason Frisbie. I'm the Division Manager of Power Production of Platt River Power Authority. The purpose of my statement is to provide the Board with Platt River's view of the importance of meaningful rate regulation as a backdrop to successful commercial arrangements between coal shippers and the rail transportation providers.

Platt River is a political subdivision and public corporation of the State of Colorado and it supplies electricity to four communities in northern Colorado. Platt River also owns and operates the Ride Energy Station, which is a 270 megawatt coal-fired power plant located north of Fort Collins. Full annual consumption for the Ride Plant is, approximately, 1.3 million tons.

I would like to emphasize at the outset that Platt River is not appearing today to raise any form of complaint regarding Burlington Northern Santa Fe. We have a contract with Burlington Northern for rail transportation of our coal and are pleased to have them as our service provider. At the same time, Platt River is very much aware of its status as a captive shipper.

In our experience, the existence of effective rate regulation at the Board has been an important factor contributing to our success in negotiating contractual service arrangements which we have been able to do on multiple occasions. Although we are currently under contract, that contract will expire at the end of 2007 and Platt River will need to make new arrangements for our coal transportation requirements.

In this context, we are concerned about the situation that currently exists in regard to the perception in the industry of the lack of any meaningful rate regulation by the Board over captive coal rates. In light of this situation, we urge the Board to do everything reasonably possible to improve the current situation. While we believe the Board needs to take action to improve its regulation of rates on captive traffic, we do not support the idea of rule-making proceeding regarding SAC issues.

Such a proceeding will require a significant expenditure of money by coal shippers. It can make what we regard as an unfavorable situation even worse. Our preference is that the Board address problems with its SAC methodology in individual rate cases as it has in the past. Platt River sincerely hopes never to be involved in a SAC proceeding before this Board. We believe the best way for us to avoid such a case and the best way to continue to facilitate commercial arrangements that are in the best interest of both Platt River and the Burlington Northern would be for the Board to apply its whole rate guidelines in pending future SAC cases in a balanced and consistent manner.

With the assurance of availability of a meaningful rate relief at the Board, negotiated resolutions will be far more likely to be achieved. The amount of coal rate litigation before this Board should be much less. Thank you for the opportunity to speak.

CHAIRMAN NOBER: Well, thank you and thank you for all those presentations. Commissioner Mulvey, why don't you start?

COMMISSIONER MULVEY: Thank you. I have quite a few questions, so bear with me, please.

CHAIRMAN NOBER: We'll do it in five minute increments.

COMMISSIONER MULVEY: We'll do it, otherwise we'll be here all night. This agreement between the shippers and the carriers with respect to the efficacy of opening a

rule-making on the SAC methodology, if the scope of that rule-making were broadened to encompass issues such as the standard for revenue adequacy, would you be more inclined to support it? And that's for the group, that's for all the members, all the testifiers.

MR. MCBRIDE: Commissioner Mulvey, I'll be happy to start by saying that EEI's position opposing rule-makings on technical issues understand that cost is limited to that context. There is, for example, a petition for rule-making that the Western Coal Traffic League filed. It is before the Board at the present time. I won't address it here today.

COMMISSIONER MULVEY: Yes.

MR. MCBRIDE: But we certainly aren't opposed to that. And if the Board were to say that it proposed to use ROE instead of ROI to measure revenue adequacy, I think you would hear us say hooray and we would participate.

COMMISSIONER MULVEY: Anybody else? Well, along those lines with the ROE and the ROI, my understanding, is that the idea of the ROI is to make sure that the railroads earn sufficient revenues to replace capital as it wears out the value of their investment. Where the ROE is the return on shareholder equity as defined by, returns divided by assets minus liability as the denominator.

It's not clear that ROE would be as effective a insuring the railroad sufficient revenues to cover their investment capital as ROI is. And given the portion of rail transportation as a share of the whole price of delivered coal, etcetera, isn't of having a healthy, well-maintained relative structure more important than further reduction in railroad rates?

MR. MCBRIDE: Both are required by the statute, but certainly it's important to have revenue adequate railroads. Starting in 1979 when Congress began to consider the Staggers Act, we never challenged and have not to this day challenged the concept of the jurisdictional threshold to allow the railroads to engage in differential pricing. We were in favor then and we're in favor now of railroads being revenue adequate. But we are also in favor of the maintenance of reasonable rates.

And what the statute says, Commissioner Mulvey, is that the revenue adequacy standards are to be sufficient to repay a reasonable level of debt and permit the raising of needed equity capital. It's in 10704(a)(2)(A).

COMMISSIONER MULVEY: Yes.

MR. MCBRIDE: And capital is raised in the financial markets. It is raised in competition with other industries which are uniformly measured on a return on equity standard. You heard, as I heard, Jim Valentine just last week from Morgan Stanley talk about how the railroads have out-performed the market. The Wall Street Journal listed them as 22nd out of 76 comparable industries in their returns over the last few years.

There is absolutely no doubt that the well-run railroads at least, and I think all of them, are having no difficulty attracting capital. Maybe not for every single project in everything that might be on some engineer's wish list, but as a general proposition when stock prices are rising and investors are reinvesting in the enterprise, there is no inability to attract capital. And that is certainly true with the railroads.

If I may also, I just want to correct our comments in one respect along these lines. On page 10 of the EEI comments, the last line, the third last word due to an editing error says "CSX" and it should say "NS," as being revenue adequate over the last five years.

COMMISSIONER MULVEY: Thank you. I think we would have caught that. Along those lines of Mr. Valentine, it's also true that when the railroads are doing well and the prices are going up, then the Wall Street tells the investors this would be the time to sell. So it's

kind of a short-term time wise and that's one of the problems.

MR. MCBRIDE: Oh, there is no question. You and I also heard Jim Valentine say just last week that because the railroad stats had out-performed the market by 25 percent, there was a bit of a pull-back. But we can't have it both ways here. The Board has said consistently the revenue adequacy should be a long-term measure, not a year-to-year and certainly not a one month or one week or three month horizon. And that's why we presented yearly data in our comments and why I think the markets look at things over a long period of time.

COMMISSIONER MULVEY: A question for Mr. Ficker. You said that you are opposed to the Board diverting resources from small rate cases to now study large rate case processes. But don't you think the two are related? They certainly are related issues, the way we look at rate cases, both large and small, and try to find ways of adopting one to meet the needs of the other. Wouldn't it be a good idea for the Board to study these in tandem?

MR. FICKER: Commissioner, I would still echo our comments that I made earlier. It is essential for the Board to consider itself an irrelevant adjudicator to the vast majority of shippers if it provides a vehicle that can be utilized by the vast majority of shippers. 75 shippers and less is what has been alluded to here this morning. Shippers can utilize the SAC methodology.

It becomes meaningless to the vast majority of rail shippers. And as such, when you have limited resources, like in any enterprise, you devote your -- those resources to where you can most expeditiously deal with the market place you live in and the market place that you live in is the market place for the vast majority of shippers not less than 75.

COMMISSIONER MULVEY: But as to this question about the number of shippers that can avail themselves to our processes, we hear of cases, from captive shippers, who to not have alternative forms of transportation. We also exempt a number of commodities, because we feel that they are truck competitive. We established these exemptions quite a while ago and that also reduces the number of shippers who can bring cases before us. Do you think there has been any change in the overall transportation environment that might suggest that we should rethink some of our exemptions, at this point?

MR. FICKER: That's a good question and one that I have thought about numerous times. I believe that the best solution to these issues is private sector solutions. And by creating a standard which people understand what the rules of engagement are, those can be addressed. Addressing the exemptions that were granted in the mid '80s and there were numerous, they went on day after day at the ICC at the time, and I participated in several of those as a shipper supporting that.

But that was in the day when the railroad environment was significantly different than it is today, and it might be appropriate for the Board to reexamine that. I don't know what the outcome should be. We believe strongly in private-sector solutions to commercial issues. However, there is a strong believe and a strong frustration on the part of many rail users, whether they are captive shippers, regulated by the Board or exempted by Board, about the rail industry today as we heard from the coal shippers and that certainly permeates many other shippers.

COMMISSIONER MULVEY: You suggest that, Mr. McBride, the railroads should raise their rates on lower rated traffic, that's an interesting term ‘’lower rated traffic’‘,since you are talking about high value traffic. But you want the lower rated traffic rates to be increased and stop increasing them on higher rated traffic, such as coal. Why don't the railroads do this? I mean, isn't it rational to raise rates as much as possible to maximize profits?

Evidence aside, railroads are profit maximizing institutions like every other private firm. But they don't seem to be behaving that way.

Are the railroads constrained from raising rates on some of their "lower rated traffic?"

MR. MCBRIDE: No, except by voluntary action. And by the way, railroads are raising rates on low rated traffic. Some of us have been saying this for quite a while and I think, I'm not saying they learned it from us, we just encouraged them. And they are doing it. But railroads will tell you, they told me privately, maybe they will tell you here later this morning, that they have some constraint on their ability to raise those rates, because of contracts they may have entered into some time ago.

Now, that's not anything that the Board can do anything about for now, but that's what I meant by voluntary action. But if you think about it, the way oil pipelines are regulated, is that all of the commodities in the pipeline are essentially captive. They don't leave no matter what the rate is that's charged and that's the definition, at least to a non-economist, of captivity. And so what does FERC do? It regulates all the rates on a constant market basis, because everybody is captive, so there is no need for differential pricing.

And we have not said here today that every commodity on the railroad today is captive. But I will observe that as rates keep climbing, no traffic seems to be leaving the railroads. In fact, traffic seems only to be increasing. So in a real-world sense, I would say a great deal of railroad traffic today is captive and therefore applying the oil pipeline model rates could come more into equilibrium on a constant mark-up basis than has been true for the last 25 years.

CHAIRMAN NOBER: Okay. Commissioner Buttrey?

VICE CHAIR BUTTREY: I have a couple of questions for the Western Coal Traffic League. What is the average length of the contracts that you have with the railroads? You said you had contracts, private contracts for the transportation of coal in many cases.

MR. SCHWIRTZ: We do have private contracts, which are private. I don't think we can -- the average length, and I wouldn't know that information, I know what our length is, but I can't divulge that kind of information.

VICE CHAIR BUTTREY: So you're not willing to answer that?

MR. LAFFERE: Under the terms of the contract, those are confidential and we can't.

VICE CHAIR BUTTREY: Okay. Can you just say do you have escalation clauses in those contracts?

MR. LAFFERE: Yes, we do in ours, yes.

VICE CHAIR BUTTREY: They are built in?

MR. SCHWIRTZ: Yes, they are.

VICE CHAIR BUTTREY: Okay.

MR. SCHWIRTZ: They are negotiated.

VICE CHAIR BUTTREY: Obviously, I'm not going to ask you what those escalation clauses are.

MR. SCHWIRTZ: Can't tell you that. Thank you.

VICE CHAIR BUTTREY: Do you have any gas-fired, natural gas-fired generation capability?

MR. SCHWIRTZ: We do.

VICE CHAIR BUTTREY: You do? What percentage of your total generated

capacity is gas-fired and what percentage would be coal-fired?

MR. SCHWIRTZ: We serve -- 80 percent of our load is served by coal-fired generation. 20 percent is --

VICE CHAIR BUTTREY: 80 percent is coal-fired?

MR. SCHWIRTZ: 80 percent is coal-fired.

VICE CHAIR BUTTREY: And do you have a thought about the comparison between the increases in the coal transportation costs and the transportation of getting the gas to the generating units?

MR. SCHWIRTZ: Well, the transportation of getting the gas to the generation units hasn't escalated that much, in no way a relation to what we're getting for coal. Obviously, the commodity price of gas has gone up very high.

VICE CHAIR BUTTREY: Do you have a thought on how the cost of the gas and the cost of the coal have compared?

MR. SCHWIRTZ: On a per/million BTU basis, that's, approximately --

VICE CHAIR BUTTREY: On some basis. I'm not quite sure what the most appropriate basis is.

MR. SCHWIRTZ: I don't know what that exact calculation would be. I can surely try to provide that for you. I understand where your question is, but I would have to do some calculations to get that for you.

VICE CHAIR BUTTREY: Do you have any construction projects underway to increase your power generation capacity?

MR. SCHWIRTZ: We don't, but I believe you do.

MR. LAFFERE: In the recent past, in the last few years, we added several hundred megawatts of gas-fired generation. Currently, we're in negotiations with the Kansas and Missouri Corporation Commissions on the construction of a new coal-fired unit at our Iatan facility, but that has not been approved. It's still under negotiation.

VICE CHAIR BUTTREY: So you don't have any permitted facilities out there where construction hasn't started yet?

MR. LAFFERE: That's correct.

VICE CHAIR BUTTREY: There are no active unused permits?

MR. LAFFERE: No.

VICE CHAIR BUTTREY: Okay. Have you ever considered building a generating unit at the mouth of a mine?

MR. SCHWIRTZ: Oh, yes.

VICE CHAIR BUTTREY: Pardon me?

MR. SCHWIRTZ: Yes, we have.

VICE CHAIR BUTTREY: You don't have any of those though, right?

MR. SCHWIRTZ: We don't have any, no, primarily because of the concerns you have over transmission of the energy itself.

VICE CHAIR BUTTREY: Yes. I understand.

MR. SCHWIRTZ: That becomes more critical than the transportation of the coal to that plant.

VICE CHAIR BUTTREY: Yes, but energy is fungible. Is that correct?

MR. SCHWIRTZ: Yes.

VICE CHAIR BUTTREY: Energy is energy. You can sell it. You can buy it. You can transfer it. You can trade it.

MR. SCHWIRTZ: But there's physical limitations on how it can move.

VICE CHAIR BUTTREY: Right.

MR. SCHWIRTZ: And in our case, specifically our case, we are kind of isolated from the rest of the world electrically and from a transmission standpoint. And so we have to have generation near our load, which is in southern Arizona.

VICE CHAIR BUTTREY: Southern Arizona?

MR. SCHWIRTZ: Yes.

VICE CHAIR BUTTREY: No further question Mr. Chairman.

