Mr. Weicher, welcome back.

MR. WEICHER: Thank you. Good afternoon.

I am Richard Weicher from BNSF.

With me is Sam Sipe, who after I take hopefully ten minutes or so will then go on with the remainder of our time.

Also with us is Jeff Moreland, the Chief Legal Officer of BNSF. This is an important case to us, as are all our coal rate cases.

I will cover some parts of the argument and try to address a few of these railroad questions that came up the last part of the argument. There's a lot here, so Sam Sipe is very much anxious to get in a number of the complex calculatory issues we've been talking about as well.

We started with the premise that the Board's function here is to protect a shipper from the potential abuse of market power. We don't believe there is any abuse of market power here or anything that requires Board intervention. We don't believe Otter Tail has been injured by pricing to its Big Stone plant. It is correct that the expiration of a multi-year, a decade long contract which we won't go into details of but at the end of 2001 our company did indeed offer a rate reduction for an extended contract period. Otter Tail chose instead to not enter into a contract and seek a common carrier rate. The company did publish a slightly higher rate in that event without the protection or the attributes that come with a contract, but there is nothing egregious or outrageous going on here. And after a decade with the contract, it is our understanding from public announcements that Otter Tail is prepared to expand and build an additional generating facility in the climate they have been in.

It is also our understanding and is in the record to expert study we put in, that it is true the cost of delivered coal for Big Stone has gone up. Almost entirely due to the increase in the unregulated cost of coal, only a little bit due to the increase in a regulated rail rate.

Nor is there evidence that the coal rates in this case, the coal transportation rates, have impacted the dispatch or the capabilities of this power plant or kept it from producing in any respect, or limited its production.

There is in elastic demand here. This is a situation where differential pricing is in play, and that is entirely correct and appropriate.

It is also true that BNSF needs over the long term to have adequate revenues to earn its cost of capital. And it's critically important from our standpoint in this or any coal case, that the Board not retreat into some cost-based allocation ignoring the broader purposes of regulation, the broader purposes of the Act and our need as well to generate revenues for massive investment. This is not the place to just retreat into formulas and arcana, not that that isn't a big part of any of these case. But investment doesn't come out of thin air. It comes out of real dollars for an expensive structure. It's not a time for arbitrary rate caps based on formulas.

Now, I have been involved in the stand alone cost cases since the beginning and since the formulation of constrained market pricing. I think I used to think I knew what this thing was supposed to do or when it started out, it was supposed to have a purpose, I believe, to create the theoretical alternative for a shipper so that it wouldn't pay more than it had to build and operate its own railroad. That was the theory, we believe, of constrained market pricing of the stand alone railroad. That original premise was to say what's the alternative, what's the economic alternative as part of Ramsey pricing for in-elastic demand. If it was elastic demand in a totally competitive situation, and there had been a built-in, we wouldn't be having this delightful discussion of all this arcana. But it is a place with in-elastic demand, so it is appropriate to look at that alternative. But that alternative, and I believe Mr. DiMichael used the term the SARR should be measured by the same test as a real railroad. Well, that's true. We've gotten so far from that such thing it's ridiculous. You have a separate discussion of issues under SAC in general, but within this case we have the same kind of issues of massive crossover traffic, multiplied by the issue of whether there are even any common facilities between the issue traffic, the Otter Tail traffic, and all this crossover traffic.

The crossover traffic in this case from a layman's standpoint, I'll put that as a layman from the economist standpoint. I am a lawyer, but this is now we're into the economic theory of Ramsey pricing and constraint about the pricing. We're so far out on the fringes now.

We've got 95 percent plus crossover

traffic driving this railroad not as a method of simplification, but as a way to put in a toll or slice a nickel or slice or a something off gazillions of tons of coal that have nothing to do with real world Otter Tail alternative. And we got all this coal going out the south end, we distribute it. And I know Mr. Sipe will use this also, but there's a map in the packet which is very similar to complainant's map, that shows their stand alone railroad and shows Cordero and Donkey Creek, the south end of the Powder River Basin.

A 100 plus million tons of coal are coming south out of the basin from a point beyond where Otter Tail goes north. And I get mixed up on this every time I get through it. But in order to create -- there is some double crossover or crossover on crossover or something that goes out the north that happens to touch some of the track that goes out the south so they can pull in 150 tons going south and then take the issue that I know is very important, you know, dollar versus mileage allocation and take a division. But before you get to that division and all that issue, you have to look at why is all this traffic in this stand alone railroad. Where is it coming from? You know, it's just popping in there we think -- I think far beyond any rational application of stand alone railroad theory as it started out.

This kind of ties in -- well, it does tie into the PPL test, which I'm sure Mr. Sipe will address in greater detail. We agree with the PPL test. If anything, it doesn't go far enough. But beyond the PPL test here, you've got they're trying to pull in all this traffic to support an PPL test or to pass a PPL test.

Another critical issue we need to address from the real railroad standpoint, a SAC railroad must reflect the real costs of infrastructure and physical plant. This is an issue in all of these cases, it's an issue here, too. It isn't, other than the productivity and indexes ones, it hasn't been of the marquee you've talked about -- or excuse me, the complainant raised in his argument. But we have another situation where we have from a railroad standpoint, a real railroad standpoint low ball estimates of earthwork, minimum grading, skip a bunch of the access roads along the stand alone railroad to service it and then out source the maintenance to the low cost most theoretically more efficient plant.

