UNITED STATES OF AMERICA

SURFACE TRANSPORTATION BOARD

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PUBLIC HEARING

REVIEW OF THE SURFACE TRANSPORTATION BOARD'S GENERAL PURPOSE COSTING SYSTEM

STB Ex Parte No. 431 (Sub-No. 3)

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Thursday,
April 30, 2009

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Surface Transportation Board
Suite 120
395 E Street, S.W.
Washington, D.C.

9:00 a.m.

BEFORE:

FRANCIS P. MULVEY   Acting-Chairman

CHARLES NOTTINGHAM   Vice Chairman

ALSO PRESENT:

PANEL I: SHIPPER INTERESTS

STEVE SHARP, Arkansas Electric Cooperative Corporation

TOM O'CONNOR, Interested Associations

JOHN J. LeSEUR, Coal Shippers

GERALD W. FAUTH, III, Wheat and Barley Commissions

PANEL II: FREIGHT RAILROADS

EDWARD R. HAMBERGER, Association of American Railroads

RICHARD E. WEICHER, BNSF Railway Company

LOUISE A. RINN, Union Pacific Railroad Company

PANEL III: OTHER INTERESTED PERSONS

C. GREGORY BRESKIN

ROBERT H. LEILICH

GEORGE AVERY GRIMES

SANDRA J. DEARDEN, Highroad Consulting, Ltd.

C O N T E N T S

P-R-O-C-E-E-D-I-N-G-S

9:00 a.m.

ACTING-CHAIRMAN MULVEY: Thank you all for coming today. Good morning and welcome to our hearing on a review of the Surface Transportation Board's General Purpose Costing System.

The purpose of this hearing is to examine issues related to the Board's Uniform Railroad Costing System commonly known as URCS.

This hearing is the first step in what will be a continuing dialogue on this issue. And as a reminder, we will keep the docket open until June 1st, 2009, to receive comments in response to this hearing.

The Board uses URCS to determine a rail carrier's variable costs in a variety of our regulatory proceedings.

URCS determines for each Class I railroad, the portion of each category of expenses shown in the carrier's Annual Report to the Board, STB Form R-1, that represents its system-average variable cost for that cost category for that year.

More specifically, URCS consists of a series of computer programs and manual procedures organized into three phases.

Phase I compiles the raw data provided by the URCS carriers, by the Class I carriers, and then uses statistical estimation procedures to determine the portion of specific expense account groupings that vary with changes in the volume of activity.

In Phase II, these cost/volume relationships are then used to develop the variable unit costs that allow costing of specific rail movements.

And finally in Phase III, these variable unit costs are applied to determine costs of specific movements via an interactive computer program that permits the user to enter operating characteristic data for the specific movements under consideration.

URCS was initially adopted in 1989 by our predecessor agency, the Interstate Commerce Commission, as the general purpose costing system for the agency. The Railroad Accounting Principles Board Final Report of September 1987, on which the ICC relied, calls for a periodic review of URCS.

Now, the Board completed its first review of URCS in 1997, at which time the system was modified to: (1) alter the procedures used to determine the variable costs associated with rail movements of intermodal traffic; (2) revise the train switching conversion factor used in the costing procedures and; (3) discontinue the collection of cost data on switching and terminal companies and (4) revise the procedure for determining the variable cost of using privately-owned railcars.

I note that during that review, the Board was unable to take a broader effort to revise and update URCS regression equations due to "a lack of resources."

This means that the regression analyses, which establish the variability factors, have not been updated since 1987, more than two decades ago.

In addition to the regression analyses, it might be that the engineering relationships on which URCS relies are also in need of significant revision. Most of these special engineering and time and motion studies, that are the foundation for the constant factors in URCS, were undertaken or presented to the ICC in various proceedings from the 1930s to the 1960s.

Given the enormous increase in rail UNIT train traffic as well as the rationalization and enhanced productivity of railroad operations over the past 30 years since the Staggers Act, it might well be that these engineering relationships need updating.

Finally, URCS relies on a variety of computer programs, some of which are now obsolete. At present, URCS uses Fortran, C++, VBNET and VB6, but all of our current programming is done in Visual Basic Access, VBA.

If we determine that recoding the URCS Phase II WorkTables is necessary to transition URCS to current program standards, we might need to reverse engineer the legacy program code.

In short, it's time for a new, more comprehensive review of URCS to determine whether and to what extent modifications are needed to account for changes in railroad operations, as well as recent changes in Board procedures.

I am committed to continuing the review and refinement of our costing system through periodic analyses such as the effort we begin today, which will include public participation.

I have long indicated my personal interest in revising and updating URCS. The purpose of this hearing is to determine whether and in what ways revisions to URCS would benefit the public.

We're hoping that the key stakeholders before us today can help us define the scope of the potential reform of our general purpose costing system.

We know that we cannot demand perfection. Rather, we will look at whether proposed changes would improve current procedures, and whether such changes can be implemented at a reasonable cost and without undue burden on our railroad and rail shipping industries, the public, and this agency.

Our ultimate goal, however, is to ensure that the Board has a costing tool that is as accurate as possible to enable the Board to more effectively carry out its statutory duties fairly and expeditiously.

Before I turn to Vice Chairman Nottingham for his opening remarks, I want to mention a few procedural notes regarding the testimony itself.

As usual, we will hear from all the speakers on a panel prior to any questions from the Board members. Speakers, please note the timing lights that are in front of me on the dais. You will see a yellow light when you have one minute remaining, and a red light when your time has expired. So, please do your best to keep within the time that you have been allotted.

I assure you that we have read all of your statements and comments and, please, there is no need for you to read the statements in their entirety here.

After hearing from the entire panel, we will rotate with questions from the Board members until we have exhausted all of the questions or exhausted the panelists.

Additionally, just to remind everybody, please turn off your cell phones. And with that, now I would like to turn to Vice Chairman Nottingham for his opening remarks.

VICE CHAIRMAN NOTTINGHAM: Thank you, Acting-Chairman Mulvey.

If I could start with just a quick two points of personal privilege, one is to - I'm pretty sure this is our first official formal hearing with you at the helm.

And I wanted just to say something I've said in other forums, which is I wish you all the best in every success in your tenure as acting-chairman, and congratulations to you.

I also wanted to note we don't do this very often, but it is a first for us in recent times, we have a recently-departed commissioner in our midst. Commissioner Doug Buttrey, welcome back. I believe it's the first time you've been back in the building since your departure.

I won't use the "R" word, because you didn't R. You departed gracefully, and we look forward to following your career as it develops further and keeping in touch. Welcome back, and it's a pleasure to see you back in this room even if it's at a little bit more of a distance than we're accustomed to up here.

Turning to the riveting subject of the day, I know that there's no place you'd rather be and no topic you'd rather be talking about on the last day of April than the STB's Uniform Rail Costing System.

We really held this hearing to really find out who our diehard stakeholders are, who are our most hard-core observers, and now we know. So, we're taking lists and, you know, if you're here today on a nice spring morning to talk about this topic, we know you are a true follower of the STB. So, congratulations, but it is a serious topic.

I want to welcome everyone to this hearing. Of course our topic today is the Board's Uniform Rail Costing System adopted in 1989 to be our general purpose costing model.

URCS as it's affectionately known, is an important tool for us. We use URCS whenever we need to estimate the variable cost of rail transportation. It, therefore, plays a prominent role in rate cases and a number of other agency proceedings.

The issue today is how best to review and improve URCS. We are always interested in finding ways to improve our regulatory processes whether it's our simplified guidelines for small rail disputes, our calculation of the railroad industry cost of capital or improvements to URCS.

Our staff has been conducting a review of URCS to find ways to improve the model, and we have an ongoing rulemaking that seeks to improve the way URCS costs movements of hazardous materials.

I fully support efforts to improve the existing model where it makes sense to do so, but we need to tread cautiously in exploring a broader overhaul of URCS.

URCS itself took years to create and replaced a costing model that the ICC had used for over 50 years, and history illustrates that even simple changes to URCS will be complicated.

Just a few years after it created URCS, the ICC undertook what it thought would be a regular review of this costing model. The resulting review took seven years to complete.

I believe the process needs to be managed carefully so that we not embark on an open-ended journey without some clear destination, timeline and project budget in mind. Otherwise, we risk repeating the mistakes of our predecessor and having a second lengthy review that may provide some benefits and improvements to URCS, but will certainly impose a heavy burden on the Board, the railroad industry, railroad customers and the general public.

I have reviewed the comments from

all participants today and thank everyone in advance for their constructive suggestions on how to improve URCS. And I will certainly keep an open mind on all of this and look forward to hearing the testimony of those parties that choose to attend our hearing today.

And I also want to thank the STB staff for their diligent efforts in preparing for this hearing.

Thank you, Acting-Chairman.

ACTING-CHAIRMAN MULVEY: Thank you. I agree that we want to do what is reasonable, and we want to do what is going to have a positive benefit-cost ratio.

But to paraphrase somebody else here in Washington, if it was easy, it's easy to do things that are easy, but sometimes we need to do things that are hard because they need to be done.

Let me now call up the first panel representing shipper interests. This is Steve

Sharp for the Arkansas Electric Cooperative Corporation; Mr. Tom O'Connor for the Interested Associations, a group of associations; Mr. John LeSeur for the Coal Shippers and Mr. Gerald Fauth for the Wheat and Barley Commission.

Mr. LeSeur is an added panelist listed on a revised speakers list, and that's available outside the hearing room as you enter.

Thank you.

We can begin with Mr. Sharp.

MR. SHARP: Good morning, Chairman Mulvey, Vice Chairman Nottingham, STB Board and former Chairman Buttrey. I'm glad to see you all and appreciate the opportunity to speak to you this morning.

AECC has appeared before the Board several times. I'll just make a quick recap. We are a membership-based generation and transmission cooperative that provides wholesale electric power to electric cooperatives in the State of Arkansas.

Those cooperatives, in turn, provide electric power to their members numbering about 490,000 there in the State of Arkansas.

We hold substantial ownership interest in three major coal-fired powerplants in Arkansas that normally burn a total of over 400 - I mean, excuse me, 14 million tons of PRB coal annually.

As described in our written submission, we are interested in URCS because of the way variable costs calculated by URCS may determine the outcome of a future rail rate case.

Two of our three coal plants are captive to only one railroad. The possibility of bringing a rate case to ensure the reasonableness of rates there is an important option for us.

Back when rate cases allowed so-called movement-specific adjustments, we didn't have quite so much reason to be concerned about URCS. We knew it was out there and were vaguely interested in it, but I really felt like if we did have a rate case at some point, that the outcome probably would not be determined by URCS calculations.

When the Board ruled out those adjustments, we knew, in a general way, that URCS was becoming more important to us.

However, the thing that really brought URCS' issues more to our attention was the Board's decision in the Kansas City Power and Light, Montrose case.

One of our powerplants, the Independence powerplant, is situated very similarly to the Montrose plant in that it served at destination by the Missouri & North Arkansas Railroad and receives PRB coal from Union Pacific through Kansas City.

When we looked at the Montrose case, we were struck by two things. First, the parties stipulated that the 180 percent revenue-to-variable-cost ratio would determine the rate. So, the outcome of the case rested on URCS rather than on the standalone cost issues.

Second, the numbers that came out of the unadjusted URCS appeared to be quite a bit higher than we expected, and perhaps than you would expect if you took results from older rate cases that permitted the movement-specific adjustments and escalated them to reflect price inflation.

Some of those details regarding this are contained in our filing in Ex Parte 681, you know, which we didn't repeat as instructed by the Board. But basically, we found that the use of unadjusted URCS, we believe, leads to an artificial rate premium of about $4.50 per ton.