MR. MCBRIDE: Commissioner Buttrey, could I just provide one bit of information for you for the record? As of about a year ago, I don't have the exact number today, the approximate relationship between coal-fired and natural gas-fired electricity is that natural gas-fired electricity is about twice as expensive as coal-fired electricity today.

VICE CHAIR BUTTREY: Thank you.

MR. LAFFERE: I was going to add one other comment. You had asked about the comparison between natural gas transportation costs and coal transportation. The difference there is is that, for us anyway, natural gas is a regulated -- natural gas transportation is a regulated activity by FERC. Anytime that the LDCs or the interstate pipelines wish to raise rates, they have to go through a rate case just as we, as a public utility, have to do that for our customers. So it's more to a cost allocated with a rate of return that they are able to get for that. Whereas, on the rail side, that's obviously not the case.

VICE CHAIR BUTTREY: Thank you.

CHAIRMAN NOBER: Okay. Well, I'm going to have a few questions, too. Let me start with some of the folks on my right side of the bench here. I think in your papers, the theme of much of what you have to say is that our decisions since 2002 are, essentially, biased in favor of the railroads. I think I can read from your paper that's essentially what you're saying.

And one question is is that because we are biased or is it because some cases have been brought that should not have been brought? I mean, isn't that another possible explanation, too, that there was a big shipper victory in 2001? We had a big bulge of cases that was filed right after that and you got mixed results from those.

Is that because we were biased or is that because if you look at the way the cases came out and the way we evaluate it, you know, if you look at the cases, maybe they weren't the strongest cases. Isn't that another possible explanation, too?

MR. SCHWIRTZ: There's lots of possible explanations. Our perception is that since that period, and I think I heard it earlier in one of the testimonies, is that we need a standard out there that we can use to negotiate commercial terms with the railroads and that standard, while it was there in 2001 and some of us were actually able to negotiate commercial terms, we don't feel that, that standard no longer exists and couldn't -- wouldn't be able to do that today.

CHAIRMAN NOBER: I mean, we had many fewer cases that have been decided by 2001 and we have had more decided in the past three years than we had in the entire 17 years before that. And is it possible that the distribution of results before that was not reflective of the distribution of cases overall? I mean, that's one of the things I'm struggling with.

Is it just that when you have 10 points on a line, eventually the more data you add to it, the more meaningful the line becomes or is it because, you know, your asserting that's because we're biased, but is it just because if you bring more cases, you get a wider distribution

of results?

MR. LAFFERE: As Mark said, like I said, there could be multiple reasons. Again, the perception from the shippers' side, for reasons of, I think, and I can't give specifics, but that in cases there are things that are being decided that are different than past precedent.

And in instances on burden of proof where it's felt that that has been raised to a level at which shippers can no longer meet the burden of proof and, therefore, default to the case that has been presented by the railroad. And that by doing that, it has created a hurdle so high that shippers can't get over it anymore and that was not felt to be the case before 2002.

CHAIRMAN NOBER: Well, let me ask a question about that, and maybe this is one that your lawyers need to add, because I know your paper makes a big deal of the fact that, you know, you think we have applied the burden of proof unfairly now on several cases that have come out at the railroads that are challenging us in court that we have unfairly applied the burden of proof to them. So it's one where everybody, I think, you know, has some concerns about how that's being applied.

To my knowledge, I think in the last six cases, we have basically gone out for more evidence and allowed shippers to rehabilitate their cases and denied railroad motions to dismiss, actions which are the railroads are now challenging in court. So when you say that we have applied a burden of proof unfairly, I'm trying to think of what.

Can you give me some individual instances of what that means because overall, you know, the railroads in their testimony, as you read, who are, you know, very critical of us on that point and we have, essentially, given the shippers many opportunities to rehabilitate their cases and sometimes they have and sometimes they haven't.

So what is it that you're referring to? Can you give me some examples?

MR. SCHWIRTZ: I think you should --

CHAIRMAN NOBER: As I said, this might be a better question for counsel, I know. And I have, you know --

MR. DOWD: I would be happy to answer it.

CHAIRMAN NOBER: Please, do.

MR. DOWD: The basic thrust of the point is that in cases past where a minor or modest defect in a party's case, particularly the complainant's case, was detected, oftentimes the Agency would make an adjustment to correct that error, but otherwise retain the larger body of evidence on the issue.

There has been movement toward a view that a modest or minor flaw in the complainant's case is cause for complete rejection of the entire body of evidence on that issue.

CHAIRMAN NOBER: Okay. Can you give me an example? I know. That's restating what you said in your papers. Now, give me an example from a case when we did that.

MR. DOWD: I think the difference in the treatment of operating expenses from cases like Wisconsin Power and Light and WTU1 versus the treatment of operating expenses in the eastern cases is one example. I think there has been an inconsistency in some respects, for example in the Excel case. There was an acceptance of the railroad's operating plan, but that operating plan did not include the Geoffrey Traffic. And so the Board on its own came up with a methodology to correct the railroad's operating plan to account for the Geoffrey Traffic. We haven't seen those types of corrections on the shippers' side and that is the basis of the --

CHAIRMAN NOBER: Right. And was that the case, correct me, where the -- I mean, the operating plans and, you know, it's one where the Board has had a lot of difficulty in trying to, you know, work through the cases and that, you know, for example, the operating plan

put in by the shippers was -- and we'll get this as, I guess, coming to one of your other points was rejected, I think, in 14 straight cases yet continued to get put in. In your papers you criticize us for allowing the other side to re-litigate issues.

MR. DOWD: I think your --

CHAIRMAN NOBER: I know that that has been corrected now in future cases.

MR. DOWD: I think that the issue of the faulty program or the rejected program on operating is more an auspice of timing that the cases in the first case where the program was rejected, there were several cases already right behind where the evidence was already closed. And so it was inevitable that there would be a similar result.

I think to be fair, I think, on the railroad side you have a similar effect in the proposed methodology for allocating revenues of cross over traffic where methodology was rejected in one case and the record was more or less closed in two or three after, thereby assuring a similar result.

CHAIRMAN NOBER: Well, I'm glad that you raised that point, because that's another question I have about one of the fundamental arguments we have, which is don't do a rule-making and decide the open issues that we have raised here through case-by-case adjudication.

Now, for the last few years we have had a number of cases pending, you know, sometimes multiple cases where the evidence has been closed. And if we find a certain way on some of the issues that have been raised, that could have the effect of, you know, in one individual case if we apply that in future cases of, essentially, changing the fundamental nature of parties that have already spent millions of dollars to put cases in without giving those parties an opportunity to comment on them.

And I mean, these are all your clients. Is that something that you would have a concern about, because I certainly do.

MR. DOWD: We would have a concern about that if the current state of the Board's docket suggested such a risk.

CHAIRMAN NOBER: Well, it does. I can guarantee you that.

MR. DOWD: Well as was pointed out, there has been a clearing away of a number of the cases, which have been pending for quite sometime. And the cases which are pending now seem to be on a track where a decision made in one can be instructive on a timely basis for the cases coming behind.

CHAIRMAN NOBER: Okay.

MR. DOWD: And that's traditionally --

CHAIRMAN NOBER: But if we decided one of the issues that have been raised today in a way that had a negative effect on a pending case where the evidence was closed, would you want us to do that in a case-by-case adjudication or let me ask clients or would you want us to give the other parties an opportunity to comment on that?

MR. DOWD: I think you can do both, Mr. Chairman. I mean, I think that if you have --

CHAIRMAN NOBER: How?

MR. DOWD: Well, if you have a circumstance where you have a case which is pending and the record has been closed, but the matter has not yet proceeded to briefing and oral argument and the clock is not running on the decision, and you make a decision in a case which makes a significant change in approach that the Board can and should be receptive to the petitions from the parties of pending cases to supplement their evidence on those discreet issues

without reopening the entire case, but supplement their evidence on those discreet issues, and you still are able to keep things moving on a faster track.

CHAIRMAN NOBER: Yes, and what if it changes the nature of the case that has been put in and they have to spend an awful lot of money to redo their whole case? I mean, we have heard a lot of criticisms today about the time and cost and expense, which would just basically force them to put new cases in. So, I mean, that's one of the reasons why we have suggested or I have suggested a rule-making rather than doing it in a case-by-case adjudication. You know, is it fair to the parties who have pending cases?

MR. DOWD: I think --

CHAIRMAN NOBER: But if you say it is, I mean, they are your clients, then that's --

MR. DOWD: I think that most of the issues, which have been identified as problematic, are issues that the implementation of the solution doesn't require one to go out and redesign a stand alone railroad or go out and re-photograph the routing or some such thing. It principally would have to do with making modifications to the inputs in the DCF model if it was a reform of the percentage reduction methodology, for example, or a reform of the dichotomy in the indices between revenues and operating expenses.

CHAIRMAN NOBER: That I agree. I think the percentage rate reduction, I'm not sure that that's the case. I agree with the RCAF. Okay. Well, let me ask one more. I'm sorry, go ahead.

MR. LAFFERE: To address your point, I think from the shippers' side as someone who has a company that is looking at this process, we have the same concern with the rule-making, I mean, to the extent you initiate a rule-making and without a known time frame or end to that, we could be in the exact same case in which we're developing a rate case, have it completely developed and then, at some point after that's done, a decision is made and have to go back through the entire process again.

So whether it's made in a rule-making or in an individual rate case, from a shippers' side, I'm not sure that there is a big difference right now.

CHAIRMAN NOBER: Well, I mean, that's certainly a struggle that we all have, which is what is the fairest way to do it. And you know, for me, I mean, giving shippers procedural fairness has been important. As you have seen in these cases, we have given shippers, at least I think, a lot of opportunity to rehabilitate their cases sometimes successfully, sometimes not.

And so it's obviously a concern that I have, is that we do be fair in how we apply procedures here. You know, outcome is what it is and, you know, we have all had a chance to discuss that. I think my primary -- Frank, do you have more questions?

COMMISSIONER MULVEY: Sure. With regard to this issue, I'm very concerned about the timely availability of data also for the shippers in preparing their case in chief, but this is all related. We need some suggestions as to how we can improve our procedures, so we can guarantee that all parties have sufficient time to prepare their presentations without having these cases drag on forever and time to respond to decisions that affect cases that are in the process or that are coming up.

But I'm not really hearing any suggestions and that's why a rule-making, I think, might give us an opportunity to find new ways to make our procedures more amenable to changes, for example, in the way we're looking at these cases and addressing changes.

Let me ask a question about the RCAF. I agree also, and I have said this before,

that we need to find a balance between the RCAF A and the RCAF U in addressing "productivity issues." Has anybody performed any analyses showing the effect on a SAC proceeding from using one or the other or have you thought about any ways of blending the two?

Again, we are looking here for suggestions and approaches we might take. Has anybody done that? I guess I'm looking for some answers opposed to asking a question.

MR. MCBRIDE: Commissioner Mulvey?

COMMISSIONER MULVEY: Yes?

MR. MCBRIDE: I haven't done a study to answer the latter part of your question, but may I comment on the earlier part of your question?

COMMISSIONER MULVEY: Yes.

MR. MCBRIDE: The reason you haven't heard me say anything about procedures to improve the availability or timeliness of the data is because there isn't a problem. If you were to do what we proposed and regulate the railroads on the basis of their actual costs, you would simply do so on the basis of the ERCS costs that are regularly filed with the Board and there would not be a timeliness or availability problem and you don't need a rule-making.

COMMISSIONER MULVEY: Okay. Thank you. Well, you expressed that contracts could be of concern as captive coal shippers expressed support for contract rates as offering a more efficient and beneficial results for of both shippers and carriers than prescribed rates. And clearly, the ability for railroads to enter into contracts was a great benefit of the Staggers Act.

But can't contract rates also bring problems with them, especially when the contracts are long-term and reduce the railroad's ability to adjust prices and rates to reflect dynamic market conditions? I mean, some of you say that you have escalation clauses in your contracts, but I know for a fact that that's not true of all rates. Do you want to address that?

MR. LAFFERE: I mean, to me those are commercial relationships that you enter into and the railroads, when they entered into those contracts, were willing parties to that and, given the circumstances at the time, chose to do it.

From the other side, as a utility customer or shipper that is looking at investing billions of dollars in facilities, I don't think it's -- I don't want to use the word fair, but to say that every three months you're subject to whatever escalation that a rail carrier may decide needs to happen because of the current market dynamics that they are facing, especially when they to a large degree can control those market dynamics to the extent that they do not choose to invest in capital infrastructure to increase capacity and you continue to have shortages, then doesn't that then mean that they are entitled to raise rates?

And unless there is some oversight on the other side saying that they will take those rates, those increases, and invest them in infrastructure that alleviates the problem, I guess I view there has to be kind of a quid pro quo to go with the other.

COMMISSIONER MULVEY: I guess what I was driving at is that there have been some suggestions that railroads have a tendency to enter into long-term contracts when they have excess capacity and sometimes there are excessively generous contracts. And then when the capacity dries up, they turn around and find they can't raise the rates on the traffic under long term contracts and turn around and raise the rates on traffic where they can raise the rates on other traffic as their contracts expire.

It has been suggested that perhaps in terms of a regulatory or a legislative approach that some limits be put on the length of time of these contracts. Now, I know that is legislation or regulation that would affect the ability of private parties to negotiate mutually

beneficial agreements but, on the other hand, this problem does seem to be particular and be unique to the railroads because of the nature of their industry. My time for the five minutes is over.

CHAIRMAN NOBER: Well, go ahead and answer. Go ahead.

MR. SCHWIRTZ: My concern would be that you can't, that you don't have the ability to come to some commercial terms with the railroad. I mean, whether we're dealing with purchase power contracts or long-term transportation contracts, if the business conditions warrant that contract, I would think that would be appropriate at the time.

What we have been experiencing, because part of our coal has moved under contract and part is under tariff, there are no performance standards. There is escalation clauses that are significant in the tariff rates. There's fuel surcharges that are being applied to those tariff rates that are risks that are very difficult to manage when you're a utility, because what that means then is, and I talked about it in my talk, we have to go back to our electric rate payers to get those revenues that are needed to meet our operating expenses.

So a very difficult process when the exposure is all put onto a utility rather than, say for example, in a long-term contract you would manage that exposure and be able to come to some business solution between the two parties.