The chart that complainant used to compare to average out of R1 maintenance of way figures for our entire 33,000 mile plus system, not the Powder River Basin; not what's happening in the real world with coal.

And, Commissioner Mulvey, you know, I have looked at the records here. These are such huge records, I can only say to the best of my knowledge it doesn't cover fugitive coal dust or the coal dust issue. I believe that the maintenance costs here certainly in Otter Tail's SAC railroad are way understated. They are probably understated for our real world experience in keeping an enormously complex plant like the Powder River Basin in place.

And as to the productivity issue, again and we had the opportunity to try to checkout while you were asking complainant, I don't know the answer to the forward looking productivity so much as we know there were great productivity increases in the past, a lot of them in the late '90s through the merger era. Certainly we as a company plan for, expect and continue to seek productivity increases in the future. Whether they can keep pace with what has happened, I don't know. And they always involve trade-offs, whether it's capital for the bigger locomotive or capital for the PTC or the systems to automate a railroad in addition, of course, in negotiation with labor over what that does to employees and what they must be paid over time. And as that happened in the past when those changes occur, they occur in our industry through that whole process, and it is not an automatic -- it can't be, or an in expensive process, nor should it be when those rights must be respected.

Though the system of a SAC railroad being propounded in our view should not be a SAC like cheapest alternative through the system, that's not feasible under the standards of constrained market pricing. That's not the standard that approaches real world.

It's a hot summer day in the District of

Columbia and in the midwest, and in the southeast and the southwest. We have 100 utilities my company is handling coal to out of the Powder River Basin. We are under tremendous stress in doing that. We are in a situation right now in Powder River Basin, we're in a 24/7 situation with maintenance being pulled from everywhere, massive pieces of equipment all to maintain the fluidity, deliver the coal and expand the infrastructure to maintain service for the user utility. This is a big dollar, major enterprise.

Our Chairman said yesterday to the world that we're up to this commitment to our customers. WE will meet it. We will continue to invest. If the Board wants to tell us that that's an improvement and that with these rates we're going to be regulated on a cheap basis, a minimal basis, a no reliability basis, a basis that doesn't have that capital, that's what happens if you just pick through and take the lowest number of every 50 columns, try and peel it down, ignore the need for capital and use artificial numbers other than the real world.

I think that was the ten minutes. I could go on, but Mr. Sipe has to cover several of the other critical issues.

We have to respond to questions, however you do it later.

CHAIRMAN NOBER: Mr. Sipe?

MR. SIPE: Thank you, Chairman Nober.

Good afternoon, Vice Chairman Buttrey, Commissioner Mulvey.

I think this might be my third or fourth time doing one of these arguments, and I was just sitting there asking myself am I maybe getting a little tired of this. And the answer is this afternoon has gone on for a while, but the overall argument I'm not tired of. I think this has been a really good discussion so far. I think Mr. DiMichael focused on the real issues in this case. I don't happen to agree with very much of what he said, but I think he focused on the real issues.

I think the Board members' questions focused on the real issues. And I'm going to try to be responsive to those issues.

Can you hear me okay, because I'm not too close to the mike.

CHAIRMAN NOBER: Yes. You're taller than the average litigant, I guess.

MR. SIPE: I could take my shoes off, but that would be a little too folksy.

Let me start with the revenue issues because I think they are, from our perspective, the controlling issues in the case although not the only issues. And I'll start with a point that was important Mr. DiMichael, which is the so-called market-based divisions. Their preferred case is built on these extrapolations of so-called real world divisions, information that they obtained from us in discovery.

First of all, I would say that the way I read the Board's precedent on crossover revenue allocation the Board has not definitively adopted a single preferred method for allocating revenue on crossover traffic. The two prior cases that had been decided prior to the submission of opening evidence, I believe TMPA and PPL both indicated that there was not at that point a single preferred methodology. I don't think it's a fair reading of the Board's precedent to say that there is a commitment to market-based divisions.

This is very important in my mind. I don't think there has been a serious effort on the part of any of the shippers who have espoused so-called market-based divisions to talk through in a coherent economic framework how a real world defendant's divisions on traffic with other real world railroads reflects a paradigm that could be meaningful in the hypothetical context of crossover traffic. Because the reality is there are no divisions on crossover movements. There are no such movements. There are no negotiations in a contestable market where an entry is completely free and exit is completely free to tell us exactly how those revenues would be determined. And I think in the absence of a coherent framework it would be extremely perilous for the Board to go back to market-based divisions or some semblance of them. And I think what you aid in the Duke NS case is that you didn't want to go that way.

I think what you said in Duke NS is that you felt that a cost-based approach to crossover divisions was a more reliable framework. The language specifically was the revenue allocation should reflect to the extent practicable the defendant carrier's relative costs of providing service over the two segments. And our economic witness in this case, Professor Ordover, although he obviously criticized the concept of crossover traffic, did state that a cost-based revenue allocation procedure would be superior to a supposed market-based approach because " a cost-based revenue allocation is a proxy for the comparison of revenue and cost that is the essence of the SAC test." At least you're taking into account of what you have to pay to carry the traffic over the two segments of the crossover movement.