If you just use that estimate for our two captive plants in which we have an interest, that translates to about $36 million per year in rail rates that rest entirely on the þ or it could rest entirely on the inaccuracy of the URCS cost.

Further time and investigation is going to be required to dissect and remedy the specific sources of the cost-over statement that appears to result from the use of unadjusted URCS for PRB coal traffic.

In the comparatively short time available for parties to prepare written comments in this proceeding, we did not go very far into the nitty-gritty details and specific problems and their solutions.

The effects of the short time frame were compounded by the scarcity of available documentation of the URCS regression models. We looked for documentation on the Board's website and several other sources, all without success.

We also submitted an inquiry to the e-mail address specified by the Board for URCS questions, but so far have not yet received a response.

If we're going to fix what's in the black box, we need to be able to crack it open. Transparency is very helpful. And for these black box-type programs, you literally have none.

Even without getting into the details, we think the big picture view provides plenty of important information regarding the types of URCS improvements that are now needed.

At the time URCS was developed, it was probably reasonable to view costs in terms of system averages, and deviations from system averages þ and the deviations from system averages associated specific types of traffic such as intermodal and unit-trains.

However, since the 1980s there's been so much technological innovation and volume growth in different traffic segments, that the whole URCS framework needs to be revisited.

Intermodal has undergone explosive

growth and relies heavily on specialized equipment, facilities and operating practices to produce a premium product with unique cost and service attributes.

Likewise, unit-train movements, particularly those involving PRB coal, have evolved to a point of heavy-haul productivity that is generally not achieved by other types of traffic.

This environment is difficult to make sense out of system-average costs without accounting carefully for the mix of different traffic types that are moving.

As a starting point, AECC suggests revisiting the URCS regressions and attempting to introduce new model specifications that permit the direct estimation of variable costs for different traffic types.

And parallel with this type of effort, the Board should revisit the unit-train adjustments currently used in URCS with the idea of adding categories to reflect different types of multiple car and unit-train movements.

Hopefully, at some point þ excuse me þ URCS can stop charging AECC and other shippers for car costs when we already bear all the costs of owning and maintaining the fleet of cars used to move our traffic.

Just making a quick calculation on the back of an envelope, PRB coal alone accounts for somewhere around 25 percent of all U.S. revenue ton miles in rail traffic.

As happened most recently in the OD&E Muskogee case, it seems likely that URCS is going to determine the outcome of many rate cases involving PRB movements along high-density trunk lines. And from what we can see, the impacts of URCS' costing inaccuracies in individual cases, can be quite large.

Under these circumstances, it is reasonable for the Board to put significant effort into making sure URCS is valid and accurate.

I appreciate this opportunity to participate in the Board's review of URCS' issues, and look forward to answering any questions you may have.

ACTING-CHAIRMAN MULVEY: Thank you, Steve.

Mr. O'Connor.

MR. O'CONNOR: Thank you. Good to be here, Chairman Mulvey, Vice Chairman Nottingham, and let's see if we can put some slides up there. You have copies of the slides before you on the panel there.

I'm here presenting testimony this morning that's sponsored by the Edison Electric Institute, National Grain and Feed Association, National Industrial Transportation League and the American Chemistry Council.

And we'll be focusing on two things, all of which is based on the testimony that's already been provided to you, the guiding principles that we would suggest for your consideration in any review of URCS that you might undertake, and we'll talk about some of our key findings.

Let's go to the guiding principles first. URCS and its predecessor, Rail Form A, have a long history. We'll talk a little bit more about that on the timeline on the next slide, and we would offer these three principles:

Because URCS is a highly-technical matter, a revision of URCS will require significant resources to be expended by the Board.

If the Board decides to initiate a revision of URCS, it must commit to a review and possible revision of all aspects of URCS. A piecemeal or a partial revision would not be appropriate.

And the third guideline is if the Board decides to initiate a revision of URCS, that effort must be transparent and the Board or its contractor must make its data, analyses and work papers available to the public.

And of course that can greatly increase the power of your analysis. The alternative, of course, would have the various bodies basically duplicating that analysis.

Let's look at the timeline, and you might hear a little bit more about some of these events today. This rail costing timeline, a certain chunk of which traces fairly accurately my own career, goes back all the way to 1907, Rail Form A came onto the scene in 1939, the statistical studies in Rail Form A source back to 1972, the new IC system of accounts in 1978, and that begins the movement towards URCS which is continuing up to and including this proceeding today.

The three phases of URCS we have presented on this slide, this kind of shows you the reason why we're urging that if you look at pieces of it, you really have to look at all of it.

URCS Phase I is where the

regression analyses and estimates of cost variability are produced, and they have an affect that permeates the rest of URCS in several different ways which we won't get into in detail today. But once the regression analyses are determined, to a large extent the result of URCS Phase III has been determined.

So, the whole thing has to be viewed as an integrated process. And if you revise it, it needs to be reviewed in that regard.

The URCS issue as identified by the STB, we've covered all of these issues in my testimony. And I won't repeat that testimony here today, but we'll talk about one or two of those issues.

The next slide is þ here's the issues. And the next slide we are calling attention to some of the 1960 source documents that are now in URCS, and this is a point on which there's broad agreement. I mean everybody recognizes this.

The statement STMT 763 which you see there on the source column and it appears seven times, that happens to be the manual version of Rail Form A, is what that document is.

And if you would like to see an actual copy of that, I happen to have one in my archives. I think that was one of the few remaining copies.

That was what was done and how Rail Form A was handled before it was computerized, which occurred in the mid to late `70s here at the then ICC.

And you can also see on that chart, that there are seven references to another source document that happens to deal with TOFC/COFC which goes back to 1969.

So, there are --- this is what you'd call a target-rich environment in terms of is there anything to review.

Some of the areas affected on the next slide by the Rail Form A costing factors and studies, the efficiency adjustments associated with unit-train, and we heard a little bit about that from Steve Sharp and his remarks, that goes back to Ex Parte 270, Sub-4, which dates back to 1974, those same factors are still being used today.

They were applied broadly in Rail Form A, they were moved over into URCS, and are still being used today.

Historical studies such as equated switch factors and at the next level down in that analysis, we find that there are certain types of switches there that are allotted portions of the minutes that are recorded, and the actual switch type has pretty much disappeared.

I'm talking about intra-terminal switches and inter-terminal switches, very short distance moves, where you would make the entire move as a switch move. It may have been part of the railroad practice then, but it's pretty well disappeared now.

I&I train switch frequency non-intermodal, is still going back to the Rail Form A study. That's one every 200 miles.

Now, here is -- these are examples where you could easily take a piecemeal approach, but we'd recommend against that.

There will be some things where you could get broad agreement, and fairly easily get broad agreement, that some of these factors need to be updated, but we have to bear in mind þ let me just go back to the structure of URCS.

We have to bear in mind that at the I&I switch level, you're down at URCS Phase III, whereas much of the result that you're dealing with in URCS Phase III, has been determined in URCS Phase I, the regression analysis.

Parenthetically, at that time I participated in that regression analysis as part of the team for the AAR. I don't recall, however, whether I kept any work papers.

Let's take a look at Factor Number 12, moving back through the course of the presentation. You asked for comments on whether the Rail Cost Adjustment Factor would be a suitable means of updating URCS' costs, and it þ the data that we're looking at suggests that it would be a logical candidate.

The Rail Cost Adjustment Factor is frequently used in negotiations and other rate-related matters. The Rail Cost Adjustment Factor is based on data assembled by the AAR largely collected from the railroads.

And of course as you're well aware, it's reviewed and adjusted as appropriate by the STB on a quarterly basis. So, it gets a lot of attention and has slowly changed in some respects over the years.

Now, if you look at the blue line, the blue line is the Rail Cost Adjustment Factor unadjusted for productivity. Of course in 1989, RCAF-A, the Rail Cost Adjustment

Factor adjusted for productivity, was adopted, and that was with the active participation of the railroads and shippers and the advice of the Rail Accounting Principles Board.

At that time, I served briefly as a consultant to the Rail Accounting Principles Board.

And what I see there on initial inspection, looks like a long-term declining cost curve.

Now, that certainly isn't conclusive analysis to be sure, but it does suggest the potential for revisions to variability estimates because we're looking at a 20-year pattern there of data that has been reviewed thoroughly.

On the next slide, we're considering your Item 13, the statistical relationships used in URCS.

We think this is the single most powerful issue that's identified by the STB, and it could generate a significant change in the estimation of railroad costs.

Parenthetically, when we consider the role of URCS Phase I, if I can move back to that slide, in URCS Phase I we not only are determining variability, we're determining cause and effect. We're determining what are those dollars associated with? Are they associated with gross ton miles, car miles? What is the service unit they're associated with?

The service unit that they were associated with also moves over into URCS Phase II, and the several successive stages of URCS Phase II tend to be informed by the relationships that were developed in Phase I.

So by the time you get to Phase III, you have made knowingly or unknowingly, lots of decisions that are going to determine your Phase III outcome.

So again, it's an integrated process. You have to look at the whole picture. That's our advice.

And in -- let me move ahead to the slide we were on. In RCAF-A, again we have a 20-year declining cost pattern, appears to be a declining cost pattern, and it suggests the potential for revisions to the variability estimates.

Any revision of URCS especially in this area, must be transparent. And we just heard one of the reasons why.

The Board or any contractor employed by the Board, really has to be effective, make its data, analyses and work papers available to the public. And that will help you do your job as well.

So, let me conclude with the guiding principles that shaped this testimony, and I have adopted these guiding principles. These principles came from the four trade associations that sponsored the testimony, and I adopted them in my testimony that has been provided to you.

And just to reiterate, because

URCS is a highly-technical matter, a revision of URCS will require significant resources to be expended by the Board. If the Board decides to initiate a revision of URCS, it must commit to a review and possible revision of all aspects of URCS. A piecemeal, a partial revision would not be appropriate.

If the Board decides to initiate a revision of URCS, then it must be transparent for the reasons we've discussed. The Board or its contractor must make its data, analyses and work papers available to the public for comment.

And that concludes my prepared remarks today. And I appreciate, again, the opportunity to be here.

Thank you.

ACTING-CHAIRMAN MULVEY: I want to turn now to Mr. Fauth. You're the third speaker on the list. Sorry, John, but I have an order of speakers here.

MR. LeSEUR: I know.

MR. FAUTH: Hello. All right. Thank you, Chairman Mulvey and Vice-Chairman Nottingham, for holding this hearing and allowing me time to speak.

I'm here on behalf of the various wheat and barley commissions. I'm joined here also today by Terry Whiteside who represents those commissions in Montana, Colorado, Idaho, South Dakota, Nebraska, Oklahoma, Texas and Washington.

One cannot dispute that URCS needs to be looked at again. It's been really 25 years since it was all developed, and the industry has changed. It's consolidated, it's become more efficient, and those changes could be reflected in URCS.

The DOT says that URCS needs to be reformulated. And it also says that the issue here is the accurate measurement of those URCS costs. And I agree that the issue should be the accurate measurement of cost, but I don't necessarily agree that URCS needs to be completely reformulated to achieve that end.

There are many things you could do, you the Board could do, without changing URCS at all to improve its accuracy.

One of the things I think Chairman Mulvey was quoted as saying, that fixing URCS is no small undertaking, and I think we all agree with that, but I think fixing URCS depends on a great deal of how the fixing is done and who is doing the fixing.

In that regard, I have suggested that if you do move forward and get Federal funding to help you with this process, that you create an independent panel of experts to take charge of this issue.