MR. MCBRIDE: Commissioner Mulvey, if I may just add, contracts have performed an enormously important role in the revitalization of the railroads. It was the railroads that were advocating contracts in 1980 and the shippers were in agreement. And I think if you look back at the history of this, you will see that the Wall Street financial community was willing to invest in large part because of the existence of contracts that showed gross revenues were going to continue to flow. If the world has now changed somewhat, that's the way the market works.

But if I may just touch on one other railroad that is oftentimes a matter of concern to the Board, the Dakota Minnesota and Eastern. The inability of that railroad yet to build track into the Powder River Basin is probably a function of the lack of contracts. Wall Street would be looking for a guaranteed revenue stream before it would be willing to lend it money. So I think there are some major pluses to contracts.

COMMISSIONER MULVEY: Oh, I agree, but it's a matter of the term of the contracts. Thank you.

CHAIRMAN NOBER: Commissioner Buttrey?

VICE CHAIR BUTTREY: I just have one follow-up question to the questions I had earlier. I presume my assumption that you don't use any eastern coal is correct. Is that?

MR. LAFFERE: Correct. We use some local coal out of Kansas and Missouri.

VICE CHAIR BUTTREY: And going back to Mr. Ficker's testimony earlier, I'm just curious. There has been a little bit made this morning of the 75 companies. I haven't seen that list of 75 companies. I don't know who those companies are, but --

CHAIRMAN NOBER: I'm not sure I do either.

MR. FICKER: It's a section of multiple testimonies over multiple years.

VICE CHAIR BUTTREY: Is it safe for us to assume that those 75 companies' gross revenues would pale in significance, in comparison to the gross revenues of many of your members?

MR. FICKER: Commissioner, I really can't answer that question. I would be just stabbing in the dark. I think if I can, while I have got the mike and it's working, I'm going to take the opportunity to address one issue that we have kind of lost over here a little bit this

morning, it was talked about with DOT, and that's capacity.

We do have a capacity problem with the rail industry in this country. We have a capacity problem in the transportation industry in this country and it's not going to be eased unless we all work together to figure out how to resolve it. And it dawns on me that if you're spending $3 to $5 million on a SAC case, that that's three to five miles of railroad that weren't built and that to me is maybe a greater concern that we ought to focus on and create an environment where these issues can be resolved.

And people are not going to agree on everything. People can hardly agree on what time it is let alone on what rates to charge. But let's put those assets and that value and that capital back into the rail industry and not into adjudicating cases like this.

CHAIRMAN NOBER: Let me just ask the coal shippers a couple more questions and let me follow-up on one of Commissioner Mulvey's questions. I mean, one of the points of the hearing was to get some ideas on some of the issues that are out there and, you know, do you all have any? Do you have any specific suggestions on how we might modify some of the concerns that you have, the percent rate reduction, the RCAF A versus the RCAF U?

I think you have heard all of us express, for example, on that subject discomfort with taking one extreme or another and wanting to find something in the middle. So do you have a proposal on that as well as some of the other issues that are out there? I mean, I think that that's one of the productive things we were hoping to get out of this.

MR. SCHWIRTZ: Well, I believe our proposal was to address those in the evidence of the specific cases and to do that efficiently and fairly.

MR. LAFFERE: And I would agree. I mean, as a shipper who is bringing a case, I'm not an expert on all the parts of it. We depend on consultants and our attorneys to develop this, and I believe that the feeling is is that there are recommendations in the cases that are before you that, from a shipper's side, we feel would be better than what is currently out there and that we would recommend you look at those. And if there continue to be flaws that you find with those, look for something in the middle rather than just throwing one out and accepting the other one.

CHAIRMAN NOBER: Well, let me ask one sort of just overall question. When you all say the SAC process is broken, it doesn't work for shippers, what does that mean? Does it mean that the cases are expensive? Does it mean that you win some, you lose some? Does it mean that you think that you won't get -- I mean, what does that mean?

MR. FICKER: If I can take a stab at that primarily representing non-coal shippers.

CHAIRMAN NOBER: That's why I was asking the coal shippers.

MR. FICKER: Well, I think that, you know, I love coal shippers and I'm glad coal shippers are out there, because when I turn on my lights I appreciate all the work that they do to generate the power that allows me to cool my home and also turn on my computer.

But in reality, the SAC case methodology, and again I don't know what the number is, Vice Chairman Buttrey, whether it's 75, 72 or 1.1 shippers who can avail themselves of this, there needs to be a process where this Board focuses on the vast majority of people that utilize this Agency, have the potential to utilize this Agency, as an adjudicator rather than that limited number who can. You have heard testimony this morning on most of my --

CHAIRMAN NOBER: Okay. We'll come to the small rate cases in a minute.

MR. FICKER: Okay.

CHAIRMAN NOBER: But let me just finish with the SAC case. Okay. When

the SAC cases are broken, what does that mean ultimately?

MR. LAFFERE: Well, I think, from our side we haven't said that the SAC process is broken unlike EEI who is talking about a fully allocated cost methodology. We do believe SAC methodology can work, that it needs what we would call tweaks. It needs to be changed a little bit. Some decisions need to be made in a slightly different manner that we view is more balanced.

CHAIRMAN NOBER: To kind of amend a non-ended approach?

MR. LAFFERE: Exactly.

MR. SCHWIRTZ: Yes, I would agree with that, too. I think when you ask what it means to us when it's broken, is that to us as shippers there is no certainty in looking at a potential SAC case, which I think we're one of the 75 that are on the list but that was yesterday. Today I don't think we would be there, but I think that list has gotten smaller. But I think we're just looking for certainty, so that we can get out there and negotiate.

CHAIRMAN NOBER: Well, that's I guess the point I want to -- I guess I'm glad you mentioned that. I mean, how can a contested, litigated process ever provide certainty? I mean, we could provide a rate formula and that would give you certainty, but how could, you know, a litigated, contested process ever provide certainty?

MR. LAFFERE: I think the word certainty may be a little -- it's a range. I mean, when you're saying certainty, it's not $10. It's, you know, $9.50 to $10.50, it's $9 to $11. It's a range that both parties know that when they come in, there are going to be major portions of a stand alone case that are fairly well-defined, the major issues, that a reasonable person can look at and understand what the results are going to be when they come out of there and know, therefore, that they need to sit down with the other party and come to agreement on a rate and service conditions within certain parameters. And that is what would allow shippers to negotiate with carriers and come to terms without having to come to the STB.

CHAIRMAN NOBER: Okay.

MR. MCBRIDE: Mr. Chairman, when the Coal Rate Guidelines were adopted 20 years ago, the ICC said that the guidelines we are adopting here provide the proper analytical framework for evaluating the reasonableness of rates charged on market-dominant coal movements. But we do not offer a ready formula for testing a rate, as some parties would have preferred. We are convinced that no single formula for measuring a rate could deal satisfactorily with the complexities of a rail-rate analysis.

I think the problem here is we're assuming that we could have a rule-making proceeding and it would answer all the questions, but it won't. And I think that's what we're trying to tell you is that through the adjudicatory process you're going to arrive at an understanding of whether it works or it doesn't. And we have no said, by the way, that the SAC process is broken for all shippers. We said it's broken for nearly all shippers. But what we also advocated to go back to your earlier question was that we do have a constructive proposal for you to tell you how this would work.

Take the RCAF issue that you've raised a couple of times now, for example. The problem you have confronted is that the hypothetical stand alone railroad is already the most efficient hypothetical competitor. Therefore, to apply productivity addressed at RCAF to that arguably overstates the appropriate adjustment. That's, as I understand it, what you said. And you have looked for some fix to that.

If you use actual cost, the law is settled. You use RCAF adjusted. We litigated that issue for 15 years. That one is nailed down. So we do have a constructive proposal for the

shippers for whom SAC doesn't work and that's to use their costs.

CHAIRMAN NOBER: Do you feel that under the law that we can really apply a cost based regulatory structure to all rail-rates?

MR. MCBRIDE: Yes.

CHAIRMAN NOBER: Even ones that are truck competitive? I mean, how can we ever do that?

MR. MCBRIDE: Oh, no, no, no. Our comments say -- and if I was not clear here this morning, I'll reiterate. We're only talking about captive traffic and we're only talking about non-exempt traffic. So it's only captive traffic. But what I'm saying to you is that when the ICC and Coal Rate Guidelines said there should be two rate reasonableness methodologies, not one, and one was based on the hypothetical costs of the hypothetical stand alone railroad. The other by definition would have to depend on the actual cost of the actual railroad.

CHAIRMAN NOBER: And under the law, the shippers -- it's the shippers' option as to how they bring a case.

MR. MCBRIDE: Right.

CHAIRMAN NOBER: Since no railroads have been revenue adequate, none have chosen to bring one of the revenue adequacy constraint. And I guess your proposal is redefine revenue adequacy, so everybody could use that. Is that --

MR. MCBRIDE: Correct.

CHAIRMAN NOBER: -- basically in a nutshell?

MR. MCBRIDE: Correct.

CHAIRMAN NOBER: And just deem everybody revenue adequate, at this point.

MR. MCBRIDE: No, no, no, not everybody. No, no, no, please, don't misunderstand me on that. I have not claimed in my comments and took great pains, including my correction this morning, to take great pains to say which railroads we think, looking after -- looking out over a five or three or one year perspective or even a 10 year, if you wish, which railroads were revenue adequate and which were not.

And we're not getting into, for the purposes of those comments, whether they paid too much for the railroads they acquired, even though they did, or whether they have operated in an efficient and effective manner over the last several years and you could argue about that. All we are simply saying is that despite all the problems of the last 10 years, they are now deemed to attract capital by the financial community. And that's the single simple test of revenue adequacy and that's true for most of them.

Maybe it's not true for CSX. You could argue about whether it is true for Union Pacific. Amtrak attracts capital, too, I mean, but that's -- it wouldn't be revenue adequate.

CHAIRMAN NOBER: We're talking about from the private community, from Wall Street.

MR. MCBRIDE: We still get loans with a lot of Government guarantees. That's a different situation, which I'll be happy to talk about, too. But I'm simply saying to you that the railroads are having no inability in attracting capital. And that's the simple test which ought to show you that we're in a different world than we were in in 1960 and 1970 and 1980.

CHAIRMAN NOBER: Do you have any questions?

COMMISSIONER MULVEY: Just one or two more question. Lets set aside the possibility of moving away from the Stand Alone Cost approach and assume that that approach is in place and we continue to find many, many or all of the railroads to be revenue

inadequate, I want to deal. With the charge that the railroads can gave the SAC process by initially setting very high rates that when reduced by the percentage reduction method, still leave shippers with higher than reasonable rates.

Again, specifically, do you have any alternatives to suggest as to how we could address the rates under the SAC process or reduce them other than a percentage reduction method? It has been charged that the percentage reduction method is not consistent with Ramsey pricing. Can you illustrate why you believe it is not consistent with Ramsey pricing principles? Anybody? I have that question for the --

MR. DOWD: Mr. Mulvey, if I may?

COMMISSIONER MULVEY: Yes.

MR. DOWD: Before I answer your question, I would also add that there is some credence to the flip side of that argument, which is that as presently constructed, the percentage reduction rule could allow gaining by the complainant.

COMMISSIONER MULVEY: Yes.

MR. DOWD: A stand alone railroad with very highly rated traffic. The reason that it's inconsistent with Ramsey principles is because it does not focus on the mark-up over marginal cost. It focuses on price. And the fix is to allow for reductions, allow for the surplus of SAC revenues over cost to be distributed based upon the relative mark-ups over marginal costs for the members of the shipper group. That will nullify any attempted gaming by either party. Because if the railroad tries it, the gaming rate would get the largest reduction. If the shipper tries it, the gaming rates will get the largest reduction.

COMMISSIONER MULVEY: Okay. I think that's pretty much all I have.

CHAIRMAN NOBER: Okay. I just have a couple more questions for Mr. Ficker. I have not forgotten about you.

MR. FICKER: Thank you.

CHAIRMAN NOBER: Even though the hearing is about large rate cases, let's talk about small rate cases for a minute.

MR. FICKER: Let's do that.

CHAIRMAN NOBER: I think the theme of much of today has been don't do a rule-making. Use the existing procedure, however flawed they are, and let the case-by-case adjudication kind of work things out. I think that was Mr. McBride's quote almost exactly. Why shouldn't we just do that for small rate cases? We have a procedure out there. It has been there for 10 years. Bring a case, bring two and let's let the adjudicatory process set parameters if you think our Agency is unable to act, which you've obviously said very clearly you think it is.

So why not just do that? I mean, why say don't do a rule-making to address issues for large rate cases, yet demand a rule-making to addresses for small rate cases? Why not just bring a case and let the adjudicatory process work itself out? That's the advice you are giving to the other shippers.

MR. FICKER: That's right. Thank you for that clear interpretation of my testimony. Chairman, I believe that and the league believes that it is important to set some parameters around which small rate cases could be brought. While there have been rules established some time ago, the Board has repeatedly said it wants to establish rules that can be understood by users. And that position to my understanding has not been placed in a position to allow someone who would think about bringing a case to understand its relative merits and how it could come forward.

Besides that, as you have said repeatedly in public conversations and in private

conversations, you support private sector resolution of issues, and so do we. We are advocates of that. We believe that, you know, I guess my personal bias would be the Board was very bored with what it was doing, because there were no cases being brought, because the private sectors had resolved these issues.

But the reality of it is nobody knows what the rules are. So they are afraid to bring anything forward. The time horizons when a small shipper looks at what happens in the large rate case and say oh, gosh, am I going to be out there for a year or two or three? Is it going to cost me a million dollars? Maybe only $500,000 or $600,000. That's not acceptable. But those the revised rule can't guarantee any outcome until somebody brings a case and it gets adjudicated. I mean, that's a practical reality of life. We all know that.

CHAIRMAN NOBER: You're absolutely right. And I wouldn't argue that for a minute with you. But there is an absolute uncertainty out there and a concern to say I just can't afford to do this. I can't afford to take this step. Somehow we need to be working with the Board to understand how we could bring a case in an expeditious and cost-effective manner that would allow users to utilize the Board or to have the over-arching parameters of the environment allow them to negotiate settlements.