Now when we filed our opening evidence in this case we were espousing the density adjusted method, which has subsequently been rejected by the Board. And we don't agree with that and we think if you went back and looked carefully at what we said and thought about it in context, you might conclude that it is the best approach. But I don't think it would be wise for me to butt my head against that wall, and

I hope Mr. Atkins doesn't quote me on it in his next brief. But I said it with full knowledge.

So what we are advocating here is a cost-based revenue allocation procedure that we think satisfies --

CHAIRMAN NOBER: He quoted me in that brief, too.

MR. SIPE: We both got in there a couple of times, at least once on the same subject.

We have presented evidence as a cost-based revenue allocation in this case which we think achieves or best achieves, given the record in this case, the Board's objective of establishing a fair cost-based division between the shippers. The issue here has to do with the origin credit that you assign as part of the MSP methodology that the Board adopted as its default methodology in the Duke Norfolk Southern case. And I think I can put this in context for you by referring you to a couple of the attachments that we handed out.

First of all, there is the map which was part of our evidence in an earlier submission which shows the Otter Tail stand alone route of movement. And we highlight in there a portion of the short haul traffic that exits the Powder River Basin to the south. And the only point I want to make right now is that there is a huge volume of traffic that Otter Tail used in its design of the stand alone railroad here that is very short haul crossover traffic; 25 miles or less.

If you turn to the next page, you'll see that there are basically two large segments of that short haul crossover traffic. And we're talking now about under their alternative case where they use the MSP revenue allocation with the 100 mile block.

There are 84.5 million tons of traffic that travel south from Cordero. This traffic averages only 24 miles on a 1200 mile railroad. One-third of it averages 8 miles or less on the Otter Tail. On and on the bottom line here is that the Otter Tail's share of revenue on this southbound traffic is almost five times larger than the residual BNSF's. Same thing for the traffic that goes south and exits the stand alone railroad at Donkey Creek.

What we think is going on in this case is that Otter Tail deliberately designed a stand alone railroad that tries to take advantage of large amounts of revenue generated by the short haul crossover traffic. And the vehicle for getting the revenue here is the 100 mile origin credit.

You'll see in the handout here that a very substantial portion of the revenue is attributable to the origin credit. On the Donkey Creek traffic, for example, 87 percent of revenue is attributable solely to the 100 mile origin credit.

We took a careful look at the costs implicit in that 100 mile origin credit. It's a system average number. As Mr. DiMichael said, it's drawn from the carload Waybill Sample. But we know that unit train originations are far more efficient than originations of single carloads which often have to be switched in and out of trains. And the Board's own adjustments to URCs suggests that they are about 25 percent of the system average carload origin cost.

Now Mr. DiMichael suggested a number of reasons why the Board shouldn't pay any attention to our evidence on the revenue allocation, the 25 mile block. First of all, he said it's inconsistent with precedent, and I really think that was also kind of the gist of his last point where you quoted from the brief. But the fact is the Board has said it's looking for the most accurate reflection of the costs. And if it's undisputed that the 100 mile credit overstates the cost of originating coal traffic, then the Board ought to go with something that's more accurate.

And we put in detailed information on that in the context of our evidence. And I'm not going to read from it here, but I'd like to refer the Board specifically to our supplemental reply evidence, dated March 22, 2004, Exhibit 3A9 where we explain in detail why the 25 mile origin credit for coal originations in shipper owned cars is the most appropriate evidence of record.

Mr. DiMichael also says that we ignored line haul costs. But if you read that exhibit carefully, you'll see that we didn't.

He also says that somehow if you were to adopt the 25 mile credit, in this case you'd be jeopardizing the Board's carload Waybill Sample. But we're not talking about using the 25 mile credit for purposes of the carload Waybill Sample. We're talking about using it as a revenue allocation in a SAC case. And the Board can surely do that without jeopardizing what it does with its carload Waybill Sample.

In short, on this issue which it's really a very big issue in the case, if you were going to take seriously what you said about trying to find a revenue allocation procedure that fairly divides the costs between -- that covers the costs of the two portions of the stand alone movement, I think you really on this record have to go with the 25 mile block.

I think it's instructive also for the Board to remember that when it departed modestly from MMP in the Duke NS case, its motive for doing so was to avoid an incentive for designing a SARR that was perhaps designed to take advantage of the revenue allocation procedure.

You'll recall that in that Duke NS case the Board adopted MSP with the 100 mile origin and termination credits and it chose to do so because of its concern that the modified milage prorate, the block methodology as the Board called it there, "leads the parties to design SARRs to take advantage of its revenue allocation rather than produce the fairest division between the carriers." And I think it's pretty clear from the data that we've presented about these short haul movements that that's exactly what's going on here. If you use something that more closely approximate costs, you are going to have a fairer result. And you're not going to have stand alone railroads designed in the future solely to take advantage of short haul movements.

Now I want to talk a little bit about the PPL test. We think that the PPL test is correctly decided, correctly implemented by the Board. And we also think that there should be a second step to the PPL test, which is to apply it at the rate prescription stage. And if you stop and think about it if you were to adopt that approach, you wouldn't really be asking the Board to go through a full fledged application of the PPL test twice. Because when the parties submit their opening evidence, the nature of the submissions in these cases is the shipper is always going to pass the PPL test based on its evidence because it has claimed vast revenues and very low costs. I mean, that's just the nature of the beast. We all know that.