I have in my statement, and I won't read it all here today, but I've suggested some improvements that you could do without changing URCS that would greatly improve its accuracy.

Number one, allow additional adjustments. The only adjustments that are allowed right now are the 270 adjustments, the make-whole adjustments which increase the cost, and we're allowed to adjust the circuity factor to one when using actual miles, but the Board's URCS Phase III program is much more flexible. It's the Board's rules that only allows to make those adjustments.

The URCS Phase III costing program has like 45 different parameters that we could adjust to make URCS more accurate.

For example, using actual switch engine minute costs instead of the URCS adjusted switch engine minute costs, or using actual train characteristics instead of the URCS average train characteristics.

And these -- The word "movement-specific adjustments" kind of became a dirty word, I think, in some of these coal cases where they used very technical adjustments to develop maintenance costs and other things.

URCS was designed, the Phase III program, to allow the user to make adjustments. It's you, the Board, that doesn't allow us to make adjustments.

The second point I've pointed out is the inclusion of nonrecurring special charges of URCS. By including those charges, it can greatly inflate the URCS unit cost. And the Board's policy, I believe, is that those special charges should be excluded, but it's very difficult to know what a special charge is.

There's nowhere in the Annual Report that says this is a nonrecurring special charge. That's very difficult for the Board's staff and even somebody who looks at annual reports like me, to figure out which is a nonrecurring special charge and which is excluded, but it can add hundreds of millions of dollars to the cost and to the results.

My third suggestion is to improve the make-whole adjustments. The make-whole adjustments have a lot to do with not URCS, but the waybill sample. The make-whole adjustments are primarily based on the waybill sample, and there's a lot of things in the waybill sample that need to be audited and corrected and adjusted that could improve the make-whole adjustments.

For example, there are over 3,000 records in the waybill sample that have no costs at all. So when you're making whole the total cost, those zero cost records essentially get allocated to somebody else because they're not allocated to those movements. And a lot of these are Canadian shipments and other traffic.

There's also a problem in the waybill sample with so-called re-bill shipments. For example, wheat moving east going through Chicago will show up sometimes as a movement to Chicago, although it might be destined to New York.

So, it essentially shows up as two records in the waybill sample, Montana to Chicago, Chicago to New York and essentially gets two terminals added because you cost it as an origin and a destination, and an origin and a destination again.

So, there's some improvements in handling the waybill sample that would improve URCS and make it more accurate.

Another suggestion I've had is segregating fuel costs and improving the Phase III costing program to show a fuel cost line item and also input for -- an input for the fuel surcharges.

As you know, fuel surcharges have become an increasing amount over the years and there's nowhere in the URCS printout that you'll see what the railroad's fuel cost is. It's included in gross ton mile cost, locomotive unit mile cost and switch engine minute cost.

And if you segregated that and had a line item for fuel, it would allow shippers the ability to evaluate the fuel surcharges and the railroads, more accurately. And it's not a big deal to do, I wouldn't think, to reprogram that.

My fourth þ fifth suggestion is there's some minor adjustments in the URCS Phase III program that you could make. One thing that some of the members of the wheat and barley commissions have had problems with is when you use actual miles and you're costing a multiple-car movement, the URCS Phase III program automatically adds a circuity factor.

For example, in the case of Burlington Northern covered hoppers, it adds a circuity factor of 12.6 percent to the actual miles. So, it automatically inflates the cost and assumes that circuity is added.

The circuity factor -- when URCS was designed, it was designed based on short-line miles which were published miles. And then when you use short-line miles, the circuity factor would be used. But most people have access to actual miles, and the added circuity factor adds to that.

So, there's some minor adjustments in the URCS Phase III program itself that you could do to make things more accurate.

I have other comments on the Board's process, but one other point I wanted to point to is without the flexibility of making adjustments, it really can distort the picture of some movements.

And we have a specific example in my testimony where the railroad has switched from 52 cars to 48-car tariffs, and because there's a default value in URCS which assumes that anything under 50 cars is multiple-car and anything over is a unit-train, and by doing so by making that switch, the cost should not be so different when you're just moving four less cars.

In fact, the railroads aren't moving four less cars, they just changed the tariff to say four less cars. But when you cost 48 versus 52, it takes the revenue-to-cost ratio from, effectively, 268 down to 158.

So, this effectively deregulates the traffic because you're taking that traffic below the jurisdictional threshold.

So, it's because the rigidness of your policies that won't allow us to adjust for the actual train characteristics. And the railroads are taking advantage of that and effectively it takes that ratio down over a hundred percent. And I have a graph in my testimony.

Anyway, those are my only comments and I'd be glad to answer any questions that you have.

ACTING-CHAIRMAN MULVEY: Thank you very much, Mr. Fauth.

Mr. LeSeur.

MR. LeSEUR: Chairman Mulvey, Vice Chairman Nottingham, I am John LeSeur. I'm appearing here today on behalf of the Western Coal Traffic League, the National Rural Electric Cooperative Association, the American

Public Power Association and Seminole Electric Cooperative. I'll refer to these shippers, these organizations, as the coal shippers.

Coal shippers have submitted a written statement for the record. This morning we want to highlight three points that were made in that statement.

First, coal shippers believe that a comprehensive review of URCS is premature at this time. Any such review will be very expensive for shippers, railroads and the Board.

Chairman Mulvey has estimated the Board's cost alone will be in the three to $4 million range.

At a minimum, coal shippers urge the Board to defer a comprehensive review of URCS at least until such time as Congress has decided whether it will fund the Board's efforts.

Coal shippers further urge the Board to consider deferring asking Congress for URCS funding until the Board has had the opportunity to see whether the new maximum rate standards the Board has adopted for application in small, medium and large rate cases are being used. And if they are being used, whether they're working as the Board intended.

The Board's URCS review appears to be motivated in large measure by the increased role URCS plays under the new maximum rate standards.

Coal shippers suggest the resources of all involved, the shippers, the railroads and the Board, could be better served by first waiting to see whether these new standards are working before focusing so much time and effort on a costly review and fine tuning of one component part in these standards.

Second, the Board has asked the parties to comment on how URCS can be improved. Coal shippers are not in a position at this time, to meaningfully respond to the Board's inquiry.

To properly answer this question, coal shippers need to undertake a substantial, costly and time-consuming effort to review the current URCS model, to obtain relevant data that might be used to test the model procedures and factors, analyze that data, and then if coal shippers determine that better procedures or factors could be developed, to develop these factors or procedures and present the results to the Board.

Third, if the Board does decide to go forward now with a review of URCS, coal shippers request the Board adopt some principles to guide its review, including the following: the Board will undertake a comprehensive review of URCS, not a parse and piecemeal review of isolated portions of URCS.

The Board will create a level playing field by giving shippers access to all relevant rail carrier data and specialist studies. If the Board's goal is to make more accurate cost determinations, the Board will reconsider its decision to eliminate movement or route-specific cost adjustments in coal rate cases.

And finally, the Board will measure its regulatory costing standards and procedures against the costing standards and procedures actually utilized by major rail carriers today.

Coal shippers appreciate the opportunity to present their views this morning.

Thank you.

ACTING-CHAIRMAN MULVEY: Thank you very much, John.

I want to start out with having a few questions. Then I'll turn it over to Mr. Nottingham, Vice Chairman Nottingham, and we will go back and forth until we have exhausted our questions.

Mr. Sharp, you mentioned about

sending us an e-mail about this hearing on URCS over the last several weeks, but we have no record of having received an e-mail from you.

You know you can always call our Office of Public Assistance and Government Affairs and Compliance at 245-0245, and they can answer any inquiries that you or the public has. They have been very, very responsive.

And so if you have an issue on this, please contact us and we will be responsive. I promise you that.

Starting out again with you, Mr. Sharp, in your testimony you indicated that a revision of URCS would likely benefit coal shippers. And many of the changes that you would make in URCS to reflect modern railroading, would probably have the result of benefitting the coal shippers in terms of their variable costs.

Would you say that's an accurate

assessment of your testimony?

MR. SHARP: Yes. We believe that just as far as the URCS analysis, in other words the numbers, the costing numbers you would get out of URCS, we believe if URCS is revised, that they would be lower.

ACTING-CHAIRMAN MULVEY: To what extent would that simply result in overall railroad costs being shifted from coal shippers to other shippers, or do you think that the total variable costs that need to be allocated would also come down, or would it be largely a shifting of the costs between groups, or would there be some reduction in overall costs that need to be allocated to shippers?

And that's for you or anybody else who wants to answer that question.

MR. SHARP: Well, I'll start out. Others may want to jump in on that, but I mean it's really sort of outside the scope of what we were looking at.

I mean we're, you know, specifically looking at URCS and what we think would need to be changed in URCS to make it more accurate, more accurately reflect the costs that the railroads actually have.

And then when you start looking at, you know, what's the þ if that does lower the calculated cost of shipping these unit coal trains that represent a lot of the tonnage, you start looking at what's the effect on the cost structure of the entire rail industry and where do the costs go.

So, that would be something to yet be determined by the Board perhaps in other proceedings.

But as far as just looking at results that have come out of URCS now that we're seeing some of these rail rate cases depending on URCS for their outcome rather than standalone rail costs or some other type of calculation, we're becoming more sensitive to some of the inaccuracies. And can see from what, you know, from the Board's notice, that there are some things here that could be fixed to make it more accurate.

ACTING-CHAIRMAN MULVEY: Anyone else want to touch that?

Tom?

MR. O'CONNOR: Thank you, Chairman Mulvey.

We touched on the reallocation of costs that might flow from a lower cost from coal. So, there's several subjunctives there.

We haven't done the studies to indicate whether a revision would result in lower costs for any particular commodity. But let's take that þ let's take your question as a hypothetical and move to the issue of make-whole, which is really what you were discussing what happens to the costs if the coal costs go down, do other costs go up.

Now, the time-honored or at least traditional means of dealing with that situation has been the make-whole factor. And the make-whole factor comes about out of a general rate increase period.

Now, I'm going to go back in my career to when I was AVP of economics for the Association of American Railroads, and I happened to have that position when we were in a general rate increase period. And then when we deregulated, then moved into the current period, and here is the rationale as I understand it for the make-whole.

The make-whole was developed so that when you applied the cost reductions that flow out of Ex Parte 270, Sub 4, which came about in 1974, and it engendered significant cost reductions for unit-trains, for example, the question before the rail industry was we still experienced those costs and we are going into a general rate increase with a cost justification for it.

And it would frequently be the case that we'd have a general rate increase every four or five months because costs were going up. That prompted the next general rate increase.

So, the mechanical problem was if we're applying Ex Parte 270, Sub 4, we still spent that money. How do we get that back into the process? That resulted in the make-whole factor.

And the make-whole factor is basically þ let me hazard -- let me take an additional step and let me say an arbitrary allocation or reallocation of those cost savings to other movements.

So, that's the genesis of the make-whole factor that still persists to this day when we are no longer in a general rate increase situation, but that's where it comes about.

This would be one of the things that if you were to do a comprehensive review of URCS, you could consider the following question: How, for example, does the cost increase for a single-carload non-coal shipper when we calculate the unit-train cost reductions for the coal shipper, how do the þ how do the costs somehow shift from the powder river basin to Houston, Texas from a unit-train to a disconnected, unrelated, single-carload shipment in Houston, Texas? That would be a good question to ask.

But what we are þ what we are doing now is we're bound by tradition. And in the current systems, make-whole is something that we deal with. But I'd be hard pressed to come up with a solid economic rationale for it, but there it is.

Again, this is the reason for a comprehensive review.