I am likened to what goes on in Canada with final offer arbitration. There have been half a dozen or a dozen or so final offer arbitration cases that most have been settled well in advance of that between the parties. If that's what kind of methodology --

MR. FICKER: Although the Chairman of the Canadian Transportation Association told me, our counterpart agency, that their final offer arbitrations are as expensive and complicated as SAC cases. You couldn't possibly want that.

CHAIRMAN NOBER: They certainly have gotten more expensive. But they are quick. They are over in I believe 120 days. The parties know what the rules are going in. It's baseball style arbitration. I'm not proposing that here today. I'm proposing something that our members, our rail shippers could understand how it works so that when they sit down with their rail carriers, they could come to a commercial relationship that satisfies both parties.

And that doesn't mean that everybody is walking away smiling happy and off to the bar to have a drink. But at least they have come to the conclusion that these agreements will work for the best interest of their companies, whether they be the rail carrier or whether they be the rail user.

I mean, we had some small shippers brought cases, too, we would have also a body of juris prudence that would help guide that as well. I mean, so, yes, we have not acted and the facts are as they are on that. But on the other hand, you know, I see press reports that people are appropriating money to bring small cases. Our offices have been contacted about getting waybill data for small cases. So clearly, people are thinking about it.

MR. FICKER: There is some issues out there about people thinking about bringing these forward. There's no doubt about that.

CHAIRMAN NOBER: And so isn't that sort of the fastest and quickest way? I mean, that's the exact advice you have given the large rate payers. So bring the case and see how that comes out.

MR. DIMICHAEL: Chairman Nober, if I may just add a little bit here, because I did testify before you on this point last July. I think the point is that there is a continuum here. There is a continuum of certainty versus uncertainty. And I don't think anyone is saying here that you have to have or even could have absolute certainty on a large rate case or a small rate case going in.

On the other hand, you get to a point on a continuum when there is so much uncertainty that it freezes the process. I think where things are on the large rate case is there is at least a level of uncertainty. Maybe the level of unhappiness as to where that certainty is going. But there is at least a level of uncertainty about how to bring a case, what a case looks like. In the small rate case process, I think you have gotten to a point on the continuum where there really isn't a level of even reasonable certainty of how much the case is going to cost, what the case is going to look like, what sort of evidence you're going to need and what the result is going to be.

So we're not talking about an absolute certainty that you have to have that, but rather you need to narrow the certainty.

CHAIRMAN NOBER: But to rule in advance can't guarantee any of that either, Mr. DiMichael.

MR. DIMICHAEL: No, but you --

CHAIRMAN NOBER: And that's all going to come out. Obviously, SAC cases 20 years ago don't look like they look today. I think everybody would agree with that.

MR. DIMICHAEL: I would definitely say that. I was one of the --

CHAIRMAN NOBER: These things have a way of morphing over time.

MR. DIMICHAEL: Well, in fact, the first SAC case which I was involved was about -- was probably a tenth of the record in the cost of what we have now. But what I think the point is that we're saying as far as the small rate case goes, you can at least reduce the level of uncertainty to a point at which you can then begin to have the process go forward in which you resolve more specific issues on a case-by-case basis. But if it's so uncertain that the whole process freezes, then you never get to that point.

CHAIRMAN NOBER: Right.

MR. FICKER: And I think just to echo a comment that Mr. DiMichael made, the time horizon for business environments today for non-coal shippers and non -- just doesn't allow for something that is going to take a period of time. Probably putting it time horizon on the thing would probably be the most important method to accomplishing bringing a case. If it's going to drag on for four years and my customers I'm no longer shipping to in two years, why should I even consider doing this? It's a practical matter.

MR. MCBRIDE: Mr. Chairman, just two observations. We may have one for you in the near future and I think if you will listen carefully to Mr. O'Connor later this morning, he may have some constructive ideas for you in the small shipper context.

CHAIRMAN NOBER: I mean, again, I mean, obviously, rule-makings are difficult to do, because the Administrative Procedures Act applies to it and you just can't wave a magic wand and say here is how our rules come out. I mean, it just doesn't work that way. You know, as you have also seen that our rulings are held accountable in a court. And, you know, we recently had a ruling that was reversed by the Court of Appeals. That was, you know, basically finds the Board, I found, in favor of the shipper, which was summarily reversed by the Court of Appeals and now, you know, the matter is back and I didn't hear any mention of that.

But, you know, we are unfortunately bounded by the over-arching laws out there, so it's not as easy as just saying well, we want to find for the shippers or find for the carriers, because we think that they are right or wrong. I mean, we do have to follow the law and I think, you know, we try our best to do that. That's why on some of these issues, we're asking for people's comments.

Now, Mr. Dowd, you offered some thoughts on the percent rate reduction and we

appreciate that. And, you know, any other thoughts that anybody has on some of these subjects, I think, would be very much appreciated, because it helps us evaluate them, have them be tested and gives them more, not less, defensibility. You know, as we found with some our recent cases, the Board taking actions and having the Court of Appeals reverse it doesn't help anybody, because then everybody is just back here with longer and even more expensive processes.

And sadly, that has happened in a number of cases recently. So we are mindful of that as well. Well, we thank you all for your -- before I go, Frank, do you have any more questions?

COMMISSIONER MULVEY: No.

CHAIRMAN NOBER: Well, thank you all for bearing with us for an hour and 20 minutes on this Panel and for your very thoughtful testimony. And we will look forward to moving forward.

ALL: Thank you, Mr. Chairman.

CHAIRMAN NOBER: Can we just take a five minute break between Panels, if we could? Thanks. We will reconvene at 11:30.

(Whereupon, at 11:21 a.m. a recess until 11:33 a.m.)

CHAIRMAN NOBER: Okay. Could we all -- why don't we pick back up again? Okay. Our next Panel representing various railroad carriers, we have Paul Moates from CSX, I guess, Sam Sipe and Joe Kalt for BNSF and Louise Anne Rinn from UP. Mr. Moates, again you're on the left, so you draw the short straw and go first.

MR. MOATES: I consider it the long straw, Chairman Nober, thank you, Vice Chairman Buttrey, Commissioner Mulvey and Members of the Board staff, thank you. I do appear here this morning on behalf of CSX Transportation, but also on behalf of Norfolk Southern Railway Company. I am wearing the two hats today. We very much appreciate this opportunity to appear to offer comments on the SAC implementation issues that have arisen in recent cases and that you have now called for essentially a time-out to get some views on.

You have my written comments. I know you don't find it particularly useful and neither do I to sort of repeat those to you, so with your lead, what I would like to do is perhaps pass on to responding to some of the things we have heard here this morning as well as a few of the points that I saw in the written materials submitted by the Concerned Shippers with whom we exchanged our comments in advance and then, obviously, try to respond to your questions.

I would like to try at the end to quickly answer a few questions that several of you have asked this morning of some of the other participants and I have a thought or two on a few of those. NS and CSX do have some concerns with the matter in which the Board has implemented certain aspects of SAC and you have seen those concerns in our filings in the opportunities you have given us to appear before you in oral arguments in the specific three eastern cases, which are, of course, the cases with which NS and CSX have had their most recent experience with the Board SAC methodology, it having been a fair number of years prior to that before they had had other SAC cases.

I would say they did have other SAC cases. The export coal litigation of a fond memory of roughly eight years in length in which I participated comes to mind as to the PEPCO case, Pennsylvania Power and Light and several others, with these Duke Energy and Carolina Power and Light cases, which remain before the Board, are obviously the most recent eastern cases in which this methodology has been employed.

NS and CSX feel, however, that from the perspective of their relative limited experience with these three cases, that we don't believe we are in the position to tell the Board or

to ask the Board to initiate a formal rule-making proceeding to deal with SAC implementation issues, so we are not asking you to do that. We are, however, saying today as clearly as we can that should the Board conclude and initiate such a rule-making, we definitely, both railroads, will participate in as constructive manner as they can drawing not only on our experiences in the eastern cases, but obviously on whatever other resources we might be able to bring to bear in any such proceeding.

What I do want to urge the Board here this morning most emphatically, most emphatically not to accept what I thought initially was the casual limitation of the Edison Electric Institute, but after hearing Mr. McBride this morning, I fear it is more than casual, to "use another rate methodology as a supplement to SAC or to use some fully allocated cost methodology." I hate to say this anymore, because I sound like an old fogie when I do, but I actually participated throughout the original Ex Parte 347(i) proceedings.

I remember the so-called 110 percent solution. I remember the agony that the ICC and the railroads and the customers went through in repeated visits to the Court of Appeals in trying to find some sort of cost-based rate-making methodology that would pass mustard and none ever did. None ever did. And ultimately, with the adoption of the constrained market pricing guidelines and the four standards, SAC being just one, as you know, we found, you found with lots of input from the railroad industry and its customers a methodology that passed judicial scrutiny in the 3rd Circuit and we believe, in general, has served the industry and customers well as a broad matter.

We certainly understand that our western brothern have some very specific concerns with some aspects of your implementation of SAC. You're going to hear about that from them. You have heard about it. And it's not as though we have none. But again, I hope I'm being clear on this. I would strongly urge the Board to give very careful consideration before moving away from the guiding principles of CMP and adopting any kind of a so-called cost-based rate- making methodology.

That is, let's put the name on it, what Mr. McBride was urging you to do was re-regulation. Oil pipelines, as he said, have all captive customers. That may be an appropriate rate regime for oil pipelines. Railroads are not oil pipelines. Railroads' customers are in the vast majority of cases customers with competitive options. Even the members of the prior Panel told you, I think each one of them, that most of their facilities have more than one railroad service.

They are understandably focused on the circumstances where they have generating facilities that are so-called captive to a single railroad and that is an appropriate concern and one that this Agency has to deal with. But let's not throw the baby out with the bath water here. Let's not lose sight of what kind of an industry we are dealing with.

Now, Mr. Chairman and Members, I don't have time today and you probably wouldn't want me to try to address all the points that they have made and their written comments are here this morning, but there are a few real quick that I would like to go through. The Concerned Shippers, as they call themselves, I think listed about five particular issues. I think three of them you have discussed here already this morning.

I'll just say a word or two about each of them, if I may, and obviously at the end we'll do the best we can to respond to your questions. The first one was the so-called gaming issue. One that obviously we're familiar with, because it was raised in all three of the eastern cases. I mean, I think the most important thing to say about gaming and whether the percentage reduction methodology appropriately protects against "gaming" is it's an important discussion to have, but so far it has been a theoretical discussion.

As you know, in those three eastern cases, you found in all of them that the rates were ultimately not unreasonable. There was no basis upon which to apply the percentage reduction methodology. There was no rate prescription. And therefore, while I don't, you know, want to guilt a lily and say it's not an issue, you don't have to worry about it, arguably it could be a issue in a future case. I don't believe that it is an actual active issue in any case that you have seen or that you have before you now.

Cost indexing. You know, we have talked about this, Chairman Nober. You may recall having asked Mr. Loftus, who is counsel for CPNL, questions about that in our oral argument over a year ago and we each had some thoughts and responses on that. I won't repeat them. But I am constrained to take issue with a point that has been made and some of the written comments that Mr. Dowd endeavored to make here again this morning, because it's just wrong, and that is the contention that the Board has routinely rejected complainant's operating plans and uncritically substituted railroad evidence, thereby, according to the shippers, baking in the inefficiencies of real-world railroad operations and associated costs, and that's just not correct.

As examples, I think I can avert to this, because these part of the cases are over. In the eastern cases, in all three of them, you may recall that even though NS and CSX do not use distributed power locomotives, they accepted that because it was proposed by the shippers in all three cases as a way to be more efficient. In those cases, you allowed the complainants to include only a relatively small fraction of the number of gathering yards that both NS and CSX actually maintain in central Appalachia to support their rather complex gathering operations that they have to smaller mines.

That became part of their operating plan and our operating plan. When Mr. Dowd says that these are only minor or modest flaws that you have rejected in some of the shipper cases, and he mentioned the eastern cases in particular, I would respectfully say uh-huh, these were major flaws completely defective strain diagram models. You are very familiar with it, Chairman Nober. You averted to the number of cases in which they kept introducing it.

That was the basis for their entire set of train operations in those cases. Operations that were hypothesized as efficient unit train operations, but the services didn't match the real-world demand of the shippers. When that happens, this Agency is absolutely not only within its right, but I would submit has the obligation as you exercised it, in those cases to reject that kind of evidence. We're not -- hypothetical doesn't mean detached from the reality of the service parameters of the shippers whose rates are being contested.

Another subject and, Chairman Nober, I think you averted to this one this morning, I think in the Concerned Shippers complaint and they call it the "no re-litigation policy." Well, we understand that. And each side, the railroads and the shippers, have obviously urged you with greater and lesser degrees of success to modify your holdings, your rulings on particular SAC implementation issues. They range from what is a fair rate of entry and whether or not it will be properly recognized to such matters as the amount of fuel that's going to be removed and cut and different types of terrain and a whole host of other issues in between.

I don't think -- it's one thing rather for you to bar the submission of, essentially, identical evidence and arguments on an issue and listen to it over and over again, that probably isn't appropriate. But I would submit it's something else and something else that would violate the Administrative Procedure Act and fundamental notions of due process to mark as off-limits for all time issues in which new evidence or changed circumstances might support the Agency's

changing it's mind, so long as it appropriately articulates the reasons it is doing so and the basis upon which it is making a new determination.

To hold otherwise could lead to and probably would lead to a regime of frozen, immutable rules binding litigants regardless of the merits of evidence they might advance to support a change in those rules. And in that regard, as I know you heard me say a couple of times in the eastern cases, with all due respect to my friends to the west, the east is not the west or as they told me this morning, the west is not the east, either formulation is acceptable to me.

But we believe, as the eastern railroads, that we should be permitted to develop that point with respect to specific SAC issues when they arise in an eastern case, even if the subject has been addressed in a prior western case. The burden of proof point idea was at great length in my -- I shouldn't say great, I deal with in my written comments. I draw your attention to page 28 of the comments of the Concerned Shippers where they describe as a problem the following: "The Board has become increasingly demanding in terms of the nature, extent and timing of the evidence required for a shipper to satisfy the burden of proof it bears as a complainant."