Similarly, the railroad is always going to show that the shipper flunks the PPL test based on its opening evidence because the railroad always says the revenues are a lot lower and the costs are a lot higher. So, in fact, you don't need to do it after the parties file their first two rounds of evidence. It's only after you've decided what the revenues and the costs are that application of the PPL test is meaningful. And at that point you're either going to know whether a rate reduction is called for or whether a rate reduction is not called for.

If a rate reduction is called for, then you take a look at the PPL test in the context of the rate prescription.

In the final pages of the handout that I gave you this afternoon we produced three schematics from the evidence we put in on March 1st of this year where we show what happens when you apply the PPL test at the rate reduction stage. It's quite straightforward. You basically have a SARR with two segments, an east/west segment and a north/south segment. In our example, the first page 3A5 you've got an overage on both segments of revenues in excess of costs. But the overage on the short north/south segment is proportionately greatly than on the east/west segment.

On the second page it shows that when you add that those two overages together for purposes of computing a system-wide rate reduction, you find the total overage in our hypothetical example of 15 percent $300 out of $2,000. And that would imply under the Board's percentage rate reduction approach a 15 percent across the board rate reduction.

And what the third page shows is when you do that, you end up with a reduced rate for the traffic on the east/west segment of $1445 versus collectively attributable costs of $1500.

And the point here, which I think came out in Chairman Nober's questioning, is that the traffic on the east/west segment is not covering its collectively attributable costs. And the essence of the SAC test is this: At what rate level would a hypothetical stand alone railroad enter the market to serve the issue traffic and other traffic grouped with the issue traffic? Would a hypothetical stand alone railroad build this east/west segment at all if it knew it was going to receive $55 less than its full economic costs? And the answer is pretty clear. It wouldn't.

We think the logic of the test at the rate reduction stage is pretty much infallible, and if there's any question on the Board's mind with respect to that, I would certainly be happy to get into it.

So those are the big, if you will, revenue issues in this case that we believe drive the result.

Let me just say there's a related issue that I want to allude to because Mr. DiMichael mentioned it, and that is the south of Cordero traffic, which we have argued in this case should be excluded.

I agree with Mr. DiMichael's characterization that if you apply the PPL test properly, and in our mind that would mean applying the PPL test with the revenue allocation based on MSP with 25 mile origination credits; if you apply it properly here, then the southbound traffic problem is really taken care of. The reason we argued in this case that the southbound traffic should be excluded is that we thought it was so clearly an attempt, to use a word that has been overused and we've probably overused it among others, to game the configuration of the stand alone system. And we thought the best way to send a message to shippers would be to exclude that traffic. Because it doesn't share facilities with the issue traffic. What is it doing in there?

We also think it is, in fact, to exclude it would be consistent with the Board's simplification rationale that it is used to justify crossover traffic in the first place. The Board says let's focus on the issue traffic route of movement. Well, here we're talking about something that's not part of the issue traffic route of movement. It would be clear and easy as a threshold matter to knock this traffic out of the stand alone model, and we think the Board could do. But I'm not saying that I think it's essential. Because if you apply PPL properly, you should get to the right result.

Now, let me mention a few of the other matters that Mr. DiMichael addressed. And let me preface it by saying that we have had so far in this oral argument a good discussion of the issues, but no discussion of the procedural posture of the case when a lot of this evidence was put in. And this is important for us, because on several of these issues where they are claiming they now have the best evidence of record, that evidence never came in as part of their opening case and we never had an opportunity to address it. We've had to file a major motion to strike back in the spring of 2004 because they came in with several categories of impermissible rebuttal evidence back then. And I'm just going to refer you to the motion. I'm to going to, obviously, read it again. But it cuts across a lot of these issues.

And let's talk, first of all, about the operating plan. Chairman Nober, you said at the outset that Otter Tail has come in and submitted the RTC model. And we have this seemingly anomalous situation where BNSF has been advocating use of the RTC model in case after case, but we didn't model the entire stand alone system and somehow they fault us for that. But how did that come to pass?

The way it came to pass in the procedure of this case is that, as usual, they came in initially with a string program. And the string program had a lot of problems, and I think everybody here agrees that it's seen its best days, if it had any good days and now we're in the RTC world. But we weren't at the beginning of this case.

So we have reply evidence. And we look at their evidence and say we don't need to model the entire system because we can tell that they have sufficient capacity on two segments of the stand alone railroad. And what is the RTC model used for? It's used for two things primarily. It's used to determine whether there is sufficient capacity, and that goes to the construction cost side of the equation. If there's not sufficient capacity, you have to build more. And it's used to determine transit times, primarily online transit times.

Here's what we did. We took a look at two of these four segments and we said capacity is sufficient and we said we'll use our real world transit times for those segments because what they built modeled what was there in the real world.

As to the other two segments, we used the RTC model.

So we went through several iterations of the string program in this case. They kept resubmitting it, it continued to have problems. Finally the Board, as you know last December and January of this year, said we're going to call for submission of evidence on these modified traffic groups. And the Board made clear we're going to let Otter Tail come in at the end of the day and use the RTC model.