ACTING-CHAIRMAN MULVEY: Well, I was going to get to that. There's three possibilities.

There is an incremental, a piecemeal approach to finding the things that are most egregious about URCS, the studies that are most needed and most out of date at least reflective of modern railroading; two, there's going back and doing everything in URCS, redoing URCS and having a new URCS with everything looked at and everything changed that needs to be changed; and then finally, there's a possibility of scrapping URCS entirely and come up with some other sort of costing formula.

Does anybody want to chime in on the feasibility of the þ especially the last of those three?

MR. O'CONNOR: I'll take that.

I have some experience with creating a cost system from a blank piece of paper. I have looked at that situation in Canada, and I have looked at that situation for one of the major railroads when I was with Conrail.

And, in fact, we created a management-based costing system and it was definitely not a trivial exercise, I can guarantee you that, but it tended to follow the structure that we sketched on that one slide where you begin with regression analysis, and then you begin with various other types of analysis, and you're doing your best to determine what caused this cost to be incurred.

And some of them I think are going to be fairly straightforward. We know that that crew was on that train, we know that that fuel was burnt, you know. We might even know it was burnt on that train.

So, you're going to get some costs that are going to be directly assignable, you'll get other costs that are going to be reasonably well-behaved. And if your records are good, you're going to get decent regression results out of it, but it's entirely possible that most of your costs are going to be in the next category. They don't have produced good regression results, so now you're into empirical analysis. This is really where you need to have a transparent process.

I would not speculate at this particular point if you were to take that course of action, exactly what the result would be. But I can tell you that when I have done that, I have come to something similar to the regulatory costing system. Something similar to it because you're describing the same industry. And it's an industry replete with joint and common costs which have to be dealt with.

ACTING-CHAIRMAN MULVEY: Anybody else want to try to address that question?

Mr. LeSeur, your group, you were the only person not only in this group, but in all the testimonies that were received, you were the only ones to suggest that the Board postpone or not move right now, suggesting that we wait until we see what the experience is with the simplified standards and the streamlined guidelines for large rate cases.

Well, we are already getting

experience with that. We have already adjudicated cases in both of those areas. While they are at appeal, they are being done.

And it does seem that we are getting that experience, and I'm not sure that that's a particularly good reason for postponing it further.

Finally, and secondly, Mr. Sharp indicates, and I think most of the testimony indicates, that coal shippers would very likely be the ones who might benefit from redoing URCS taking into account modern railroading.

So given that, you feel comfortable still saying that we should postpone this?

MR. LeSEUR: I think if the Board would stipulate that the variable costs for coal movements would go down, we might have a different position.

(Laughter.)

MR. LeSEUR: But we, the groups we

represent, we don't have access to any data to say that that's going to be the case. I mean this is a very complicated process.

Anybody who went through it the first time around knows how complex and how expert-driven this exercise is. And our experts today can't, you know, say that costs are going to go down or go up.

It would depend upon the types of studies that you do, it would depend on how extensive those studies are.

So, I think at this point, you know, it's extremely difficult for anybody sitting in our position to know what the answers are going to be.

That's one of the reasons why you undertake analysis, is to determine what the answers are.

Insofar as your experience is concerned, I think you've had one, in effect, small rate case, you haven't had any medium-sized cases, and you had a couple of large cases and one standalone cost decision.

You have to understand from the standpoint of the shipping community, you know, one of the things that's very important is just kind of know what the rules are and it affects sometimes what the answer are going to be.

And to the extent that you start to go in and basically create a lot of uncertainties to, you know, one huge component, you're creating uncertainty within the community.

And for our part, you know, coal shippers and other shippers have been through three or four, maybe five years, where the standards were up in the air.

And when the standards are up in the air, it's hard to know how to advise your clients, clients don't know what to do, they don't know what the answers are here.

And when you reopen URCS particularly on some type of comprehensive basis, you know, you're creating a lot of upheaval and folks won't know what the answers are again.

And our position basically is we've been through a period of a lot of upheaval, you have had a few cases, you haven't had a lot of cases, take a look, see where the answers are coming out, how things are going, and at that point if you think URCS is where you need to focus all your time and attention insofar as the rate cases are concerned, then go ahead and do it.

ACTING-CHAIRMAN MULVEY: I wouldn't say we're focusing all of our time and attention there, but it's certainly a major concern.

And in your testimony, you do admit that a revision of URCS is needed and your question was more of a timing one. And you also suggested that the Board secure funding from the Congress before it went forward.

And as I have said, we are trying to get the Congress to pony up some of the money to get this thing started. It will take several years.

And so the sooner we get started on this, I think the better off we're going to be. If we wait several more years, it will be a decade before this thing is put into place assuming that it takes three or four years to complete the analyses. And then of course it will be challenged in the courts, as everything else is.

And so by the time it finally goes into place, it could be half a decade or more from now.

MR. LeSEUR: I think in terms of what we said in our comments, just for clarification, we agree with the Board that you want to develop accurate costs. I don't think anybody disagrees with that principle.

I think that the only way you can determine whether the current system is now producing accurate results, is to go through the exercise of collecting data, running all the analyses. And you may find in the end that the answers that are, you know, coming out of URCS after you make all these changes, aren't much different than what you have today.

Our basic position is, you know, we don't know the answers until you go through the exercise.

ACTING-CHAIRMAN MULVEY: But clearly we can't make the exercise to make things more accurate dependant upon whether we get an outcome that we like, but I think we want to make it as accurate as we possibly can.

And I think we've made other changes in the Board. For example, it was at the behest of the Western Coal Traffic League that this Board undertook a review of how we calculate the cost of capital, especially the cost of equity capital.

And the coal shippers were very active in putting resources forward and helping the Board look at that and make the changes. And we appreciated that. And we have made changes.

Again, we think that our new cost of capital estimate is a better measure and it's a more accurate measure than the one that we had before.

And I think this is part of a long process that we are trying to get as accurate measures as possible, cost of capital and anything else this Board does.

Do you want to ask any questions, Mr. Nottingham?

Thank you.

VICE CHAIRMAN NOTTINGHAM: Thanks, Acting-Chair Mulvey. I'll be happy to ask a couple questions. Thanks, panel. Welcome.

Mr. Sharp, thank you for jolting me to attention. Nothing gets my attention more than a public claim that the STB is not being responsive to routine inquiries for public information.

I think if I recall, you and I have chatted about that personally before where I reached out to you to express my concerns and my interest in making sure you had full access to the Board and I want to reiterate that.

Could you just recount what you have not þ what you've asked for from the Board that you've not received, when you asked for it, and who exactly asked for it?

I didn't see it in your written testimony. So, I just -

MR. SHARP: Right. I do not recall the specific dates. We can provide that to you.

But our consultant who was running the analysis of URCS for us, Mike Nelson, is the one that sent the e-mail to the e-mail address that was suggested there, and didn't get any response.

And part of the reason we didn't contact you all by phone, there again, was just the short lead time of the proceedings. I mean we got to a point where the last few days there, you know, we wouldn't have been able to do anything with it.

But we will do that. We'll follow up with a phone call.

VICE CHAIRMAN NOTTINGHAM: If you could, please, get to us what you're looking for, and also to help us address any potential problems we may have internally getting back to the public.

I've spent, and I know my colleagues on the Board have too, we've made exhaustive efforts to make sure that we are more transparent, more accessible, using websites, using the telephone.

Please, my direct dial, (202) 245-0200. If there is ever þ let me say this: If there's ever a time when you are not getting public information or responses to inquiries of the Board, please call me.

MR. SHARP: Okay.

VICE CHAIRMAN NOTTINGHAM: The most efficient way is probably to call the number that first that the Acting-Chairman gave you, the 245-0245 number, which is our Office of Consumer Assistance.

But if you don't have þ if you have any trouble getting response there, please call because we've þ I've reached out to you personally two years ago, going on memory here, called you to say hey, I understand you may have had a problem with responsiveness or the type of response you've received in the past, I want to correct that, I want to make sure that never happens again.

And to hear -- and then, frankly, a year or so later you went up to the House Transportation Committee and publicly recounted the same old episode from a previous þ under a previous Board where you were concerned you didn't get the responses from the Board.

I just þ I worry that you have a tendency to come into public forums and want to lambast the Board's professionalism or responsiveness. And maybe I'm a little sensitive on this, but I'm starting to see a pattern here. I mean let's just keep communicating as best we can.

If you could, please give us who asked for what, when, and then what you need, and we'll make sure -- now, let me understand. Was this in the context of a rate case that you were not a party to?

Did you say this was the KCPL UP case that you were kind of tracking for your own þ

MR. SHARP: We were just tracking that. We're basically looking for information on URCS. Like I said, this is not þ and part of the reason we didn't call the customer service number is this þ I mean it's a þ this is an URCS-specific kind of an issue.

I mean it's not, you know, it's not the kind of thing where we've got a problem with the railroads, we're going to call the STB.

We were trying to get information about URCS. And it says there, you know, if you got a question, send this e-mail to this address. And we did that.

VICE CHAIRMAN NOTTINGHAM: It says where, what?

MR. SHARP: I'll get the specifics to you.

VICE CHAIRMAN NOTTINGHAM: Okay.

MR. SHARP: I don't have that with me at this time.

VICE CHAIRMAN NOTTINGHAM: But, please, any -- no matter what the topic, if it's an inquiry that depends on the STB to provide you with something, please call the number we've given you or call either one of the Commissioners' offices.

MR. SHARP: Sure.

VICE CHAIRMAN NOTTINGHAM: I have every confidence we'll get right back to you assuming the information is not privileged. And if it is, we'll explain why.

But now the case you þ

MR. SHARP: Part of the problem was just the time frame. Like I said, you know, there was þ by the time we got to this point of starting to wrap things up, we realized we didn't have that and -

VICE CHAIRMAN NOTTINGHAM: Was this information important to you?

MR. SHARP: I think it would have helped us preparing for this presentation.

VICE CHAIRMAN NOTTINGHAM: For today's presentation?

MR. SHARP: For today's presentation.

VICE CHAIRMAN NOTTINGHAM: But it was important, but not important enough to pick up the phone and call someone about it or to follow up or þ

MR. SHARP: Well, we just ran out of time.

VICE CHAIRMAN NOTTINGHAM: I didn't see it mentioned in your written testimony at all and I just þ now, the case you were tracking that you mentioned, the KCPL UP case, I can understand the point that when parties mutually agree to resolve a case based on the 180 percent of revenue-to-variable-cost ratio, that it could accentuate the reliance and importance of URCS. That's a good point.

I will note that was a shipper victory, if I recall. It also was a shipper victory with substantially reduced timelines and attorneys' and consultant fees.

And so, I hope you're not holding that type of case up as a problem example as, you know, if it is, I think we've come a long way from when I came to the Board. We weren't complaining about shipper victories in record time at record-low expense.

But if you want to amplify what

your þ do you have a problem with the fact that those two parties and the shipper agreed to address that case that way and that it resulted in a shipper win?

MR. SHARP: No. And I'll expand on that a little bit.

And like I said, we appreciate the fact that these cases can be simplified and can be dealt with in a short time frame.

But the point is prior to movement-specific cost adjustments not being used and prior to that type of result in a rate case, we weren't all that concerned about URCS because it wasn't likely going to be the determining factor in a future rate case that we might be in. So, I mean that's the point.

The point's not that we have any problem with, you know, with the direction things are going. But the direction things are going puts more of the specifics of what your rate is going to wind up being in the hands of URCS, which is pretty much a black box.

And that's where we say we were þ we're trying to understand as much as we can about URCS.