I don't see that as a problem. I see that as the appropriate set of rules that any administrative agency, including this one, should apply to litigants before them in administrative adjudications. The last thing they mentioned in their written comments was, and you've heard this, I think, more in the background narrative in the eastern cases, they complain about the availability of data.

They say that the railroads have all the data you need to do a SAC case. The railroads routinely, they claim, use the discovery process to frustrate and impede their ability to present their cases. We're not only -- we don't only think that's incorrect, but, frankly, NS and CSX are actually offended by that statement. Each railroad spent many hundreds of thousands of dollars in these eastern cases of computer and personnel time to respond to the incredibly detailed and extensive discovery that was served on us. It was time and resources that were diverted from the important business of running the railroads.

We maintain our traffic and our revenue accounting and our operating and real estate and engineering records in places and in matters that make business sense for us. They are not organized for the litigation convenience of coal customers or other shippers who may want to seek discovery in every aspect of the company and its operations to support a complaint.

I would submit that shippers and their advisors can do something here to help themselves by more narrowly tailoring their discovery requests and focusing on data they actually intend to use in their cases. For example, by not routinely seeking system-wide data when their stand alone railroad will ultimately only involve a much more limited geographic area, perhaps only a state or two.

As to the issues, if I may, you'll stop me when you want me to stop, I guess. I would like to, if I could --

CHAIRMAN NOBER: Okay. If you would begin to wrap-up. I think your time is up.

MR. MOATES: All right. Okay. If I could just respond to one or two questions --

CHAIRMAN NOBER: Two, please.

MR. MOATES: -- that Commissioner Mulvey asked of, first of all, Mr. Smith. Mr. Mulvey, you asked does he believe the railroad or should the decision of where to invest profits from coal traffic or other kinds of profitable traffic be left just to the railroads or should

some broader public interest criteria inform that judgment. I think the answer there is very emphatically leave it to the market. It must be left to the market, I think as a matter of law, and should be left to the market as a matter of good public policy.

To do otherwise, I was sitting here trying to think about how that could be otherwise, would the Board have proceedings and invite all stakeholders to come in and make arguments about where the railroads ought to invest to deal in capacity issues. It's a port versus utility. It's a grain shipper versus who knows. I just don't think that would be an appropriate thing to do.

My time is up, so I'm going to go, I guess, to the one other point that I really did want to get to on the issue of are railroads constrained in raising rates on lower rated traffic? Commissioner Mulvey, you asked that question, too. I think that answer is self-evident. Of course, we are and it's lower rated not because we are terrible organizations, it's lower rated because there are all kinds of competitive forces coming to bear on that traffic.

And, you know, the railroads do the best they can at pricing all their traffic. They want to get the most they can out of all their traffic. Do they occasionally make a mistake? Well, of course, they do. They are big businesses. There are lots of different situations. But on the whole, it is the effort and the direction of every marketer of the major railroads in every commodity area to try to maximize the amount of profit they can get out of traffic.

I will stop then and look forward to your questions later.

CHAIRMAN NOBER: Okay. Well, thank you very much. Mr. Sipe and Mr. Kalt?

MR. SIPE: Good morning, Chairman Nober, Vice Chairman Buttrey, Commissioner Mulvey and Board Staff Members. My name is Sam Sipe. I'm here today on behalf of BNSF Railway. As you know, I think you know, I represent BNSF in a number of pending cases, coal rate cases, before the Board. To my left is Professor Joseph P. Kalt, who is the Ford Foundation Professor of International Political Economy at the Kennedy School at Harvard University. And I'm going to be very brief and Professor Kalt will use most of BNSF's allotted 10 minutes.

John Lanigan, the senior marketing officer of BNSF, was going to be here and he has submitted testimony. He had a scheduling conflict arise and is not here. In the audience is Jeff Moreland, who is the Executive Vice President, Law and Public Affairs for BNSF.

Very briefly. As you know, BNSF has a strong interest in these coal rate cases. BNSF has been a pioneer over the last 35 years in the development of Powder River Basin coal and the growth of Powder River Basin coal over that time period has been, frankly, one of the great economic success stories of our country in the last third of the 20th Century and the first few years of the 21st Century, and BNSF is committed to continuing to provide high quality coal transportation from the PRB competing there vigorously, as you know, with Union Pacific and we are committed to providing and replenishing the infrastructure necessary to transport that coal.

You know, it should be our most profitable line of business given the nature of the demand for that transportation. Over the years coal has been less profitable than we would have liked and, frankly, we believe and we have submitted evidence in certain cases to the effect that the constraining effect of threatened rate litigation has played a role in that.

We believe that the conceptual underpinnings of the Coal Rate Guidelines are sound, and we think it would be a tremendous mistake for the Board to back away from the

theoretical framework of SAC. I think it has been, frankly, a regulatory success story for this Agency to have been able to put the guidelines into place.

The implementation over the years has been challenging and there are issues in individual cases that we are concerned about and we think the guidelines can be, in fact, strengthened, reaffirmed through the process of a rule-making proceeding, a formal rule-making proceeding, which focuses on certain discreet issues we have identified in our testimony, and I would be happy to answer questions about those.

Right now the only thing, the last thing, I want to say before turning it over to Professor Kalt is we litigate these cases as a litigant litigates contested matters, but we are aware that there is a public policy context in which these cases are litigated. We think the Board has a responsibility to the public interest and we think that refining the guidelines will be a big step forward in speaking to that public responsibility. And I will turn it over to Professor Kalt.

PROFESSOR KALT: Thank you, Sam. Members of the Board, Board Staff, it's a pleasure to be here. I have been asked to appear here by BNSF to express views I have been expressing to them privately, which is that I think it is an opportune time for the Board to broadly revisit the implementation of the SAC methodology.

Even as the guidelines were being promulgated, the ICC noted that the workability of the guidelines is most appropriately evaluated in light of experience. We may find after some experience with applying the guidelines that modifications are needed to make this approach to maximum rate regulation fully workable.

This observation is now timely advice. Rate proceedings have pushed policy and the Board into areas of theory and evidence that arguably were not even anticipated during the development of the guidelines more than 20 years ago. Over the last 20 years, the de facto requirement that the letter and spirit of the guidelines be developed and applied through case-by-case litigation has made rate proceedings before the Board increasingly contentious, acrimonious and expensive.

Working out the details of sophisticated economic theories via case-by-case litigation often seems to be turning economic concepts that could undergird sound policy, concepts like cross-subsidy Ramsey pricing and the like, it turns these phrases into catch phrases used as ammunition by parties, but whose meaning and concrete application are poorly understood.

I believe that a careful review through a formal rule-making proceeding of the economics of constrained market pricing and the advances in these economics since the adoption of the guidelines provide the foundations for a productive rule-making proceeding. In the 20 years since the adoption of the Coal Rate Guidelines, the many issues presented in the course of the various rate-making proceedings have resulted in standards that have evolved incrementally, but have resulted in an overall policy that may be diverging in important ways from promotion of the broad public interest.

A rule-making proceeding now will allow the Board to consider how the economics of constrained market pricing are properly applied to contemporary concerns, such as the treatment of crossover traffic, barriers to entry, percent reduction, etcetera.

If there is one thing we know from public administration, it is that regulation that becomes untethered and untetherable through case-by-case adjudication from a foundation of a firm theory and framework leads to what economists refer to as winner-take-all rent seeking in which the parties continue to ramp up into a kind of arms race hoping to move the next case away from previous precedent. Precedent needs to be grounded in firm theory, in firm

framework in order to help reduce the cost, not increase the cost of the litigation that comes before you.

The broad public interest can get lost when, as here, the details of an applicable regulatory framework must be adapted on a case-by-case basis, and when the politics and process of maximum rate regulation pit shipper against railroad. The broader public has interests ranging from insuring a financially sound and sustainable rail network to rail pricing that reflects the cost to society of running trains over dangerous highway crossings and through congested cities. Yet, the broader public does not generally show up in the STB hearing rooms.

Under the circumstances, the understandable tendency of even well meaning regulatory processes can suddenly shift from promotion and protection of the public interest to minimizing conflict and finding a fair balance between the interests of the parties that do show up in the hearing rooms. Fairness is a laudable goal of public policy, but when the broad public's interest is not given voice in the rough and tumble of policy-making via litigation, the well meaning balance that is struck can be imbalanced against the public indeed.

Sound rate-making policy is now at a premium. In the case of coal, demand for Powder River Basin coal, for example, is strong and is expected to continue to grow. Little excess capacity is available to handle increasing demand and the supply and demand balance of the coal transportation marketplace is putting upward pressure on efficient market prices.

Proper policy recognizes the critical role that market determined prices play in this situation, signaling where supplies are scarce and providing incentives for investments in capacity expansion. Rate litigation that is used to keep rates artificially low even when demand is high is understandably sought by individual shippers, but is inconsistent with the public's interest in the efficient use and growth of the rail network.

At the extreme, artificially low prices result in the need for rationing, a nightmare for any regulator who has ever had to take over the market's function of deciding who gets service and who does not. Over the long run, artificially low prices that reject the need to bring supply and demand into balance usually create the eventual need for even higher prices as demand is artificially spurred and capacity expansion is choked off.

In light of the public interest, the Board needs to ensure that it is not applying SAC tests in a way that inhibits the railroad's ability to react efficiently and rationally to current market conditions.

It's important at this time, I think, to remind ourselves of the economic principles that underlie constrained market pricing and its implementation under the SAC methodology. CMP and the SAC methodology arose directly from the intersection of economic and policy necessities. Constrained market pricing directly attacks problems of monopoly abuse by using the principles of contestability to establish maximum rates for market-dominant service while allowing differential pricing across services and customers. Both are appropriate and necessary in network industry like railroads.

Since the inception of the Staggers Act, which first explicitly allowed railroads to use differential pricing, such pricing has frequently been the focus of shippers, railroads and regulators. The high fixed cost and the capital intensive nature of the rail industry make differential pricing a necessity that both the Staggers Act and the guidelines recognize.

In order for railroads to recover their fixed costs and sustain the levels of capital investment necessary to maintain their networks, they must have the ability to offer different customers different prices based on individual customers' alternative transportation options and customers' resultant willingness to pay for rail transportation.

The role of differential pricing is not dependent on whether railroads are revenue adequate or not. Whether revenue is adequate or not, differential pricing is an absolute of efficient pricing in a network industry like railroads.

The guidelines, in addition to embracing differential pricing, also embrace the economics of contestability as the applicable framework for limiting rates under conditions of market-dominance. The guidelines are fully cognizant that the railroad does not actually satisfy the conditions needed for contestability, that is absolutely free entry and exit.

As the guidelines put it, under constrained marking pricing and SAC analysis, rates will be judged against simulated competitive prices. The simulated competitive prices are those that would result if incumbents had to face entrants who were unimpeded by barriers to entry or exit. In my written statement I talk about two attributes of the SAC methodology that bump into and are becoming increasingly inconsistent with the economics of contestability. Those are barriers to entry and the treatment of crossover traffic.

The value of a rule-making proceeding, at this time, would be to allow the parties and yourselves to step back, look at the framework underlying the Coal Rate Guidelines and particularly the economics of contestability to derive answers to questions like the treatment of crossover traffic and barriers to entry, answers that would indeed serve the public interest.

While it would raise the status of economists relative to lawyers, that's not the only reason I think that a rule-making proceeding would make sense at this time, and I would look forward to joining you in a deep conversation about the policies that you are now addressing. Thank you.

CHAIRMAN NOBER: Very well. Ms. Rinn?

MS. RINN: Good morning, Chairman Nober, Vice Chairman Buttrey and Commissioner Mulvey. My name is Lou Anne Rinn and I am here on behalf of Union Pacific Railroad. Union Pacific applauds the Board's initiative in having this hearing. We appreciate the opportunity to be heard on the importance of the SAC methodology and we urge you to institute a rule-making to explore ways in which its application can be improved.

The railroad industry and its customers and the public that we serve and, therefore, the Board face an unprecedented challenge. Excess capacity is gone. Demand for rail transportation is strong and growing and shippers and the public officials responsible for transportation are calling upon railroads to increase capacity. But where is the revenue? Where are the resources going to come to do that?

Until SAC is applied in a way that we believe is more congruent with the need for adequate revenue in the railroads, we believe that we are going to continue to be challenged and may not be able to meet the need for investment that is called for. I'm not going to repeat our written comments. I would like to instead address a couple of points, which would be the need for revenue, how railroads lack the capacity to meet the need for investment and, finally, what the benefits of a rule-making would be.

Railroads have a pressing need for additional revenue and it is fair to ask for our coal customers to contribute more. Railroads are estimated to be under-investing in the railroad infrastructure by $1.5 billion every year. In other words, state transportation officials say that in addition to the $2 billion a year we are currently investing, we should be investing another $1.5 billion a year, and that is in and above what we are already putting to just replace the track assets as they are wearing out.

If you would ask the coal shippers who were testifying earlier, and I think they did say this, they believe that they are paying more than their fair share and that other people

should be stepping up to the plate. But I don't recall Mr. Ficker saying that his membership is willing to pay more. But it is clear, in aggregate, railroads are not getting enough revenue.

Rail investment must be paid for by rail shippers. It is inevitable and it is unavoidable. We believe that it's an urban myth that coal shippers are paying too much, and I would like to share a couple of facts with you on this, that coal is not paying an unfair share of our revenue or of our earnings.

Currently, 44 percent of our revenue ton miles are associated with coal traffic. Yet, coal brings in only 20 percent of our revenue. By contrast, intermodal traffic brings in 19 percent of our revenue, but only provides for 15 percent of revenue ton miles. In other words, coal traffic is 44 percent of revenue ton miles, intermodal is 15 percent, but they are both bringing in about the same amount of revenue.

Why am I focusing on the metrics of ton miles? That is because not only is ton miles a very rough proxy in terms of what the costs are associated with the traffic but, more importantly, ton miles is probably the single most useful metric in evaluating what the need for investment dollars is to replace track assets, because most track assets measure their life in the basis of cumulative ton miles. That, to my mind, definitely suggests that coal shippers are not paying a disproportionate share of our revenue or our earnings.