Well, that's fine. I'm not saying the Board shouldn't have done that. But I'm saying that was not their opening case. If they had put in a full RTC model opening, of course we would have modeled the full stand alone railroad. But things never unfolded so as to give us the opportunity or incentive to do that. And we accepted basically what they modeled in the RTC.

They turn around and say BNSF's operating plan is flawed because we only did a piece of it. But under these circumstances it's clear why we only did pieces of it.

Now what is really driving any differences between the parties on the operating plan? It's primarily two things related to the yards. It's dwell time in the yards and it is yard capacity.

The RTC model does not tell you terminal dwell time. Terminal dwell time is an assumption that the parties put into the RTC model. They said two hours, we said six hours. Our six hours is consistent, I believe, with what you've decided in prior cases and we think it's well defended in this case. But the answer should not be does the RTC model spit out two hours or six hours or some other number of hours. Because it's an assumption that is input into the model, it's not an output.

As to yard capacity, think about it. Dwell times means how many rail cars and locomotives do you have sitting in a rail yard. Capacity is going to be a direct function of dwell times. If they're only in there for two hours, you're going to be able to move them in and move them out and you won't need so much yard track and other space in the yards. If they're in there for six hours, you're going to use more capacity. That's how we got the different dwell times and yard capacity in this case, and we think the record fully supports our assumptions.

Now, Mr. DiMichael said you couldn't run the RTC model to completion -- I think he said this -- if you used our terminal dwell times. The answer to that then is for the Board to go back, if it decides our terminal dwell times are the right times, is for the Board which now has the model to go back and run it with the six hours and see if you need anymore capacity on this stand alone railroad so that the model will run to completion. There's no reason you can't do that. But we should not be faulted under the facts of this case for not having modeled the entire SARR.

Productivity. This is an issue where impermissible rebuttal and the burden of proof clearly comes into play. In their opening evidence Otter Tail had one sentence and stated without any explanation or supporting evidence that the annual inflation forecast should be the RCAF-A.

We said they didn't put in a case. They put in a naked assertion. We said the RCAF-U; that's what you've used in all your prior cases for reasons that are pretty well grounded.

Now I think everybody in this room believes that a hypothetical stand alone railroad might experience some modest productivity gains into the future. I don't think it was our obligation to say in response to their opening evidence what that might have been based on this record. I don't think there's anything in the record that tells you what those modest productivity gains might be. They didn't make any effort whatsoever to link their laundry list of possible productivity improvements to specific productivity gains effecting different areas of stand alone railroad operations. There's no basis, unfortunately. I know the Board would like to do something in these area, but there's no basis in the record for the Board to make an informed intelligent statement that we're going to use, let's just pick a hypothetical number, ten percent of the RCAF-A and 90 percent of the RCAF-U going forward.

A similar issue with respect to debt costs, similar in the sense of this is an issue that first came up on rebuttal. It's not correct to say that Otter Tail simply updated debt calculations. What Otter Tail did was to modify the basic approach that it used on opening, which was to use the industry average cost of debt for the period 1999 through 2001. On rebuttal, Otter Tail used the industry average only through 2002 and then assumed, simply assumed that OTRR will refinance the debt portion of its capital structure in first quarter '03 at a much lower interest rate. There's no justification or rationale as to why this approach is justified.

It clearly wasn't responsive to BNSF's reply evidence since BNSF accepted Otter Tail's opening methodology. Otter Tail provided no evidence that the SARR would be able to refinance a debt burden of the size of the SARR's debt, no evidence about the interest rates that might apply to such a refinancing, and no evidence about the financing fees that would be required if a financing were feasible.

And it's true, a lot of people have probably refinanced their mortgages. But if there's someone here who has done it without paying any fees, maybe he or she could give me a call and refer me to your mortgage banker so I could take advantage of that deal, too.

But I think that there is an important point here about the state of the record. The Board laid down rules in one of the eastern cases about the circumstances under which rebuttal would be appropriate. And we think that in several of these areas Otter Tail has not adhered to that.

It looks like I'm almost out of time.

On the maintenance of way issues, Mr.

DiMichael urged you to look carefully at the evidence. I would simply urge you to do the same. We've approached maintenance of way from the bottom up, haven't out sourced it. We've provided realistic justified estimates of what it would actually cost to maintain a high volume, high density coal hauling railroad. And we think that as in the recent cases, our evidence is the best evidence of record.

I'll stop there.

CHAIRMAN NOBER: All right. Thanks.

Commissioner Mulvey, you want to start?

COMMISSIONER MULVEY: First of all, with regard to refinancing using 2003 rates do you know what happened to railroads' cost of capital for 2003 and 2004?

MR. SIPE: I think the industry cost of capital has been trending down somewhat over the last few years.

COMMISSIONER MULVEY: Our most recent calculation, however, shows the cost of capital increasing for 2004, largely due I believe to the cost of equity capital, albeit the cost of debt financing seem to be either flat or trending up.

I have a question. You didn't model the entire system, but would it have been that expensive to have gone and modeled the entire system so we wouldn't have this dispute between who modeled what and whether or not there was comparability between the two?