And Tom O'Connor here talking about his long history and involvement with it, probably has a lot more insight to it than myself and the consultant that we were using who were þ we were not involved in the development of it and don't have some of the source documents in our files. And just reaching and not being able to find some of those things on short notice, like I said, that's really kind of the problem with that that we were kind of pointing out.

We like the fact that the cases can be done with a lot less time and a lot less detail. And we like the concept that the Board has put forth here that the Board feels that URCS needs to be revised to reflect current rail costs.

Like I said, there may be other

problems, as Chairman Mulvey has pointed out, that that results in. But just in that narrow context, we're glad the Board had this proceeding and certainly don't have any problem with the way that the rate cases in general are going.

But it does wind up putting a lot more emphasis, in our minds, on URCS.

VICE CHAIRMAN NOTTINGHAM: I understand. Thank you.

Mr. LeSeur, I wasn't sure if you were completely serious, but did I hear you say that you'd be happy to move forward with a comprehensive review and improvement of URCS as long as we could stipulate that your clients would benefit?

MR. LeSEUR: Well, that wasn't þ

VICE CHAIRMAN NOTTINGHAM: Are you seriously saying þ I mean is that þ

MR. LeSEUR: No, that was not -- that was a joke.

VICE CHAIRMAN NOTTINGHAM: Okay.

MR. LeSEUR: Everyone was þ

VICE CHAIRMAN NOTTINGHAM: I have a sense of humor too. I just want to make sure I know to distinguish between what's þ because I mean we are þ this is -- obviously, if we þ I mean who are we kidding?

If we take on a comprehensive review of URCS, someone is going to possibly be paying higher rates, someone at lower rates. And if the going-in sort of assumption is that if anybody ends up paying a higher rate, then it's a flawed process no matter who we get to bless it as being completely objective procedurally and transparent, I mean, you know, it makes it kind of hard to get excited to launch off on that journey if that's going to be the reward we get.

MR. LeSEUR: We haven't said anything about what the outcome of the proceedings þ other folks have been saying that the variable costs in coal will go down, and that was þ

VICE CHAIRMAN NOTTINGHAM: And I don't know that for fact. That's þ

MR. LeSEUR: Either do we.

VICE CHAIRMAN NOTTINGHAM: I think that would be þ

MR. LeSEUR: That's why I'm always asking a question about that. So, that was our, you know, our response to a question which was, you know, why don't you want to go forward if the variable costs on coal will go down.

So, that was the repartee there.

VICE CHAIRMAN NOTTINGHAM: Thank you.

Mr. O'Connor, are you familiar -- how familiar are you with the railroad property investment piece of the puzzle, the fixed costs versus variable costs, and the fact that for many, many decades that there's been kind of a rough compromise that that should be apportioned 50 percent, 50 percent; 50 percent of a railroad's real property should be attributed to fixed costs, 50 percent to variable?

That would seem to me, to have the effect of keeping their costs from an URCS vantage point, lower, but what's your sense of the expert community's opinion on the accuracy and sort of how that has stood the test of time as far as that 50/50 split?

MR. O'CONNOR: Sure. The 50/50 split -- we've been talking to some extent about things that were analyzed in the past. And time has passed since that analysis. I'm talking now about like the Rail Form A regression analyses going back to 1978.

But even during that period, to the best of my knowledge, there was no regression analysis of the road property investment. And that would be a good candidate for running a regression analysis and see what the data tells you.

The 50 percent, I really don't know what is behind that, although I've been familiar with it for decades. It was in place when I first entered this profession.

And one of the first things that I did when I was an economist at the ICC, was to write a report on the cost evidence that was brought to bear in various ICC decision-making processes, and it kind of sprang from Ex Parte 270, Sub 4.

So, I came across the fact that we had a 50 percent sort of assumed variability there and it caught my attention, but I didn't delve further into it then.

That would be a logical thing to take a look at. I wouldn't presume that the answer would be up or down, but that particular piece of data should respond reasonably well to a regression analysis.

MR. LeSEUR: Can I just add something on that?

VICE CHAIRMAN NOTTINGHAM: Please.

MR. LeSEUR: The 50 percent that you refer to was extensively reviewed during the last URCS proceeding. I don't claim to be an expert on this.

My understanding is that despite all of the efforts from many þ all sides including the Board's contractor, no regression that met the standards of, you know, a proper regression could be met. And so, therefore, it's a default, but it was something that was extensively reviewed when URCS was put together.

And the 50 percent based upon the evidence of the record at that time, was determined to be the proper standard.

So, but it was -- that was not something that was just glossed over the last time around, to my recollection.

VICE CHAIRMAN NOTTINGHAM: Mr. O'Connor, it occurs to me you may be if not singularly qualified, we probably have a few others with us here, but you've worked on some complex data research projects possibly in even an oversight, managerial role, as well as a technical role.

One of the challenges we have to face looking at this from a project management perspective is, and maybe I'm showing my old highway project management background, but how do we scope this out, put a budget and a timeline together in a way that we can brief Congress and the stakeholders and earn their trust and respect that we have a plan that's going to be on a fairly tight budget, it's not open ended, and that when we go to Congress for funding, we know what number we're asking for and it's not going to be an annual guesstimate as to with no end for ten years?

That could be very embarrassing to the Board, it could be very much of a waste of taxpayer dollars if we don't manage this þ as important as this topic is, it seems to me it could be studied and analyzed until the cows come home with unlimited expenditures before everybody would agree that it's completely spot on right.

And so, any advice on how we might want to think about embarking on this in a way that gets us to a sound, a well-managed project?

MR. O'CONNOR: I can offer some thoughts on that. And I, you know, indeed when I was with Conrail, I took over. I took over, and in fact practically doubled the size of my staff, a project that had been underway for several years.

It was an internal cost-finding project, if you will, for internal management purposes. It had nothing to do with the regulatory arena, so you probably haven't heard much about it.

And the way we tackled that was to first make an analysis as to where we would likely be able to be identifying major costs in the first instance.

We'd look at the history, what are the past efforts to resolve this problem? Were they promising or were they a dead end?

I would not begin, for example, with general overhead. I wouldn't begin there.

I would begin with costs that your heuristic analysis or your prior research indicates should be directly assignable. And then I would move to what are the results of the regressions that have been run in the past, what do our past efforts show in terms of þ excuse me þ the responsiveness of major blocks of expense?

Think of fuel, for example. Fuel is a pretty decent and pretty well-behaved cost category. And if we were in Canada, for example, you would probably see a regression from time to time proposed for fuel that would have things like car mile, it would have gross ton mile. So, we've got distance, we got weight.

And you would probably find an argument in that regression called gradient. And gradient is a surrogate in the simplest form for uphill/downhill.

Now, when I was going back to when I was in grad school, I was a yard clerk on the SOO line. And I got the concept of uphill and downhill, because the trains on the SOO line coming from Madison into Milwaukee, were longer and heavier than the trains going from Milwaukee to Madison, because that was uphill.

And so you -- there's a certain common sense to this thing and -- but begin with what you þ begin with your experiences as a highway project manager, that's an excellent place to begin, and sort your problems out; these should respond, these might respond, these probably won't.

And you're talking to Congress, let's start with the ones that should respond. Let's do those first, especially if they're big-dollar items, you know, especially if you're getting a lot of complaint and debate about it. I would begin there, but it's a project management process.

And the key to project management is communication. You communicate with your audience, you let them know what you're doing, you let them know what you're going to be doing next, you listen to them, and you reflect their views.

The project management approach is a perfect approach for this.

ACTING-CHAIRMAN MULVEY: Chip, let me follow up on that a little bit.

It's been suggested that þ and I think this gets to Chip's question about doing this in a way that gives us a result that is efficient, cost effective, et cetera. And it does depend upon how you frame the question, how you communicate the question, how you communicate the project.

There have been several who have suggested that the Board might put together a panel of experts who would look at the issues similar to what we put out in our request for this hearing, the major issues that need to be addressed, and to sit down and talk about what will be the best way to approach them, and then develop an RFP, Request for Proposal þ I've been in Washington, D.C. too long, but put out a proposal that was well thought out and was focused, et cetera.

It might be comprehensive, but this panel of experts would be the ones who would develop the proposal request. And that could include, and it would definitely include, of course, board members, board staff.

Board staff are the ones who are going to need to work with it. They also have the expertise and the experience working with URCS.

But then there's also the possibility of including people from the railroad industry, the shipper community, and perhaps some academic experts and sort of envision this as a sort of star panel.

We should be able to put something

out like that in several months. Would you care to comment on the feasibility, doability and desirability of that approach?

MR. O'CONNOR: Yes, I can comment on that. And þ now, I should be clear here. We've now -- I'm speaking as Snavely King at the moment. Okay? Because I haven't discussed issues like this with the clients in response to the testimony that I put forward today. Although, they may or may not agree with my comments in the question and answer period.

ACTING-CHAIRMAN MULVEY: Understood.

MR. O'CONNOR: So, speaking from a Snavely King's perspective, I think that kind of approach could be quite useful, and you will know quickly whether it's going to be useful or not.

Bear in mind again, now, this is project management, this is communication. And if that attempt turns out to be a blind alley, to be unproductive, you'll probably know fairly quickly.

And the Board staff would be an excellent member of that. As you know, we've had excellent interactions with the Board staff. I think very highly of them.

You would need involvement from the railroads. You would need involvement from shippers. You would need involvement from, I think, the academic community.

And just to put some size to that, TRB would be a logical place, I think, probably to look for that kind of involvement.

I would give them specific tasks. I wouldn't give them a blank piece of paper and hope for the best. I would give them a specific task.

If your first thing is a project plan, that's what I'd ask them to do. And if your first thing is a timeline, that's what I'd ask them to do.

And I would ask questions

initially that you are pretty confident about the answer yourself. You thought you had a pretty idea on the answer yourself. I would not ask them for the meaning of life, which could take them a bit.

And in that kind of an iterative process, they can help move you forward and you'll quickly see whether this is a productive avenue of attack or it's something else. In which case, you're going to of course correct.

ACTING-CHAIRMAN MULVEY: Anybody else want to address that?

Gerald?

MR. FAUTH: I've put that idea in my statement.

ACTING-CHAIRMAN MULVEY: Yes.

MR. FAUTH: I think you saw that. I think it would be a good idea, and I think that's what they did with URCS. They had a panel. My father was on that panel and helped develop some URCS ideas. There's also been other precedent for those.

I think the -- I was on the Conrail Transaction Panel Council which came out of the Conrail merger, and I felt that was very effective working through with the railroad's ideas and how to get through the Conrail transaction. And I thought it was effective council and helped work through some of the difficulties with that transaction.

I think such a panel could be effective with URCS, although I'd have the fear of the railroads controlling it and there would have to be an independent sort of chairman of the panel.

Certainly you need the railroads there. They're the major stakeholders, but - and STB staff. And academic people on the panel would be certainly a good idea.

ACTING-CHAIRMAN MULVEY: Well, certainly it would have to be the case that whoever chaired the panel and was directing the panel would be somebody from either the

Board or an outside, unbiased academic. You would not have either a shipper or the railroad running it. And that, I believe, was part of your suggestion.

And your suggestion was also echoed in some of the other testimony, the idea of having a bipartisan, an unbiased panel help to formulate the Request For Proposal that goes out to sort of speed things up, but I think that's something that's very much worth looking into.

One of the questions that comes up, however, in all of this, and I address all of you even when I think I know the answer, but I want to hear it from the panelists, and there's a problem of there's þ this is a very, very data-rich and data-intensive process and there's real problems of confidentiality of the data.