Moreover, I think that if you look at what the history is, we are, in fact, being very energetic in raising rates where we can and those rates have been coming up for all of our traffic, except coal. If you look at the last five years, we have been able to raise our average revenue per unit of traffic, which is a carload, for the railroad overall by 7 percent.

Coal revenue per carload has been flat during that period of time. We have been able to increase intermodal revenue by 9 percent during that time frame. Coal is not paying an unfair share and we are, in fact, taking rates up where we can on more competitive business.

We believe that the application of the SAC methodology, as it is currently being applied, however, is interfering with our ability to raise rates for coal traffic to raise it to market levels. It does that directly in terms of rate prescriptions. It does it indirectly in terms of chilling our pricing on coal customers, so that we give them rates that are perhaps below market levels in order to avoid litigation.

And I think that you heard a number of coal customers this very morning in this room basically confirm that they have used the threat of rate litigation in order to, they would call it negotiate, I could use another verb, in order to get lower rates than they would otherwise.

Why is that important? It's important because the Board's revenue adequacy test is an accurate indicator of the financial health of the railroad industry, and it would tell you that Union Pacific in particular, and we believe that the industry generally, lacks the resources currently in order to make the investments that the public interest and that shippers seem to be calling for.

I want to go back to a statutory provision that Mr. McBride I think did not read the entire provision, perhaps because it's lengthy, but I want to focus on another aspect, which is that the test of revenue adequacy is not whether railroads can generate any capital. It is whether or not they can generate revenue sufficient to "attract and retain capital in amounts adequate to provide a sound transportation system in the United States." I submit they cannot.

If it were enough to merely bring capital in, could I use the case of the Southern Pacific in 1994 to illustrate why it's adequate capital? In 1994, SP was able to borrow money. It was also able to launch a successful IPO. But in 1995 we had 1,500 shippers and others interested in rail transportation provide overwhelming support for the UP-SP merger because

they recognized that the SP did not have the resources to maintain the infrastructure that it had and it certainly could not raise the capital necessary to restore and improve service, and that it was becoming increasingly noncompetitive and high cost relative to its competitors.

It is not whether or not a railroad can bring in capital. It's whether or not it can bring in enough capital. And railroad managers are not the only ones who have that concern. Wall Street and other informed observers are definitely concerned about the ability of railroads to not only sustain their current levels of investment, but their ability to meet the demands for more investment in infrastructure.

Mr. Scott Flower who every year does a review of capital spending by the railroads, Zen and the Art of Railroad Management, focuses exclusively on return on invested capital and cash flow and says little or nothing about return on equity. And while he applauds the current trends where railroads are able and have been taking advantage of current market conditions in order to raise prices and therefore improve revenue, he is very cautious about whether or not we are going to be able to continue to do that and whether or not we are going to be still matching our capital expenditures with the revenue stream there to support it.

The AASHTO report likewise recognized that it was the gap between net operating income and capital needs that was driving investors away from railroads. Now, at that period of time, railroad stock had under-performed relative to the rest of the market. We may have over-performed in the last year, but that is because the rest of the market had gone up. We're still playing catch-up and the reason stocks have performed in the railroad industry in the recent year is because we have been taking prices up and the market is hoping we're going to be able to keep that revenue.

We are still not generating earnings sufficient, however, to satisfy investment demand and we believe that while the SAC methodology is not the only explanation for that, it is seriously a contributing factor since coal is such an important part of our marketplace.

Just briefly on what the benefits of a rule-making would be. I think I can speak from a unique perspective here as probably the only individual who has appeared before you today who is responsible for reviewing bills from outside counsel and outside consultants in a range of litigation.

And I have to tell you, as a person who is charged with dealing with trying to manage litigation in a cost effective manner, I view rule-making as my most cost effective opportunity. I also view rate litigation before the STB, while not cheap, a better bargain than contract rate litigation in the courts or, in some cases, even arbitration regarding a contract where we have dealt with the same issues where we have a coal customer who wants to pay a lower rate. It isn't cheap, but any litigation involving a large commercial dispute is going to be expensive and parties spend money on the basis.

And my last point is simply that UP has no active rate cases before the Board. Nobody, we believe, has more of a stake in the outcome of STB methodology than we do. But without a rule-making, our voice is not going to be heard on issues that are currently being debated. Thank you.

CHAIRMAN NOBER: Okay. Well, thank you. Vice Chairman Buttrey, Commissioner Mulvey?

COMMISSIONER MULVEY: The UP witness, Ms. Rinn. Would you care to expand a little bit on the -- recently the Board went out to visit the Powder River Basin and we rode on some of the joint tracks and some of the rights of way of the UP and the BN and moving that coal, and we were told that the actual maintenance cost of the infrastructure for that traffic is

far higher than most people had imagined. Could you expand on that a little bit?

MS. RINN: Certainly. It comes down to, as my engineers have tried to pound through my head, a basic matter of physics that coal trains are heavier than our other traffic. They are moving at a great rate of speed that creates all sorts of stresses on all of the track materials.

We thought we had anticipated and were therefore measuring those costs appropriately, but one of the things that has happened in Western Coal recently as a way of maximizing line capacity is we have encouraged our customers to put more coal in cars and the trains have gotten heavier and the forces coming down on the rail are heavier.

That means that even though we tried to study and estimate what the impact of that was going to be, what we are finding out is that bridges are not able to sustain these weights. We're having to reinforce the bridges. We are also finding that concrete ties are basically being pulverized and we're having to repeat them after a shorter life than we would have anticipated.

We're finding that rail defects that were tolerable under what had been the historic weights of coal trains are not tolerable for these kinds of coal trains and that precipitates more derailments. And we are likewise finding that the derailments we have are appearing not only in frequency, but in their severity partly because of the impact on track and partly because it appears that heavy axle loads for cars that are doing the heavy duty mileage that coal cars do give out sooner, and you have very dramatic photographs that happened with those derailments that we don't otherwise see.

And therefore, we're finding that we devote a considerable amount of our maintenance budget on lines where we have a lot of coal trains.

COMMISSIONER MULVEY: Thank you. Mr. Moates, you note that in all civil litigation a party must satisfy its burden of proof will have its case dismissed for failure of proof. But isn't it also true that the Board is not simply an adjudicative body and we are also charged with carrying out the nation's rail transportation policy and, specifically, with investigating the reasonableness of challenged rates and taking appropriate actions to enforce the statute?

This implies, I think, giving the parties more leeway than you would give them in civil litigation, no?

MR. MOATES: No. Yes, I agree with that broad precept, but I know this is the famous, "we don't just call balls and strikes," and I understand that.

COMMISSIONER MULVEY: I try to avoid that, but yes.

MR. MOATES: Well, I understand, but I think we're all on the same wavelength. I think our concern, and we express this repeatedly in our written materials and in the oral arguments in the eastern cases and I think there is a flavor of it in my written submissions for this hearing, is that we just -- I think fundamentally we disagree with you a little bit as to how flexible you have been. And I realize this is line drawing and you're the expert.

Yes, I would agree that it's not the same as a regular civil court litigation and your decisions are, and they are, informed by a broader public interest concern. I would submit, however, that a broader public interest concern should not be allowed to transform itself, as I believe it has on a few occasions, into essentially giving the shippers a chance and a chance and a chance again to invite them to keep coming back and get it right.

And now I think I hear them here today and I have heard them in some other oral arguments arguing that well, even if we can't get it right, you should get it right for us. And I really don't think that that is the role of the Agency in an adjudicatory proceeding. So you

know, my answer is yes, some flexibility, but not that much.

CHAIRMAN NOBER: Okay. Well, let me start with I guess a theme that all of you have said in different ways. I think, you know, Mr. Moates, you said it in your oral argument, is we ought to be able to charge the commercially reasonably rate. I think, BN, you talked about we shouldn't impose artificial rate caps through the SAC proceeding. And I think, Ms. Rinn, you said that the rates can't get to market rates.

I mean, is it essentially your view that you ought to be able to charge what you want? I'm trying to figure out what those -- I mean, all of you have said it at one point or another. Is that your view on these cases?

MR. SIPE: Chairman Nober, I don't think that is our view. I think that the Stand Alone Cost rate cap defined in the Coal Rate Guidelines as a kind of hoped for approximation of a Ramsey pricing outcome is something we would comfortably live with.

I think from BNSF's perspective, what troubles us is that the rate caps we have gotten in some cases have been a lot closer to the jurisdictional threshold than they have been to the RSAM. And we ask ourselves if our rates on our most demand inelastic traffic are constrained to levels below the RSAM, which is the rate that on average you would need to recover from your captive traffic, how are we ever going to get to revenue adequacy?

So the answer is I think we recognize the conceptual appropriateness of a cap. We think the caps have been somewhat lower than they ought to be.

MS. RINN: I would agree with Mr. Sipe. I believe that in some cases, misapplication of SAC principles has resulted in finding rates unreasonable that were reasonable and, in other cases, has found rates unreasonable but prescribed rates at a level lower than they should have been, and that effectively it appears that for much of UP's Powder River Basin coal, we are subject to a cap of 180 percent.

And we think that that cannot be the law, that we ought to be entitled to differential pricing freedom at some level above 180 percent and that if, in fact, we are held subject to that limit, it has a very pernicious effect, because it means that even if there is nothing that happens that makes you more efficient on that particular move, if on the system as a whole you become more efficient, for every dollar in cost savings we lose a $1.80 in revenue.

And yet, our fixed costs have not been reduced, but our contribution to those fixed costs has been reduced and a methodology that appears to consistently come up with that result, we think, bears serious consideration as to whether it is being properly applied.

CHAIRMAN NOBER: Well, the shippers certainly and the previous Panel didn't feel like we were consistently coming up with decisions that came out at 180 percent. I think if you look at the cases, as I said in my opening statement, you get a range.

Some have been 180, some have been reasonable, some have been in between, some have had, you know, jurisdictional -- have had procedural problems and I don't think that our body supports one extreme or the other. You know, you get a range of outcomes as I think perhaps the law intended. You know, what's a reasonable rate is going to be individually dependent on that movement.

MS. RINN: If I may, sir. I think that that is a range of outcomes on a range of different networks and different parts. What I am saying is that I believe that if you were to re-litigate Wisconsin Power and Light, but substitute another customer, say Northern States Power, we would have also come up with a rate prescription on SAC principles that would have been far below the jurisdictional threshold, which is why we propose to that shipper we forego the Stand Alone Cost and we litigate it on a variable cost basis, because we could read the

handwriting on the wall.

Given our particular circumstances, we saw very little chance that we would come up with a SAC prescription that would have been above the jurisdictional threshold.

CHAIRMAN NOBER: The shippers have pointed out in their cases and in their earlier, I'll give myself license to finish the question, in their earlier testimony that they believe the railroads can control the outcome, through the percent rate reduction, of where the ultimate rate is set by the setting of the tariff rate.

Do you all agree that that's true or do you disagree with that?

MR. SIPE: I don't think there has been any case I have been involved in in which the railroads have controlled the outcome by the level at which they have set their rate. Every time we have been asked on behalf of BNSF to establish a tariff or a common carrier pricing authority, that rate has been set based on commercial considerations. In terms of the relationship to a contract rate that had previously been in place, the relationship has always been rational and explainable by the typical difference between contract rates and tariff rates.

So I know the issue is out there and, as Mr. Dowd indicated and as the Board in fact has recognized, it's an issue that can cut both ways. But I don't think it has been shown to be the case in an individual case that I have been involved with. And Mr. Moates probably wants to say something about that.

MR. MOATES: No. I mean, the eastern cases are the poster child for this, because we all know those were the cases in which there were relatively large rate increases from expiring contracts, which the railroads were willing to renew, someone like the western, for example, but where the eastern utilities had been convinced that they could do better by coming to this Agency.

And we said in our evidence, and I give NS and CSX credit that they were forthright, that their managers had missed the market with those utilities for a couple of years and they also had been probably out-negotiated because the utilities had argued that, you know, they had more flexibility to get business, to move it to one of their other plants so the marketing pricing people had to essentially react to that, which is a nice way of saying their rates were too low.

And so when they understood the market better and brought those rates up, there was a shock, but this Agency found that the rate levels that they were taken to were reasonable.

CHAIRMAN NOBER: Okay. Well, Commissioner Mulvey?

COMMISSIONER MULVEY: Mr. Chair, a couple more questions. For BN, the data you presented on capital investment for 2004/2005 show an increase in capital spending. But it's also the case that BNSF cut back its capital spending significantly in the late '90s. In fact, a famous quote from an executive at the BN states that "I'm not going to make any more investments that are not going to pay the cost of capital."

And in fact, in 1998, BNSF spent almost $2.2 billion, which is more than projected for 2005, and that's in current dollars. And yet, although you cut back your capital spending, when you had this great surge in traffic in 2003/2004, BN was positioned to take advantage of it, whereas other railroads were not. The others also had cut back on capital spending, but they had not had the previous high rates of spending in the late '90s that BN had.

So has that investment paid off for you. Was it a mistake to cut back your capital investment, in 2000-2001, because you were focusing on the short-term rather than the long-term benefits of the investment?

MR. SIPE: You realize you're asking me to comment on what Rob Krebs did

and my degree of confidence to address all the issues rolled into that question, Commissioner Mulvey, is, you know, problematic to be candid. I am aware of the circumstances. I remember the time when Mr. Krebs, who is no longer chairman, expressed frustration about the level of capital investment.

Let me put it in context. When the Burlington Northern/Santa Fe merger was consummated in the '95/96 time period, there was tremendous capital investment associated with getting the new merged system up and running, particularly large investments in intermodal yards and so forth like the Willow Springs Facility in Chicago, which have paid off.

What happened in the late '90s was Mr. Krebs was not seeing the immediate payoff or the quick payoff that he had hoped for from those investments and he said, as a prudent manager, I have got to ramp back a little bit.

Mack Rose came in a couple of years after that and with his team, I think, looking into the future said, you know, we're in a position where we see the need for increased capital investment and we're going to start ramping back up again. And fortunately, the traffic has materialized.