MR. SIPE: I think in the scheme of things had we known that the issue was going to be here, we would have certainly done the modeling. But the circumstance we were facing was that they had put in a model based on the string program. Our people who know railroad operations looked at it and said it looks like they have enough capacity on two of these segments. Why don't we just go ahead and accept that and avoid -- and this is ironic -- avoid a dispute as to those and model the segments where we think there's an issue. In hindsight one would say we should have done it otherwise, but I think we had a good reason for doing it the way we did it.

COMMISSIONER MULVEY: With regard to the crossover traffic moving south, I realize that relatively little of it operates over the SARR. But hasn't the Board used crossover traffic in other cases that didn't use the SARR at all or didn't use any of the SARR's facilities and hasn't that been in our precedent?

MR. SIPE: I think the Board did do that in the CSX Duke case. And I read the discussion of the issue a couple of times, and I'm not sure I understood it. And here's my problem on this particular issue, but it may be just a lack of understanding.

The guidelines talk about grouping traffic so as to share joint and common costs between non-issue traffic and the issue traffic. That's pretty much a statement out of the guidelines. That's an objective that we all recognize as a valid objective and it's part of what makes SAC work.

Where you don't have traffic sharing the same facilities, it seems pretty clear that the sharing of costs, at best, become tenuous.

And then we have statements in a couple of subsequent cases to the effect that a shipper should not be asked to pay for facilities it doesn't use.

So we thought under the Board's precedent it is more colorable to say that that traffic should be excluded. But as I mentioned if a proper application of the PPL subsidy test solves the problem, then maybe it doesn't need to be a big issue here.

CHAIRMAN NOBER: Let me start with the same issue I started with with Mr. DiMichael, which is what is -- if we assume for the sake of argument that the shipper puts in a feasible operating plan, what amount of deference ought that to get?

Now, you all have objected very much to the Board extrapolating operating plans in past case. You have felt that that placed an unfair burden. You've objected to being asked to model entire railroads. I think you've made a point not to quote briefs of having the Board make the railroad prove the shipper's case for it.

Now here, just for the sake of argument, let's say we have an example where the shipper has put in a feasible operating plan, which is what everyone has wanted them to do. In that circumstance then how much deference should we give even the assumptions that go into it like yard and dwell time if we have one?

MR. SIPE: Okay. Well, let me try to be as specific as I can. And I will tell you, Chairman Nober, that I don't view myself as necessarily the world's expert on these issues, but I am familiar with them.

I would say that where the Board accepts the shipper's operating plan, that means that the shipper has proved its case regarding mainline facilities; that is the amount of track capacity you needed. It hasn't proved its case, obviously, as to the unit costs of those facilities. But it terms of miles of track it's proved its case. Basically how much railroad infrastructure do you need.

CHAIRMAN NOBER: Okay. And would yard capacity be a function of that?

MR. SIPE: No, yard capacity is not a function of that. I tried to explain this and may not have been sufficiently clear.

CHAIRMAN NOBER: No. You said you think

it's a function of dwell time.

MR. SIPE: I think yard capacity is primarily a function of dwell time, and dwell time is not an output of the string program. It's an input, it's an assumption. Our witness on that in this case is Mr. Loren Mueller, who is a former BNSF operating officer who took a look at real world yards and knows what you have to do in yards.

And I could go down the different other categories. I mean, transit times, line haul transit times are a function of the operating plan. Line haul transit times effect number of crews, so I think you probably have a pretty good correlation there between a valid shipper operating plan and the number of train personnel you might need. But I'd better watch myself, because there's some things buried in the details there like assumptions that some guy's going to work 270 days a year. I don't think we necessarily agree with that.

Locomotives, however, there are issues other than the output of the operating plan that effect the number of locomotives you need, which has to do with how you calculate the peaking factor which is an issue in this case.

So, you know, what I would say as a generic matter is if I am you, Chairman Nober, saying to my staff produce for me a decision that generates the right results based on the fact that we're going to accept the shipper's operating plan, what I'd say is go and identify for me how closely each of these factors is determined by the output of the operating plan, and you should be able to figure it out.

CHAIRMAN NOBER: Did you have a question?

VICE CHAIRMAN BUTTREY: On that same point, we've visited several yards, several inspection points on the different railroads. And the information that we get when we do that, I believe, I'm accurate in saying that the information we get is that coal trains, the coal -- transportation of coal on rails tears up more cars, more rail and requires more inspections than anything else that the railroad does. Now, I don't know whether anybody else would agree with that or not, but that's the information that I take away from these site visits that we do.

And I'm also under the impression, anyway, that there are more inspections done at the beginning of the trip as the coal moves out and the beginning of the trip going back, so to speak, with the empties than anywhere else along the line.

Wouldn't have a significant effect on these dwell times and the yard capacities.

MR. SIPE: I think clearly if you're doing more and more intense inspections, Vice Chairman Buttrey, you're going to have longer dwell times. Sure. Not to mention all the other things that go into it like switching out bad order cars and so forth, which happens a lot with coal trains.

MR. WEICHER: And if I may, Vice Chairman Buttrey, that is also why, empirical observation is why the data in one of the charts that the complainant put up comparing system average maintenance of way numbers out of the R1, spreading everything across everything, is not an accurate portrayal for coal. Our's is, as Mr. Sipe said, a ground up or from the ground up build up of the true costs.