There is going to be a need to see data from the railroads, their costing models, et cetera, that are digging very much into the railroad costs. And the railroads quite rightfully want to make sure that proprietary information is not leaked out.

How would you ensure the confidentiality of the data in going about an URCS revision?

MR. FAUTH: I'll just say that URCS is based on all public data. So, I mean I don't know what confidential data they would have that you would really need.

I mean they might have other regressions or other information as þ certainly they have fuel studies, that they do their own that could be incorporated into URCS, but I think basically you're using the basic public R-1 data and transforming it into URCS.

So, I don't know if there would be big confidentiality problems, but we could have the panel members sign agreements to maintain the confidentiality.

ACTING-CHAIRMAN MULVEY:

Confidentiality pledges.

Tom?

MR. O'CONNOR: Yes, I have a comment on that.

There would be a need for a very stringent Confidentiality Agreement on this and it's driven by the data.

Back when we were analyzing the URCS regressions the first time through here and certainly back with the Rail Form A regressions, you had enough individual operations, individual observations, railroads, so that you could come up with a statistically meaningful inference from that population set.

We now are down to six, so we're going to þ the size of the universe drops from roughly 40 members down to six or fewer.

Now, again we can learn from how other people have handled this problem. And the way that problem is handled in Canada, we have two. And you've had two observations, CN and CP for quite some time.

The unit of observation is the operating division within each of those, not mixing the two. It would be CN operating divisions, and CP operating divisions.

Now, that takes you out of the realm of publicly available data. That takes you beneath the R-1.

And it would be very likely be the case that with as few as six or seven observations, you'd want to consider making some sort of a data panel out of the data that you had before you.

As soon as you leave the public record, you need very, very strict confidentiality agreements, but those kind of agreements have been used quite successfully in Canada.

The analyses I've just described that were þ we're going back 25 years with no problems.

ACTING-CHAIRMAN MULVEY: Yes, that

was one of the thoughts I had with the problem of only five or seven railroads. Depending upon the data that are available, you would have to break it down by regional or divisional traffic, and that does get you into data that are not in the public domain.

Other possibility, of course, is to mix time series and cross-sectional data. I'll talk about that a little bit later on. There are problems with that. There are issues with that statistically, but we don't need to discuss that here.

Anybody else with that question?

John?

MR. LeSEUR: For shippers to meaningfully participate in any review of URCS, we need to have basically this access to the same data that the Board and the railroads have. Otherwise, you don't have a level playing field.

And, you know, confidentiality comes up all the time in proceedings before the Board, it comes up in merger cases, it comes up in rate cases, and the Board has an established procedure to deal with it. They have a Protective Order that's been developed over the years.

And in the URCS proceeding, you could, you know, use your Protective Order procedure and material that's designated as highly-confidential can only be seen by, you know, outside counsel and consultants and can't be disclosed to clients.

So, I think something along those lines could be used. I think the important thing at least from the shipper perspective, would be that you actually þ the shippers do have access to all the data.

ACTING-CHAIRMAN MULVEY: We do want the process to be transparent and I am sensitive to the black box argument. And we have in the audience today a couple of our former consultants who did some work on competition in capacity for us, Christensen

Associates. And they did a competition study that was certainly excellent and that was transparent.

They did lay out all the econometric analysis, all their assumptions and their results, which I think makes for perhaps not the most exciting reading for the non-economist, but certainly it's transparent and you know what's done and you know where you agree and where you might disagree with the approach that was taken.

So, we will, I think, in doing any of this, be as transparent as possible.

I'll turn it back over to Vice Chairman Nottingham again.

VICE CHAIRMAN NOTTINGHAM: Thank you.

Just perhaps for Mr. O'Connor having worked with the ICC and having worked at the technical level on these issues in the past, you may, and I know others probably have too, but maybe you'll address þ this could be just a hypothetical question, but I'll ask it anyway: If the Board were to revisit or were to be mandated to revisit on a fairly tight timeline the issue of whether we should adopt replacement cost accounting versus the historic cost, and at the same time try to embark on an ambitious schedule to rework and update URCS, would you see any problems with that, those two projects going on a parallel track at the same time from either þ just from any perspective?

MR. O'CONNOR: Sure. The replacement cost versus historic cost, that would be a good example of a debate that could go on forever. So if you're looking for something to do later, that would be a good choice.

On that issue versus URCS, let's come at it from a different perspective. URCS affects all traffic, all shippers, and actually goes beyond the regulatory arena since the URCS þ you become the Esporanto, if you will, for cost analysis even outside the regulatory arena.

And as we've talked today, you've indicated the project management approach to URCS as to what do you do first. And we heard from the panel the advisability of having an overall plan, if you will, commitment as to where you're going.

What you would not want to do is start with a þ this would be the worst possible outcome, I think, this would be the worst possible approach, would be to start with a piecemeal approach that significantly benefitted one party or the other. That would be not good.

VICE CHAIRMAN NOTTINGHAM: I'm sorry. Let me clarify to keep us on track.

MR. O'CONNOR: Go ahead.

VICE CHAIRMAN NOTTINGHAM: It's hypothetical, but if we were to be, let's say, directed on a tight timeline to conduct a process to quickly adopt a replacement cost accounting methodology, and at the same time we were authorized to look at URCS, would you have any concerns about the workload that would present as well as just what the - how that could impact some of the underlying assumptions and data that would affect an URCS project if we were directed, mandated in law to do a quick adoption of replacement costs?

MR. O'CONNOR: I haven't considered a mandated replacement þ I've seen the proposals that have been put forth from time to time on replacement costs, and we've considered it numerous times over the course of my career.

It is þ that particular issue is you're not likely to get agreement, you're not likely to get agreement on that.

So, if you were talking about a tight timeline, just defining the issue as replacement versus historical, it kind of rules out a tight timeline. It's an unreasonable request to ask for that to be resolved in that tight timeline.

ACTING-CHAIRMAN MULVEY: The replacement cost issue is one that has been suggested that be included in the revision of URCS by some of our subsequent testifiers here. So, we'll address that at that time.

Steve, you also suggest that the URCS should reflect input substitutability. Do you want to elaborate on the steps required to carry out that change to include input substitutability?

I wasn't quite sure exactly what you were talking about there. It's on Page 9 of your testimony. The Board should - let's see.

Such refinement should include, but not be limited to, specification changes that intercept terms for the regressions, reflect economies of density and input substitutability.

MR. SHARP: Well, I think the reference there is just to allow, basically,

to get us back to the point where you can
model movement-specific traffic rather than
just the system-average type thing.

I think it's basically just trying
to say there where you get down to the point
to where you can put different data in there
as opposed to the system-average.

ACTING-CHAIRMAN MULVEY: Well, one
of the things the Board was trying to do in
its streamlining processes, was to get rid of
the þ all the adjustments to URCS that the
parties before us were coming, both the
shippers and the railroads, try to streamline
it.

And what I think what the
refinement of URCS would try to accomplish,
would be to go in and do that anyway, but then
fold those changes into the URCS processes.

Is that a fair characterization,
Tom or Steve or Jerry or John? Anybody want
to -

MR. O'CONNOR: I have no comment at

the moment.

MR. SHARP: I'll just very quickly. That was part of our thinking on the process, was rather than having to run URCS and make a bunch of adjustments to it, is to have the þ change the model to where if you were talking about coal traffic or if you're talking about intermodal traffic, you know, you just þ that gets input from the beginning. And the program takes care of that because it recognizes the differences and handles those rail costs differently.

ACTING-CHAIRMAN MULVEY: One would presume that that kind of an approach would be better than ad hoc adjustments.

So, Jerry, any comments on it?

MR. FAUTH: Well, I just would comment I don't know if this is exactly what he's talking about, but the URCS Phase III program has places where you can change the inputs like train weights.

The thru train weight may be like

5,000 average, system-average train weight. But if you know you have a larger train size average, then you could change that input. And it's already flexible, it allows you to do some of those changes. Car days is another example.

So, I think it's flexible right now that you could do that if the Board allows you to do that.

ACTING-CHAIRMAN MULVEY: So, it's increasing the þ more or less increasing the flexibility of URCS and coming up with new parametric results.

MR. FAUTH: Possibly, but it's already þ it's already flexible and allows you to do those things. It's the Board's policies that don't allow you to do those things.

The Board's program, you can make some adjustments. It has þ allows the user to change the system-average numbers to put different inputs in.

ACTING-CHAIRMAN MULVEY: Chip, do

you have another question for the Board, for
the group?

VICE CHAIRMAN NOTTINGHAM: Thank
you. Just one last question.

It does occur to me that of course we're talking here about the cost of doing railroad business, the cost of each major activity within the business of running a freight and operating a freight railroad.

It occurs to me that there are probably some people in this room and elsewhere who actually keep maybe that information and spend a lot of time making sure it's as accurate as possible and that would be freight railroads.

They have every incentive to keep track of their costs and to know exactly what each major activity costs.

Rather than hire squadrons of PhDs and embark on a five or ten-year journey, what about the idea of just figuring out some way to protect the confidentiality and any kind of business secrets involved, but to actually look at the railroads who are the most efficient freight railroads in the world running the most efficient and productive freight railroad system in the world and actually say hey, let's have a panel sworn to some kind of appropriate confidentiality, take a look at the best practices out among the industry and put together a hybrid approach that wouldn't reveal any particular firm's technique or approach, and just save a whole lot of time and trouble.

Any reaction to that?

MR. LeSEUR: We put in our comments, one of the things we think the Board should look at if they are going to undertake a comprehensive review of URCS, is to look at what the railroads are actually doing. And I think that should be one component part in your analysis.

And then whether you want to rely exclusively on that, over the years there's been individual cases the railroads have said that what they're doing internally is different than what the Board is doing, has different purposes.

I think that we would recommend that you do take a look at that as you go forward as part of your comprehensive review of URCS for the very reasons you just articulated.

MR. O'CONNOR: And I would return, actually, to the guiding principles that I opened and then closed the testimony with, and I think it speaks to that issue.

A revision of URCS really is a highly-technical matter, so it's going to require significant resources.

So, asking the railroads what they think about it as a means of not spending the resources, I -

VICE CHAIRMAN NOTTINGHAM: If I could, Mr. O'Connor, please, that's not what I propose.

My thought is that each railroad probably spends þ has spent millions of dollars and millions of internal hours developing very sophisticated systems of tracking costs.

And rather than ask the railroad for their opinion or what they would like, you know, looking at those systems, which probably the cumulative time and money and effort spent in developing each of those systems, would far outstrip anything the Board could do in our wildest dreams as far as, you know, in-depth þ right now my understanding is the railroads basically have to keep two, you know, for lack of a better phrase, two books.

They have their real books they run their business on, and they have their books they use to keep up with STB's URCS process. And that's expensive and burdensome unto itself, but that's just the way our process, I guess, works.

But maybe it's naive, but would it

be possible just to have one set of books where we're actually using something very close to a hybrid blend of the best practices in the railroad industry of all their collective efforts over the years of updating and adjusting their cost analyses?

MR. O'CONNOR: Well, it's a good thought, but let me come back again to the three principles. Let's go through all three of them.

Highly technical, going to require significant resources, you can't debate that. I need to review all aspects of URCS, and the third one is really important. If you're going to embark on a revision of URCS, the effort must be transparent. Must be transparent.

Now, at any given railroad you may in fact find more than one set of books. You might find that you have a combination of companies, each one of which up until some given point in time had its set of books.

Matter of fact, that's very likely what you will find.

So, there's going to be þ when you turn to the corporate books, if you will, that will not completely eliminate the processes that you're going to have to deal with, but the need for being transparent, I mean, is absolutely critical.