I want to emphasize that a huge amount of that traffic has been exempt intermodal traffic where BNSF, to some extent, was betting on the come by building this high speed transcontinental route that, as you know, is really basically a state of the art transcontinental route for intermodal traffic in the country.

Now, capacity on the transcon is basically consumed and BNSF is having to build additional double and even in one place triple track on the transcon. So I think the commitment to continue to invest is there. And yes, to some extent, BNSF was fortunate that we built and they came.

COMMISSIONER MULVEY: This is a broader question. You mentioned Mr. Krebs was not getting his expected payback in the short run. But, unfortunately, railroad and railroad investment are a long-term committment. And yet, Wall Street, of course penalizes railroads when they make long-term investments.

Given that situation, given that state of affairs, how do we, going to, encourage industries like railroads to make long-term investments? It's not just railroads. It's also true, say, of chemical companies, pharmaceutical companies, all companies where the payoffs may be 5, 10, 15 years down the line. How do we deal with that when we have Wall Street slapping them? Mr. Kalt?

MR. SIPE: I think that would be a good one for Joe to take a run at.

PROFESSOR KALT: There's a lesson in many of these industries, stable rules of the game. That is where rules of the game, and in particular here, of course, rules of reg making, are stable, can be predicted not with respect to their numerical outcome, but that they will be adjudicated and fought over within a well-defined framework that is tethered to a coherent theory, that's where you see people willing to make investments.

When the sense is out there in the market that there is kind of a waxing and waning with respect to the regulatory environment, oh this year was a good year for revenue, next year might not be, when there is a waxing and waning in the policies that's where you see people shorten their time horizons with respect to investment, because they are not going to make 25 year investments when they're not sure if two years from now there will be another change in the rules of the game or another evolution in policy that comes back to bite them.

COMMISSIONER MULVEY: Well, to some extent, the longer the investment, the greater the risk. Some have argued that, in terms of regulating railroad rate-making, we

don't adequately account for the riskiness of the asset, which sort of argues that rates would be even higher than they are in some cases, rather than lower as is being suggested here today.

CHAIRMAN NOBER: Commissioner Buttrey, please.

VICE CHAIR BUTTREY: As a relative newcomer to the rail industry myself, having spent my career in aviation, I found the length of rate prescriptions to be bizarre to say the least, and I was wondering if any of you at the Panel today have any -- are willing to say or comment on what you think the outside limit on rate prescriptions should be.

MR. SIPE: Well, I have thought about that issue in the context of a couple of specific matters that have been before the Board, and I suppose the flip response would be that where the rate prescription is something the railroad could live with going forward, we don't necessarily want to have it removed and supplanted with a lower prescribed rate.

But I think a less flip response is that there are pretty well-defined standards for reopening in the Board's decisions and if somebody can come in and show, based on changed circumstances or new evidence, that a rate prescription is no longer valid, then I think it should be lifted at that point.

But I don't think it's appropriate for the Board to say as a kind of arbitrary matter that we're going to limit rate prescriptions to a particular number of years less than, I guess, the implied limit of 20 years because of the length of the DCF analysis.

MS. RINN: Yes, I have considered that, given the fact that we face the prospect of rate prescriptions that would extend even beyond my retirement date, which is further away than I care to think about, and it creates an interesting way of how to manage this.

I am not advocating these. I'm just throwing it out as a range of things that we have discussed without coming to an informed view about what would be best. But if, in fact, the Board wants to continue using a 20 year DCF, one could basically use a combination of historical data as well as a projection for a shorter period of time going forward, which eliminates a lot of the risk or the variance due to forecasting error and provides you with some actual information about what the operations were is one alternative.

We have had to live in a world where we have a rate prescription based on variable cost which does change, obviously, every year with the new ERCS. And we have had to work with our customer in that regard to work out a mechanism to how do we update the data and how do we come up with a revised calculation in a way that we can live with and can simplify?

That would suggest to me that instead of having an exact prescription for each year into the future that perhaps there could be a finding based on that time frame, but some mechanism that would provide a facilitated manner to update or revise the prescription as necessary without having to overcome the inertia and incur the additional cost of establishing a reopening, because we are, in fact, concerned.

Harking back to a point I think that you were making before, Mr. Mulvey, you have the same problem with the 20 year rate prescription that you have with a 20 contract or a 15 year contract, which is something that looks reasonable under the circumstances at the time may not make sense under the operating and the marketing conditions 5 or 10 years down the road. I'm not advocating any of those, but I think it is a serious issue that ought to be addressed in the rule-making.

CHAIRMAN NOBER: Okay. Let me ask Mr. Kalt. I'm not an economist and I have been struggling to understand contestability theory, but I think I got the basic parameters of it. And in the Powder River Basin, we have a third carrier that's willing now to go to the

markets and build an entire brand new line into there.

What does that say about the rates that are being charged and the returns that are coming from there if you have a real-world? I mean, they are living with all the environmental regulations and all of the barriers to entry that a new entrant would have to.

PROFESSOR KALT: Well, in a sense the market is starting to do your contestability test for you and if it's true that a third carrier can and will come in, then of course it will put competitive discipline on these parties' rates. Contracts will run their course and when those contracts either come up for reopening or come to termination, they will be subject to that competition.

So in a very real sense, you know, in these situations the market actually can be contestable and it is giving you an indication that, you know, if that's a realistic option, then that will be a source of competitive discipline as current contracts come due.

CHAIRMAN NOBER: But isn't that at odds with everybody's statements that the current rates are being set below the current market rates if somebody is willing to build in given the rate environment we have?

PROFESSOR KALT: I don't think you can say that until you get down and look at the level of the individual case, if you will, the individual shipments and so forth. To make a broad statement like that doesn't, I think, capture the dynamics of the market. You all know that individual cases are fought with particular locales and particular shippers going to particular destinations and until you pick those numbers apart, I don't think you can draw that conclusion.

MS. RINN: Chairman Nober, if I could offer this observation. The DME is basically just going to get the coal started. It is not going to be paying for the network that is going to get the coal to the destination. Compare that to the coal network Union Pacific has to support, which basically calls for delivery of PRB coal in Oregon, Texas, Louisiana and even Arizona. The DME is not attempting to raise money for or to pay for a network that extensive. That's the coal network we have to support and pay for.

MR. SIPE: Just one other point on this. I believe it was Commissioner Mulvey who commented if they are ever going to actually build this line of railroad, they are going to need to have contracts that will support the investment. And I haven't studied this situation closely, but I would be highly skeptical as to whether that financing would ever be obtained. I think we'll have contestability when we have an entrant.

COMMISSIONER MULVEY: Well, contestability when it was originally proposed did not say that you had to have entry. It said that the threat of entry would be sufficient to keep down rates. And of course, for most railroad cases, there really isn't a credible threat of entry. We presume that entry could happen and then try to estimate the costs that that entrant would incur.

The difficulty with that, of course, is , as you were pointing out, how difficult it is to construct what the actual costs really are given all the complexities, it reminds me of comparative economic systems when you studied socialist economies who try to plan the entire ecoming, solving all of the equations. The SAC analyses seem to be similar to that although on a micro scale.

And I agree that, differential pricing is an optimal second best solution. We all understand that. Sometimes I just wonder if Stand Alone Cost analysis is something that really is, even with all of our powerful computers today, something that we really do with a great deal of accuracy.

CHAIRMAN NOBER: Let me just point out -- can I finish my questions?

PROFESSOR KALT: I'm sorry. I'll answer you in a minute.

CHAIRMAN NOBER: Let me just finish my questions first and then we'll recognize everybody else. We have identified and I think everybody has recognized that there are problems with the percent rate reduction and I asked the shippers this and I will ask you this.

Do you have any suggestions for how we can revise that to get around the problems that are identified other than start a rule-making to look at it?

MR. MOATES: Well, again, with all due respect, I'm not convinced there's a problem. I think I have heard the theoretical problem. You haven't seen the problem in any case come before you. There have been allegations and you found those allegations are not supported and there was no predicate, as I said before, for a prescription in those eastern cases in any event, so it was a moot issue.

All I can say is the percentage reduction methodology has the very great and very significant benefit of its being based on demand principles. And if you're going to start searching for some substitute or surrogate for it, I don't think you can ignore those principals.

That is when you make a determination of how to allocate the excess revenues that theoretically you have found to exist in a stand alone system among not just to the complaining shipper obviously, it's to all the users of the stand alone railroad. I think Professor Kalt should address this and not me, but I think the economists tell us that the right way to do that is to allocate it back across to those users of the system in a manner that recognizes their various demands for the network.

PROFESSOR KALT: I would say the way I look at this, and it is the economics of contestability, Mr. Chairman, many of the questions that you are now confronting, percentage reduction, crossover allocations and so forth, in fact, if you step back and do the kind of hypothetical analysis and ask the questions, what would an efficient entrant have to charge both for the challenged traffic or issued traffic and the rest of the traffic in order to be a viable entrant and work through that analysis?

And it's not the easiest thing in the world, but this is what the Board did 20 years ago and made tremendous progress. When you work through that analysis, I don't want to be too glib about it, but the answers start to fall out. That is when you ask the question, they fall out as a result of underlying principles that have to be true about a contestable market.

One of those principles I talk about in this little statement. If an entrant comes in, a SAR comes in, and isn't rebuilding the entire network of the UP or whatever, they are actually dependent upon the UP for portions of the movements. It has to be the case that the residual incumbent is also stand alone in the sense that the revenues that they can gather will be sufficient to allow that residual incumbent to survive. Otherwise, the stand alone railroad isn't viable, because there will be no residual UP to move the stuff all the way to Louisiana.

So if you start to work through these principles, then you start to get answers to these questions. Oh, the rates to the residual incumbent have to be sufficient to allow the UP to move it all the way to Louisiana. You start to get answers to these questions of crossover, percentage reduction and so forth. So actually that's why I intimated, I have been telling BNSF for quite some time, there needs to be a rule-making to slow down and think about exactly these kinds of questions.

CHAIRMAN NOBER: Commissioner Mulvey, do you have some more questions?

COMMISSIONER MULVEY: One question I had was a reverse of the one I asked the shippers, and that is if we had a rule-making on the SAC methodology and if we

broadened that rule-making to include issues such as the measure for revenue adequacy, would you be less inclined to support such a rule-making?

MS. RINN: No.

COMMISSIONER MULVEY: Thank you. That's the answer I was hoping for.

MR. MOATES: I have a different answer. My answer would be not we wouldn't participate, but I really do think that if you're going to reopen revenue adequacy, you ought to do that in its own right.

COMMISSIONER MULVEY: One last question on this issue of long-term contracts. It has been suggested by some, I'm thinking particularly of John Spycnalski of Penn State, that railroads have a tendency by their very nature to enter into long-term contracts at long run incremental or long run marginol costs when they have excess capacity and they periodically will do that.

I raised this before and not gotten much reaction. Railroads are a regulated industry and the question would be would you favor a regulation or legislation, whichever is more appropriate, that might restrict the length of time for which railroads can enter into long-term contracts with shippers to protect the railroads from their tending toward locking themselves into excessively low cost contracts.

MR. SIPE: Absolutely not.

MR. MOATES: No.

MR. SIPE: I mean, you know, there is regulation in the rail industry. Large sectors of traffic are not regulated. Railroad managers have demonstrated that they know how to price that traffic rationally in accordance with the market, and I think any movement towards controlling the length of contracts and sort of from a benevolent despot kind of perspective would be a disaster.

COMMISSIONER MULVEY: Well, the presumption you have is that the people negotiating the contracts have perfect knowledge of conditions for the length of time of the contracts, which indeed they don't.

MR. SIPE: Well, that's true. I will tell you the trend and I think everybody sitting at this table would concur. The trend has been both towards shorter contracts for coal and other commodities and towards more public pricing.

COMMISSIONER MULVEY: Yes, so you're saying that you're responding yourselves, but right now you're not in a period of excess capacity time that you might see that behavior?

MR. SIPE: That's true and I don't know when we'll get back into that, if ever get back into that mode.

COMMISSIONER MULVEY: Yes, Mr. Kalt?

PROFESSOR KALT: To only disagree with Mr. Sipe a little bit, I don't think it's the case that you have to presume sort of perfect foresight. In fact, people are increasingly writing and learning to write, not only in this industry but in other industries, contingent contracts so that when market conditions change, whether it's a fuel price or something about the capital that needs to be invested, people write contingent contracts.

This industry coming out of the legacy of regulations in very kind of narrowing form is a little bit behind. For example, I work a lot in the electric power sector. People have gotten very sophisticated about contingent contracts there and it's a standard method of contracting that makes the actual term, whether it's 15 or 20 years, less relevant because it gives parties on both sides of the contract an opportunity to change the contract or modify it either by

direct indexing or by reopening.

COMMISSIONER MULVEY: Yes, absolutely right. In fact, one of the problems with some of these contracts is that the railroads are unable to even put in fuel surcharges. Obviously, writing a contract in 1989 that didn't take into account what happened in '79 doesn't seem to be very sensible. But yes, contingency contracting would help tremendously on that. Yes, Mr. Rinn1`.

MS. RINN: Speaking on behalf of what is now an incumbent railroad, but was once the contesting railroad, it is hard for me to conceive how we and our partner, Werpy, could have gone forward with the investment that got us into the Powder River Basin without having done long-term contracts.

And therefore, that causes me to believe that just as we cannot foresee the future today, there will be times and circumstances where it does make economic sense to do a long-term contract and it would be very difficult to write a law or a regulation that would provide for that flexibility.

We're prepared to live and die by the market. We think that you have to let the players in the marketplace who have to live with the consequences of their decisions should be the ones making the decision about the appropriate length of a contract and living with the consequences of the deals that they do.

MR. MOATES: Commissioner Mulvey, if I may, too. I don't want to speak for the coal shippers, but I have a little experience here, too, that makes me believe that they probably wouldn't be terribly supportive of limiting either, because typically they have wanted to have contracts ideally that would be coterminous with their coal supply contracts, so they want a base load set of contracts and they want their transportation in place for that base load.