COMMISSIONER MULVEY: Otter Tail expressed a purpose for its operations to develop the Fargo area. I, too, have visited Fargo and am quite fond of Fargo and its people. But I'd like to ask you, do you have any data on what the delivered price of coal is to the final consumer compared to the transportation? What share of that is rail transportation costs?

MR. SIPE: It's in the record, and I think I have a volume in a briefcase, I could look it for you. But I can tell you where it is. In our reply evidence we sponsored it would be section 3A somewhere. We sponsored testimony by an electric power expert, Mr. Kenneth Slater who looked specifically at delivered cost of power to Big Stone. And as Mr. Weicher say, what Mr. Slater found is that the delivered cost went up by a nontrivial amount between the end of 2001 and 2002, which was when our rate increase took effect. A vast preponderance of the increase was attributable to an increase in the unregulated price of coal.

You wouldn't have to be too paranoid to think that maybe these folks are trying to make up for whoever made that decision on the coal, by getting a little money back from the railroads.

COMMISSIONER MULVEY: Mr. DiMichael submitted this evidence, I'm sure you've seen this.

MR. SIPE: Well, I saw it this afternoon.

COMMISSIONER MULVEY: And it does look as though the amount of revenue for the short haul both on a revenue per ton mile basis and on revenues per ton are very much less favorable for the short line. Are these numbers representative of shipments when it has to be revenue division between two railroads?

MR. SIPE: I certainly can't say that they are representative, Commissioner Mulvey. What I can tell you is this: That Otter Tail's regressions that drive the vast majority of the revenue allocation consisted of five movements on which the BNSF portion was less than 200 miles. And these are two of the five.

COMMISSIONER MULVEY: A regression with five observations?

MR. SIPE: Yes. None of which was a Powder River Basin coal movement. I mean, I just don't think you can place any credence in that at all, even if you were to say that what happens in the real world is a valid paradigm for what happens in a contestable market. And I don't think you can say that.

COMMISSIONER MULVEY: I'm just wondering what kind of confidence you can have in a regression model result based on five observations?

MR. SIPE: We put in a detailed study of their regressions. And I think, frankly, we knocked that out of the park. We have no confidence in it.

CHAIRMAN NOBER: Let's come back to this issue.

MR. WEICHER: I just wanted to make one additional comment, Commission Mulvey. And I guess we are not, and I assume we can't discuss in public the details of these exhibits he gave you, but there are-- and a lot of this is in our evidence. But there are issues in terms of the nature of these movements and in a contestable market, the elasticity or inelasticity of one or the other end of these sample movements that make them completely inappropriate to compare it to coming out the Powder River Basin on a short haul division. I realize that's sort of a mouthful.

COMMISSIONER MULVEY: Yes.

MR. WEICHER: But in addition to how few samples they are, they're irrelevant to the texture of what is supposedly being created here, a stand alone railroad.

COMMISSIONER MULVEY: You said in your testimony about this crossover traffic that 95 percent of the traffic in this instance is crossover traffic. Our approach permits crossover traffic. But do you feel that there should be some sort of cap on how much traffic that's accepted or what percent would be too much?

MR. WEICHER: We have argued before there should be a cap out and the Board reject that. Things like 50 percent or so. But that issue doesn't have to be reached here from the standpoint, as Mr. Sipe has gone through and I tried to explain.

The principle of sharing of facilities is violated here by all this traffic coming south from Cordero and Donkey Creek. It doesn't use the same railroad except artificially when you loop in a bit of crossover that goes north that comes from a mine farther south that you can get an overloop. This is a construct on a construct. It is not proper crossover traffic, at least and you know Mr. Sipe referred to one of these two cases, nothing like you've ever done in a western coal case that I'm aware of and something that would be economically a real stretch, an abuse of crossover and crossover.

CHAIRMAN NOBER: Let's turn to productivity, which again I guess been an issue in the last five or six straight cases, as you know. And what I'm struggling to understand is what is a fair measure here. And, you know, the shippers here presented some evidence and they've talked about some productivity gains that they might achieve and how the RCAF-As even calculated it if it's a rolling average of past-productivity. And the question is why is it not fair to say that a SARR might gain some productivity and at this point the same productivity that a class 1 would gain?

MR. SIPE: Well, I think --

CHAIRMAN NOBER: What productivity is BN getting that the SARR wouldn't?

MR. SIPE: There are two questions there, and let me start with the first one.

CHAIRMAN NOBER: Okay.

MR. SIPE: I don't disagree with the proposition that a SARR might realize some productivity in the future. But I think in the context of an adjudication where the evidence is going to be based on substantial evidence of record, there is not substantial evidence of record submitted by the shipper in this case that shows you what such productivity is. I mean, if that sounds --

CHAIRMAN NOBER: Well, they put up a list of 15 different things.

MR. SIPE: They put up a list of factors. They put up 314,000 pound railcars.

CHAIRMAN NOBER: They --

MR. SIPE: Have you guys talked to Carl Ice about when those 315,000 pound railcars are coming on line? I mean, it's all conjecture. That's not evidence. You've got to try and quantify it, tie it to the numbers in the record.

MR. WEICHER: They have put in a list of things that could result in productivity but not evidence of what -- or anyone's real prediction that specific items could occur that would lead to a specific productivity included to reflect what they're asking for the index.