MR. FAUTH: Can I just add, vice Chairman?

VICE CHAIRMAN NOTTINGHAM: Please.

MR. FAUTH: I think that's a good idea. I think most of the railroads have their own internal costing system, they don't use URCS generally unless they þ for internal purposes, and I would think most of their programs are probably þ many are more accurate.

Many studies I've seen, they use more accurate fuel studies, crew studies and switching studies that they don't rely on the URCS outdated studies.

So, I think it would be a good idea to take a look at some of their internal studies that they have, and there might be a more accurate way to look at them.

ACTING-CHAIRMAN MULVEY: And that would certainly require protective orders and confidentiality since this is internal þ

MR. FAUTH: It would be proprietary.

ACTING-CHAIRMAN MULVEY: Proprietary railroad information, yes. All right.

I have one last question for Mr. O'Connor. You suggested there was an important distinction between the RCAF-U and the RCAF-A.

Could you tell us which one you believe should be used in conjunction with the revised URCS and why?

MR. O'CONNOR: Well, the - it's kind of a classic question, isn't it? The þ both of these lines, the þ you guys have got it before you.

The blue line that's going up and the red line that's sort of drifting downward, one reflects productivity, and the other does not reflect productivity.

Now, the question is who is responsible for the productivity?

And clearly the railroad is involved. These are railroad numbers we're looking at here. But did the productivity -- was the productivity enabled by the, for example, shippers represented by John LeSeur, the coal shippers who ship massive amounts on exactly the same pathway day after day, year after year. You can be pretty efficient.

ACTING-CHAIRMAN MULVEY: And grain shippers.

MR. O'CONNOR: Exactly.

ACTING-CHAIRMAN MULVEY: And grain shippers with shuttle loading facilities involved.

MR. O'CONNOR: Exactly. Exactly.

So, it will not be - probably if you would adopt RCAF, probably neither one of those lines viewed in isolation would get you an answer that would be acceptable to both parties, but some mix of the two, some represent þ some recognition of productivity.

Now, let's think about - let's go back to the regressions again. The regression is going to have the form Y = A + b(x) + c(x) squared and so on. And the Y is the dollars, and the X is some measure of production.

Now, if you were to rerun those regressions with this time span in mind, I would be utterly amazed if you did not see some of that productivity evidencing itself.

ACTING-CHAIRMAN MULVEY: Thank you. I want to thank all the panel members. It was excellent testimony and this panel is dismissed.

Okay. I want to keep going while the Vice Chairman takes a break.

VICE CHAIRMAN NOTTINGHAM: Thank

you.

ACTING-CHAIRMAN MULVEY: Let me call up our next panel. Representing the freight railroads, Mr. Ed Hamberger, and for the Association of American Railroad; and Mr. Richard Weicher for the BNSF Railway Company; and Ms. Louise Rinn representing the Union Pacific.

Ms. Rinn is also an additional panelist whose been added late to our revised speaker list, so welcome aboard.

The Vice Chairman, I'm sure, will be back in a second, Ed. I'm sure he wants to hear all of your comments. So if we wait a couple of seconds þ

MR. HAMBERGER: As long as the light's not on.

ACTING-CHAIRMAN MULVEY: What?

MR. HAMBERGER: Just as long as the light's not on.

ACTING-CHAIRMAN MULVEY: The light's not on. Well, doesn't count until the light is on.

BNSF always has very colorful hand-out stuff.

MR. WEICHER: We look for a graph or a map on something.

ACTING-CHAIRMAN MULVEY: What?

MR. WEICHER: We look for a graph or a map just to break it up a little.

MR. HAMBERGER: They keep our paper customers happy.

ACTING-CHAIRMAN MULVEY: A graphic of URCS, I mean that would be þ

(Whereupon, the foregoing matter went off the record at 10:45 a.m. and resumed at 10:46 a.m.)

ACTING-CHAIRMAN MULVEY: We want to thank you all for your testimonies. We have as the Vice Chairman has said and I have said, we have read all the testimonies, so we would appreciate it if you summarize your remarks.

And, Ed, we'll begin with you. I'm sure Mr. Nottingham will be back very,

very shortly.

MR. HAMBERGER: Thank you, Mr. Chairman, and I just echo Vice Chairman Nottingham's opening comments. This is our first opportunity to testify before you as the Chairman, and congratulations on your designation by the President as Chairman.

I want to thank the Board for the opportunity to present the views of the AAR this morning on the Board's proposal to conduct a review of URCS, the Uniform Rail Costing System.

Obviously, issues relating to the accuracy of railroad costing systems for regulatory purposes, are critical to our industry. And a review of URCS must undertaken deliberately and with a view to the full range of impacts and consequences.

If the Board ultimately chooses to go forward with such a review, we stand ready to fully participate in that process.

With the limited time available to

prepare and address the questions raised by the Board in your notice for the hearing and in view of the magnitude and significance of the issues involved, like some of your former witnesses, we will, by necessity, present some general views, observations and principles on how the Board should proceed if indeed it decides to do so.

Before we can consider specific proposals for modifying URCS, we would require additional time to assess the potential costs and benefits of possible modifications.

As the previous witnesses, we have principles. So, we will come forward with five principles that should be the objective of any Board review of URCS.

They are; number one, URCS should reflect all costs associated with rail transportation movements or categories of movements, and these costs should be fully allocated as precisely as possible to the movements or to movement categories that give rise to those costs.

The Board has inquired previously about the full cost of transporting toxic inhalation hazards in Ex Parte 681. This is one of the more obvious areas where substantial costs are not currently properly identified and allocated.

Other possible areas for investigation include the relationship between costs borne by intermodal unit-train services and also proper identification of switching costs.

Two, URCS should reflect the full variability of all costs. And to the fullest extent possible, variability percentages should be based upon current, actual data, not default values.

Railroad operating conditions of course have changed over time. And when URCS was developed, the primary rail traffic was carload merchandise moving small, average carload sizes.

Loads are much heavier now and tonnage density has doubled since 1980. This means tracks and structures wear out more quickly and it is, therefore, probable that a higher percentage of infrastructure replacement costs are variable with traffic today.

Three, the structure of URCS should be sufficiently flexible to ensure that future changes in railroad operating conditions can be readily accommodated.

For example, positive train control has been mandated by Congress to be implemented by 2015 on main lines carrying TIHs or handling passenger trains.

Clearly, this will increase the costs, however it cannot be predicted today what impact PTC will have on longer-term future costs for the carriers once it is implemented.

Four, the capital portion of variable costs should be based on replacement cost methodology rather than a return on investment calculated on depreciated value of book assets.

As this Board and the Interstate Commerce Commission before it have recognized, replacement costs are the value in which a carrier must earn an economic return if it is to sustain its business.

And I was somewhat perplexed to hear Mr. O'Connor earlier testify that he thought that such þ addressing this issue would be, quote, unreasonable, when one of his principles is that this approach must be comprehensive.

To be comprehensive, I would argue, means that you must take into account replacement value, not book value.

Five, changes in the accounting and the reporting processes that support any revisions to URCS, should be effected in a manner which minimizes administrative burdens and systems adaptations.

To the extent possible, the Board should attempt to use the current reporting framework so it does not place an undue burden on the carriers.

We recognize that as a decision to proceed as you've discussed here this morning, will result in a significant proceeding that will be lengthy, extremely complex and quite costly.

We look forward to further participating in that proceeding should you choose to move forward.

Thank you.

ACTING-CHAIRMAN MULVEY: Thank you.

Mr. Weicher.

MR. WEICHER: Good morning, Mr. Chairman and Vice Chairman. Thank you for the opportunity to appear. I am Rick Weicher from BNSF Railway. I apologize for the hoarse voice. It was a lot of airplanes and wind in places.

We thank you for the opportunity

to appear. It's clear that this is to us, and that we support the Board's direction. This is an important issue to be looked at, we believe it needs to be looked at, and we believe it needs to be looked at thoroughly and correctly.

It comes about because of the statutory mandate that you use a URCS system in calculating variable costs and you're using them very extensively now in many regulatory arenas more than ever.

Whether it's the simplified SAC cases, the three benchmark standard or your average total cost methodology in coal cases, it's permeating everything.

That doesn't mean we agree that this fixation on revenue variable cost for rate making is the right policy, the right direction, but that's not what this proceeding is about. We fully recognize that.

If you're going to use RVCs, you're going to use URCS, then we think they should be as current and as accurate as they can be.

And as I'll go through, and others have, we're dealing with an outdated, antiquated system that we don't think necessarily reflects today's railroad realities either.

As other witnesses have gone through, some of these studies go back at least 50 years.

I was practicing in the mid to late `70s before the former Board with the ICC, and was first working on Rail Form A and then, people were saying gosh, some of the stuff in this is 20 or 30 years old, and where did this thing come from, and where did this default come from, and you sort of roll along with it.

That isn't to say that I'm faulting the ICC or the STB for not doing more to update it. It's a big effort. We know that. But that still leaves us with the fact that it is old and it involves assumptions that are not where we are currently.

Your last review that began in 1990 þ I say "your" generically. This agency's last review started out as with noble intentions and great goals, and others have taken you through the timeline.

It started out to look at three or four specific issues, it was going to take just a couple of years. And within six months it was extended to three years, adding some issues, dropping some other issues.

By `93, we just went back through this and went, well look what happened last time.

Well, some more issues were added, some more were dropped, no real decisions were made, and it boiled down at that stage, boiled down eight or nine years later to do some refinements and some tweaks.

Because of the lack of resources, it didn't approach the major issues, the things like variability, the datedness of the study, because that all takes time and money.

Having said that, we think it's time to do it recognizing that you do need to spend some time on process and what the process is going to be.

As you've correctly noted this morning, a little time at the beginning to figure out the right approach and the right way to do this, could yield real dividends in having it done right on a more cost-effective basis.

I think we do not think it is a good idea to do a piecemeal tinker. We may not like it the way it is, but we're not sure that you should just start poking at the thing if you're not going to really take a real look at it, because then we'll get into more aberrations, more side games.

At the end of the day, all the costs we report and we spend, our costs, certainly we are very interested in how these are portrayed and what that means to the regulatory thresholds, but we have a slightly different interest than some of the shipper groups that appear before you.

And in their own interest, it's very easy to say, well, this costs þ doesn't go on coal, it goes over there, it goes on grain, it goes on intermodal, it goes on þ they can each say that. Well, we have them all.

So at the end of the day, the accuracy particularly as your methodologies are bringing in the relationships between movements, this is very important that it be done right. And that mitigates, from our standpoint, against doing piecemeal things.

As we say in one of these slides, I don't know if these are three points, five points, whatever, but as you're doing that, recognize with this proceeding today you need to establish some priorities, establish realistic schedules, perhaps consider some kind of phased approach or a concurred approach looking at some of the bigger issues on a longer-term basis while you look at some of the þ and there are no simple issues here, I guess, but some of the smaller modifications in a similar vein.

We do think that you should elicit as you're doing, and should continue to do, and I'm sure will, comments from the parties and the public on that process. Maybe there's a role in the legal sense, for an ANPR on process and what you're going to do. Those things can move quickly, they don't have to move slowly.

And if you believe or come to the belief that you need to use consultants or do RFPs and so forth, as you indicated you would, we think it's appropriate that comments be solicited, that that process be open. What are you going to ask the consultant to do, what is their work task going to be?

And if they're going to be given

guidelines on what to do, we'd like input on those guidelines.

Turning to the next one, these are some of the highlight issues. You've got your list of issues in the order. They're all important. Some of them are easier, some of them are harder to deal with.