They also want the railroads to have the flexibility to deal with spot market purchases when the market conditions change like they have right now. So I think trying to create, if you will, an artificial length of time for a contract would not probably get much support either from this Panel or the other one.

COMMISSIONER MULVEY: I think the issue, of course, is that there is another party to be concerned with here, too, and that's the public interest. If contracts are entered into, which may be beneficial to the two private interests but somehow or another run counter to the public interest, then the question is how do we address that? If that wasn't an issue, we wouldn't be here. If there wasn't that third party, this proceeding or this group would not be here. That's all I have, Roger.

CHAIRMAN NOBER: Okay. Well, I just have one last question and that's on an issue Mr. Ficker raised this morning about small rate cases and I'm not sure all of you can speak to it, but his suggestion was that the Board not engage in a rule-making in large rate cases, as you have all endorsed, but instead focus all its energy on issuing a rule-making on small rate cases.

Do you all agree or disagree that we should do that?

MR. SIPE: Well, I think a rule-making on SAC would be probably a more focused rule-making. I think in some sense, this is not necessarily a reason to do it, but in some sense it would be an easier rule-making, because we know where we're coming from as a matter of first principles and I think the objective of the rule-making is to get the practice consistent with the first principles.

Everybody who has thought about revising the small rate case standards, to my knowledge, has kind of come up against a wall in terms of finding something better. So I would

rather have the Board do something that it's pretty confident it can do well and get it right in the relatively short-term than taking on something uncertain that might prove to be intractable.

CHAIRMAN NOBER: Anyone else want to take a crack at it?

MS. RINN: I have nothing to add.

CHAIRMAN NOBER: Okay. So we're left with the shippers would like to see us not do a large rate case rule-making, but do a small rate case rule-making and the carriers would like to see us not do a small rate case rule-making, but do a large rate case rule- making.

MR. MOATES: Again, and as for CSX, we're not advocating a rule-making for SAC.

CHAIRMAN NOBER: Correct.

MR. MOATES: We said we would participate if you have one while I do think that's --

CHAIRMAN NOBER: Okay.

MR. MOATES: We're in a different position, I think.

MR. SIPE: Certainly, BNSF, and I have worn the AAR hat in the context of the small shippers, too, we would obviously participate. I think it's, frankly, more challenging for all involved and there is a standard out there that ought to be tried. As you said yourself this morning, Chairman Nober, I don't think you used quite those words, but you asked well, isn't there a standard out there? Yes. Let's have somebody give it a try.

CHAIRMAN NOBER: Well, again, thank you. I guess if there are no further questions, we'll move on to the next Panel, but thank you all very much for your time and your answers and your very thoughtful commentary.

And we'll now hear from the last two witnesses. I apologize for keeping you waiting for as long as we have, Tom O'Connor from Snavely King and Michael Nelson from Michael Nelson Consulting. We do have a good view of the projector, but thanks. Okay. Mr. O'Connor?

MR. O'CONNOR: Thank you. As the slide indicates, we are talking about an alternative and this alternative we have developed that meets some of the needs unmet by SAC and we have heard about some of those unmet needs today. A little bit of background. I have appeared in three SAC cases as a witness over the years. I have some familiarity with it, but I'm not dwelling on it today.

This is the process that we follow. We begin with in serving our client base and, basically, we deal with clients in chemicals, petrochemicals, food, grain, intermodal, coal, minerals and more in terms of commodities. And we begin with commercial negotiations.

Occasionally, we arrive at an impasse on those negotiations. Usually, we arrive at an impasse in a situation which some would describe as captive. When that occurs, we go right around the second bullet. We do not even consider Stand Alone Cost. It just has nothing to offer in the way of a solution for this client base.

We would recommend that the Board provide STB-assisted mediation and we would recommend that it be voluntary, both parties would have to ask for it, but if they ask for it, it would be binding. We see that as a very welcome addition to the services the STB provides.

Now, as a ramp up to what would qualify and what would not, we would begin with what is. The STB has three measures that we consider to be serviceable as a test for qualification here. The RSAM, that's Revenue Shortfall Allocation Method, is computed each year by the STB staff. The most recent data we have is 2002. So of these three measures two are known. The RSAM benchmark is known. The RBC greater than 180 benchmark is known.

And with access to the waybill sample we can compute the third one.

I would submit that if the rate that we're talking about, and this is a rate that we're probably in a captive situation on, we know it's RCR coming in, if that rate is greater than two of these benchmarks, then we could come to you and we could ask you to help. And what we would be asking for would be assistance with mediation to move the process forward.

The action plan is spelled out on the next slide. Now, bear in mind we're in a situation where rail or other modal competition is not available or it's not economically or commercially practical. We actually did hit the dark side of the moon. We could, with the proper application of money, anything could be done, but commercially and economically practical is the test.

The RCR, of course, would be greater than 180 and it might be greater than that by a significant margin as we'll see in just a minute. The traffic would not be exempt. We heard a little bit about that today. We're not talking about that traffic. We would be demonstrating by two out of three of these benchmarks that we would probably have a case that would require your assistance, and we see those guidelines that I mentioned and showed on the previous page as serving as a good method, good base for discussion, both in negotiations and in mediation and a good test as to whether you had a sensible case.

We also recommend, and this is the last time I was here talking with you about this particular matter which was in Ex Parte 646, I did not have this particular feature, but I have added it since. I would suggest that any rail revenue reduction that would flow from mediation on a given lane would be capped at $500,000, and I will show you a little bit later why we selected that.

Why the $500,000? I listened last time to a fair amount of spirited debate about a bright line figure of $4 million, which Nittley offered for consideration in 2003. And then in 2004 they offered $4.8 million. The AAR response, and there is merit to it, there was concern that that could challenge revenue adequacy. With the $500,000, we'll see in just a second, that argument goes away.

Quickly now, so I don't use up too much of your time, my discipline is right over here to my right. The graph is showing you that the RCR's -- this is your data from the 2002 waybill sample parenthetically, and the graph is showing you that the RCRs vary significantly by commodity. It is also showing you that the percentage of commodity revenue below RCR 180, which of course would be exempt from regulation, also differs significantly by commodity.

The percentage of revenue with RCR above 180 percent, chemicals on the left, 61 percent, coal, we have heard a bit about that today, 44 percent, and then you have the others. Not all of that revenue would be subject to challenge and not all of that revenue certainly would be arriving here for mediation.

The maximum damage that I can see on this, downside risk to the railroads if -- now, this is quite far fetched I think. Let's say that you approve the method as I have proposed it. Let's further state that 100 cases were brought before you. That's pretty unlikely. Let's say that the shippers won all 100 cases. Let's say that the award maxed out at $500,000 on all 100 cases. We're still only at $50 million. That's about one-tenth of 1 percent of rail revenue. Again, I'm taking my rail revenue measure off the 2002 waybill. It's roughly $40 billion.

I have personally been involved in negotiations that exceeded that change in rail revenue, a single negotiation. And lo and behold, the next week everybody was still in business. So the revenue adequacy issue, I think, is put to rest by that cap.

So to conclude, what we are recommending for your consideration is we remain

with commercial negotiations as our primary reliance, and that is going to solve the vast majority of the problems. When we run into impasse, and again predictively we'll be in a captive situation and we have a very high RCR, an RCR that passes two out of those three benchmark tests, then we would like the avenue open to come to you and ask for STB-assisted mediation which is both voluntary and binding. Thank you.

CHAIRMAN NOBER: Well, thank you. Mr. Nelson?

MR. NELSON: Chairman Nober, Vice Chairman Buttrey, Commissioner Mulvey and Board Staff, I appreciate very much the opportunity to bring my testimony to you both in writing and today. My written statement contains descriptions of 10 specific items that I believe to be technically sound ways to address some of the concerns that the Board has identified and to refine the practice of Stand Alone Costing.

I don't think time permits me to get into any detail on each of them on a line item kind of basis, so to try to generalize from my written testimony, I think for the most part it's fair to say that it suggests that the Board should more fully embrace the concept of ongoing improvement in rail productivity. And when I refer to productivity, I'm including incorporation of productivity changes in the DCF, but I'm talking about something broader.

The Board is well-aware that many large shippers have used build-outs to convert formerly captive plants to competitively served plants. It's also fairly well-documented that for a long period of time, at least prior to public pricing, that PRB rates to competitively served points had declined over an extended period of time and the industry had survived those types of impacts on its revenue stream largely through productivity improvements and cost reductions, which are a natural byproduct of marketplace competition.

I guess I could summarize by saying that the Board should make decisions in rate cases that endorse and reflect the continuation of that process. By ensuring that rates on captive shipments fully reflect attainable productivity improvements the Board would provide an increased measure of protection for captive shippers. But at the same time, by making sure the prescribed rate is not artificially inflated by a lack, and I struggle to come up with the proper phrasing on this, a lack of optimal efficiency on the part of the defendant carrier, the Board would provide a stimulus, and a valuable stimulus, for further innovation.

That is to me what ultimately will determine both the financial health of the industry and its ability to provide suitable and adequate performance for its shippers. Innovation beats litigation and the Board can use a refined SAC process to help steer the industry in that direction.

A secondary point I wanted to touch on is probably more of a process point than a substantive point, and it seems to be rooted in a communication problem perhaps, as a way to describe it. We heard earlier about the $3 million that shippers invest in rate cases. They have gotten results that they didn't expect when they spent their $3 million and they come away with the impression that the process is unfair.

The Board, from my reading of the decisions in some of these cases, has reviewed the record and has in many instances cited major defects in the evidence and arguments advanced by the shippers in the course of reaching its decision. If the shippers really are that far off course, it would seem as though there would have to be some way to improve communication earlier in the process, so that they wouldn't have to get to the end before they got the bad news about the path that they had pursued.

And this is related to my discussion of parameterization. Perhaps there is a way for the parties to put on the table earlier in the process some kind of non-binding ballpark

assessment of how their positions fit established precedents and where, if at all, they are relying on the Board to depart from past practices as part of their position in a case.

Like I said, that might make use of the parameterization concept I talked about in more detail, and it seems like it might help to focus the litigation on the areas where it's most needed and avoid some of the unpleasant surprise problems.

To the best of my knowledge, none of the points that I have just raised or that I have talked about in detail in my written testimony inherently require a rule-making, and I don't really have a position with respect to whether or not one is appropriate in this situation. I would be happy to answer questions.

CHAIRMAN NOBER: That was perfect timing. Commissioner Mulvey?

COMMISSIONER MULVEY: Mr. O'Connor, you called for voluntary and binding mediation, but often if it's binding, it's usually involuntary or if it's voluntary, people will go into it if it's non-binding. Will many shippers and carriers agree to voluntary binding mediation, especially after they have some experience with it?

MR. O'CONNOR: Well, that would remain to be seen. I have participated in voluntary and binding mediation and it had solved, the particular case I have in mind, the problem that had about 10 years of life to it and it resolved it. Here is what I don't think would work. If the perception was that the mediation would automatically lead to a court appeal, I do not think that would -- that would be terribly helpful.

The mediation, as I'm envisioning it and as I have experienced it, engages the mediator, engages the mediator who has all of the skills and resources at their disposal as an active participant in working out the solution. In a very real sense, you're making case law on an ongoing basis and you're learning as you go. But you bring to it all of the collective experience and wisdom that the STB has now. They would be an active participant, that's the way I see it or whoever was designed as the mediator would be an active participant in working out the solution.

And although my experience in mediation is not extensive, it was successful and the mediator drew from both sides worthwhile parts of their argument and synthesized it into a solution that both could subscribe to and the case went away.

COMMISSIONER MULVEY: Thank you. Mr. Nelson, I just wanted to thank for your paper in the sense that that was one of the ones that we received that had a lot of specific ideas as to how to address some of the issues that we're faced in dealing with the SAC analysis.

CHAIRMAN NOBER: Well, thanks again. I want to thank both of you for your thoughtful comments. I just have one question for Mr. O'Connor and that is could we implement what you're suggesting without a rule or without even a statutory change? I mean, do we have the power to bind parties to mediation, do you think?

MR. O'CONNOR: I'm not averse to practicing a law without a license, so I'll plunge ahead. Yes. But we have behind me some -- one of these people behind me might have better advice on that one.

CHAIRMAN NOBER: And that would be one question. And secondly, we have imposed binding mediation by rule at the beginning of large rate cases and I think somewhat discouraging, but not completely, you know, impossible results, and that is what we found is that at that point so far and now we have, you know, a sample of two and I have been a big advocate of not drawing too much in the way of conclusions from small sample sizes, being the lawyer that I am. But that, you know, because the parties have spent so much at getting to the point where they are at, that it is often times, you know, mediation is -- you know, there are

sort of some costs are so high they might as well just go ahead and see what the outcome from the Board is. At least so far that appears to be the case.

MR. O'CONNOR: Right. Let me put some numbers to it, if you will. In a case like this, I can see from the first encounter with the facts to a decision as to whether you want to go being less than 30 days and with a budget that is significantly less than the millions we have talked about.

CHAIRMAN NOBER: If both parties asked us and we do get requests from time to time to be a mediator in cases, and I think we have accommodated every single one of those requests.

MR. O'CONNOR: Yes.

CHAIRMAN NOBER: The trick is getting both sides to want us to mediate.

MR. O'CONNOR: Sure.

CHAIRMAN NOBER: That's always the problem.

MR. O'CONNOR: Well, you've got one. Most of the time there's just one.

CHAIRMAN NOBER: Well, again, I want to thank both of you for your thoughtful presentations and for taking the time and energy to come down and talk to us about it. I want to thank all the participants today. I think this has been a very useful hearing and we have been able to air a lot of-- hear a lot of different viewpoints and talk about a lot of specific issues and hear some bold ideas being offered.

You know, obviously, it's one that the parties in this room care a great deal about and because you care about it, it's important to us as well. As I said, I think we all have an open mind as to how to proceed next and to what our next steps will be. But I can assure you that we are committed to trying to see some improvements in these areas and address some of the concerns that have been raised by both sides.

So with that, thank you all for being here for three and a half hours and we'll stand adjourned.

MR. O'CONNOR: Thank you.

(Whereupon, the Public Hearing was concluded at 1:07 p.m.)