CHAIRMAN NOBER: Well, isn't what's before us to decide whether or not a stand alone railroad is entitled to the same assumption of productivity increases that a class 1 would be? And up to now the argument has been well, you know, the class 1 -- a brand new railroad would be state of the art and the class 1 is still bringing itself to state of the art, if you will. So the class 1 will achieve productivity increases that a brand new railroad wouldn't. And the question is is that really true going forward?

MR. SIPE: Well, that is an interesting question.

CHAIRMAN NOBER: I'm just trying to understand the point.

MR. SIPE: But I think --

CHAIRMAN NOBER: Well that's what we have to decide.

MR. SIPE: No, it's a question that has to be decided in the context of the record in this case. I mean, I will say as a counsel for BNSF that I did not believe that we were under an obligation to come in and make a showing to the Board about our real world productivity. Maybe the Board wants to ask us to do that in a future case. But I think where the Board --

CHAIRMAN NOBER: But that's not what I asked. I asked -- what I asked was what -- they give a list of productivity; you said it speculative, can't accept it. So I said well what then would they not be entitled to. So I mean essentially you've met -- their evidence you've responded to by saying well it's not true.

MR. SIPE: Well, we didn't --

CHAIRMAN NOBER: Am I missing something.

MR. SIPE: We didn't have a chance to respond to it, Chairman Nober. It came in on rebuttal. If you'd like to ask us now to submit evidence on that, we'll do it. But I can't refer to evidence that we haven't produced.

CHAIRMAN NOBER: I guess what I'm trying to get at is what would they have to show in order to satisfy you that they have met -- not to satisfy me, but to satisfy you.

MR. SIPE: Well it would be hard to satisfy me.

CHAIRMAN NOBER: Could it be done?

MR. SIPE: How about let's take a hypothetical reasonable person.

CHAIRMAN NOBER: Or me, for example.

MR. SIPE: And that would be you.

CHAIRMAN NOBER: Or us collectively, yes.

MR. SIPE: That would be the three of you and your esteemed advisors collectively.

What I think it would take to satisfy you reasonable people would be something that showed a correlation between specific areas of productivity and a particular operating cost that escalates over time, like labor, like locomotive maintenance;.show me the nexus.

CHAIRMAN NOBER: Should we assume one man crews or assume the same rate that class 1s are assuming one man crews?

MR. SIPE: No, I wouldn't -- I wasn't aware that class 1s were assuming that. But I --

CHAIRMAN NOBER: They're hoping for, excuse me.

MR. SIPE: I don't think on this record, unfortunately, you can do that. And I know maybe that sounds like a lawyerly response, but that's part of what we're up to here.

MR. WEICHER: Well, I don't know if it's both a lawyerly and a practical response from a railroad standpoint. I don't know how you could assume in the context of something like this those kinds of dramatic changes. Might they occur sometime in the future? It is possible. These are goals of an industry. But how you could assume that in the context of a rate case without concrete evidence, especially for coal trains to assume dramatic productivity increases when this is already one of the most efficient that runs on a railroad. There's always an issue in contract negotiations or issues with utilities. From the railroad standpoint these areas are already highly efficient. This is the ordinary stuff. But you can't, I don't think, simply assume dramatic changes in the future based on someone saying a list of here are things that could happen, especially in such serious areas.

COMMISSIONER MULVEY: Well, there are several kinds of productivity increases. There are some productivity increases that rain down like manna from heaven and effect all railroads. These would be things like major technological changes that come in the future and that all railroads can adopt. Other productivity increases come from changes in operations where the railroad becomes more efficient over time.

So you could possibly separate out those two kinds of productivity increases and say that well the ones that the portion of productivity increases that have come from technological change, that is that effects all railroads equally, you might be able -- I mean, there are ways of doing this. I do think the Board needs to look at it because I think we all agree that the RCAF-U and the RCAF-A are two extremes, neither of which fully capture what the potential is over the long haul.

So it's something, I think, that needs further investigation.

MR. WEICHER: If I may, Commissioner Mulvey, it's self-serving to say this but I think my company is already a low cost carrier, if not the lowest cost carrier. And therefore to assume the most dramatic productivity changes would be pretty radical.

But also, as you said, this has been raised at least in the other proceeding, nonproceeding or whatever, on SAC. Because it does have ramifications across industry data.

COMMISSIONER MULVEY: You also mentioned cost-based versus market-based estimates. Are you all concerned about the philosophical issue involved here? We start getting back to cost-based analysis and we start moving away from the whole purpose of deregulation, getting away from cost-based calculations and focusing on the market and the demand-based calculations?

MR. SIPE: Well if I understand the question correctly, I think there is a concern that any cost-based revenue allocation is going to have an element of arbitrariness that you wouldn't get by observing actual through rates made in a real market. But the reason why it's okay to use a defendant carrier's real through rates is that those rates made in a real market and you are in some sense testing not just the rate of the challenged shipper, you're testing a subset of rates.

There are no rates on crossover traffic. Be definition they simply don't exist. It's like a unicorn or a jackalope. And the best you're going to be able to do is come up with, I think the Board has used the word, precision. It's going to be an approximation, and that's dangerous.

COMMISSIONER MULVEY: Thank you.

CHAIRMAN NOBER: Okay. Well, Mr. Weicher thank you very much.