But certainly, we have to deal with the issue that many of the factors and allocations, whether to develop unit costs or the regressions that say what are fixed and variable, are from very outdated studies and there's no question that things have changed.

Certainly of interest to us and our customers, the focus on allocation of cost between single-car, multi-car and unit-train shipments is an important issue. We recognize that. It's important to us. It's important to our customers.

I'm sure we would not necessarily agree with some of the shipper groups on which way the thing should go, but we probably agree whatever it is, it can't be really, really right. That doesn't seem possible with the changes in technology.

This next slide, and as you indicated, we thought to throw in a slide or two because þ but this is not an URCS slide. This is just sort of a trend slide.

If you look in the growth in unit-trains on our railroad in the grain product segment, you see we, as everyone knows, we handle a lot of unit-trains and still a substantial number of single-car trains.

If you tried to extend this line backwards, and we took a quick looking for that and I'm not sure we can do it, but if you go back to the early `80s, we didn't have anything like the shuttle system, the multi-car system or multi-car offerings that we have today with the different rate structures, with the different layout of our unit.

That means that the historic premises that are baked into URCS should be updated in this area as well.

Similarly, basic operations have changed because of the nature of our firm, where we have had shifts in larger trains, heavier loads, increased densities. Many of these things, and we know this is a fundamental issue and the commentators this morning said this will need to be addressed, what's fixed and what's variable.

We know that's a core issue. Whether it's the 50/50 for road property, what's done for maintenance and so forth, those things need to be looked at.

And to my knowledge as a practitioner in this area, I'm not a cost consultant, but I þ to my understanding, that stuff hasn't been updated in decades.

And we don't think it can possibly reflect the current what we live in, in terms of the money we put into the railroad on an ongoing basis and our ability to vary that investment or vary that expense level just as we're facing in the current unusual climate.

The next slide is another one of these things that just shows, gosh, the world has changed. This is sort of a comparison. The colors try to show incremental changes in density and so forth, but all our lines are not the same.

And since the time of approximately our merger, we've had substantial changes in the way this physical plant is utilized to provide efficient network service across our system.

It is not clear to us that these fundamental changes in density could possibly þ it does not appear to us that it's likely that they are properly reflected in the kind of regressions and in the kind of assumptions that are made today by URCS and it may be appropriate to separate cost categories into different variabilities or categories.

This hasn't been studied in ages between the different þ the cuts that are done today in the system.

The next one, obviously intermodal is very important to us. We're not suggesting intermodal is regulated or should be regulated, but intermodal traffic is part of our big cost base and it's permeating into SAC cases, it's permeating into revenue adequacy, it's permeating - it's so a big part of our firm. Whether the buckets are right between our big groups is something certainly worth examining. It affects such things like the RSAM.

We have an intermodal terminal system today and costs there that are far different than they were.

A couple on the next slide that were not necessarily on your list. They may be smaller items, but they can be important in a given situation the way third party payments are categorized today.

Whether it's between railroads, major railroads, short times or typical switch payments, these things, these third party costs, it's not clear that they are reflected in any current basis.

The next one, normalization incurment costs, if you look at þ may I proceed for a moment or two?

ACTING-CHAIRMAN MULVEY: Continue, yes.

MR. WEICHER: Okay. The time periods, what you consider for normalization, the five years on some things, those should be looked at. They should be looked at in a statistical way. What's the right way to do these things? For some areas of expense, should they be shorter?

And we also agree that replacement costs should be reflected in þ rather than book value, in the return on investment component of URCS. That is important þ an important piece of this.

No one size necessarily fits all for all the existing categories or what's in there today, but it needs a fresh look at how these are approached.

If you look at the last graph, you've probably seen this in another context, we're very capital intensive. Which means the capital portion, and I'm just talking here of the variable costs that are in there, it is not trivial, it is important, and those are the dollars we have to spend on an ongoing basis to provide the equipment, to provide the assets, to provide the service to our customers.

Finally, we certainly intend to participate actively in whatever proceeding you have here both in terms of the process, we know railroad data will be called upon, there are a lot of issues on how that's done, so it's done properly, but we think it's important and we want to help support an effort for more accurate costs.

Thank you, sir.

ACTING-CHAIRMAN MULVEY: Thank you.

Ms. Rinn.

MS. RINN: Good morning, Chairman Mulvey and Vice Chairman Nottingham. I appreciate the opportunity to appear before you and have an opportunity for Union Pacific to be heard in this important matter.

There are three basic points I want to cover in my prepared comments; the fact that UP endorses the review of URCS; the fact that your resources are not unlimited and, therefore, it is important to focus on meaningful opportunities for improving URCS; and, finally, to command to your attention just some, not certainly all, of the items that we think would deserve your attention in this effort.

UP endorses a review of URCS. I won't go into detail of repeating what many other witnesses have pointed out, which is that URCS is more than 20 years old and much of that data is already þ was old at that point in time.

And I'm going to say as a statement of fact, not a criticism, that when URCS was adopted, the plan, the expectation was that on a regular basis it would be reviewed to see whether it was still doing a good job, whether it was still reflecting current railroad operations.

Unfortunately, that did not happen because the ICC, the Board, then felt it did not have the resources to do it. And I think that as a result, opportunities were lost. That's just a statement of fact.

But now the fact is we are more than 20 years later and railroad operations have changed profoundly, and there is a need to take a look at many of the underlying relationships.

That said, you don't have an unlimited resource in terms of time or money. One lesson I have always kept from my freshman year in college in studying economics, is that economics, as my professor was explaining, is the study of how to allocate finite resources among infinite demands.

And certainly the railroads understand increasing in ever-changing demands and only having limited resources. That is the situation the Board, the railroads, the shippers and any other interested parties are going to face here.

In the time we've had available, we have not been able to do an exhaustive study to say here are the things that we think definitely need to be focused on.

But what I would suggest as one possible way of helping to focus and shape the study is if we can by an analytical analysis say there are certain, either, minor cost categories or major cost categories where the current regressions still seem to do a reasonably good job, that might be something that could be determined early so efforts could then focus on the areas where it seems that there is a greater discrepancy between what URCS currently does versus what might be a better, more appropriate fit.

The other thing I would urge is that there should be attention paid to improving þ URCS was an improvement over Rail Form A in terms of accessibility and usability. There are still some rooms for improvement there. And I think that based on the comments from the shipper panel, and I certainly know from railroad panelists, opportunities to do improvements like that should not be overlooked.

It may not be the top of the item list, but we ought to be looking for are there ways of improving the usability of URCS.

Finally, as I said, you have 13 different topics. It would be hard to argue with any of those categories.

At the risk of making it sound like I only want things that are going to help my railroad or the railroads generally, I'm going to have two things I'm going to point out that certainly deserve attention, but I'm not saying they're the only ones.

One is road investment variability. It has no data. It has no science behind it. And yet, what we spend in our capital budget every year to maintain our road bed is one-and-a-half billion dollars as a run rate.

We spend another several hundred million dollars a year adding signals and track capacity. That tells you that that really is tied to output and ought to be considered variable, but we're stuck with a 50 percent variability based on an educated guess from the 1930s.

Clearly, that's an area that warrants attention. I don't have a solution to it, but I think that there are avenues that the board has to explore.

Another one that actually will cut both þ could cut both ways, is I think that currently there are certain movements that are being over costed on car for private shipments or in private cars, and there are other movements that are being under costed as a system-average, and that that is an area that needs attention.

Thank you.

ACTING-CHAIRMAN MULVEY: Were you finished?

MS. RINN: Yes, I was.

ACTING-CHAIRMAN MULVEY: Okay. Well, thank you very much. Thank you to all of our panelists. It was very, very interesting.

I'm glad you mentioned the need for science. I mean I think for many years now we've gotten away from reliance on science and on facts, and I think it's important to bring science back to our analysis. And sometimes it takes resources.

And I don't think we can make the argument that the resources just aren't there, there's too much at stake.

I've been here now for about five years and I've seen these rate cases and how much monies are involved. Hundreds of millions of dollars over the life of a contract, for example, can be involved in a particular rate case. Which means that ultimately billions of dollars can be involved across the system almost on an annual basis.

To say that spending $3 million or $4 million over three or four years is a lot of money to get this right, I think that does not do justice to the importance of the issue.

And in fact, virtually everybody who has come today has said that URCS has got problems, it needs to be adjusted, and only one person suggested that we might want to delay acting on it.

But I do think it's already been 20, 30, 40 years since some of these things have been revisited and more, and so I think the time to act is upon us.

You mentioned about the need to

focus on scope. I think that's a very important point that several of you have made and that we need to nail down exactly what we need to do.

Now, I do believe that focus is going to have to be comprehensive, but nonetheless we need to be specific as to what we expect, regardless of whoever we give to from the outside on direction as to what we need to do.

It has been suggested that one way of getting better information and perhaps even a way of expediting some of these analyses, is to go to the freight railroads to work with them on their internal cost data, internal models, et cetera, to help that as an input to getting a better handle on these costs.

Would you care to comment on the willingness of the individual railroads to share their cost data and their cost models with the Board and whoever the Board contracts with?

MR. WEICHER: I'll be happy to comment.

We don't like the idea. I don't think it's a good idea. It has legal issues and business issues.

First of all, what we do internally in different context at different times, you can imagine at different times in the economy, how you think of costs and what you should go after for business advice is quite different than the regulatory function set up by URCS.

Secondly, we consider it proprietary from the standpoint of our competitors. How they think of what we think of our costs for business purposes is not the same.

Now, our basic accounting data, what we're spending on lines, maintenance of way that fits in the regulatory cost system, some of that can be proprietary and confidential, but we think that is something that has to be looked at in the URCS system.

But how you go about taking the major railroads' internal cost systems, I can't sit in a room and go through what they're using for these plans, I don't think.

I'm very uncomfortable with some consultants doing it or it being, you know, debated in the public arena. So, frankly, no, I don't think that's an approach that should be pursued.

MS. RINN: I'm in agreement with Mr. Weicher. The reality is that as much as I trust and regard Burlington Northern Santa Fe, I would be very, very concerned about being in a situation where our internal costing information is out there for them to see. And I cannot believe that they'd be any happier about Union Pacific personnel having to do it.

And yet, you need to have knowledgeable railroad personnel involved in these efforts, and those tend to be the ones who are likely to be involved with both regulatory and/or internal costing efforts.

I also question, quite frankly, how valuable or relevant it would be. I do not question how much. Some of our customers or their lawyers and consultants would like to see it, because we see this as a repeated effort in discovery.

I cannot think of one proceeding recently over the last several years where I haven't had a request in discovery for our internal costing system, and we've never turned it over.

Internal costing systems are obviously data intensive, but they also reflect key commercial strategy. And I think I can cite an example from far enough in history that I'm not revealing anything out of scope.

Back in the `80s when we were working for transitioning from a four and five-man crew to a two-man crew, UP adopted an approach where we basically negotiated with our labor unions to pay them to have a Reserve Board.

And we treated that as a fixed cost and we said okay, here's what our true variable cost is on adding a train and take people off the Reserve Board.

That was a very successful commercial strategy for us in terms of increasing our market share on key parts of business, including the powder river basin.

Well, that's now history because we're down to two-man crews, but internal costing systems reflect key commercial strategies. And, therefore, they cannot be safely þ I don't care what the confidentiality requirements are, we share an environment where it is exposed to your competitors and to your customers.

But we are prepared þ clearly we've got a lot of public data that is out there, and there is certainly operational data that could be used to help update some of the relationships in terms of switching and whatever, that definitely the railroads are going to have to look at what we can come up with and help on updating those relationships.

And we would be willing to cooperate with that with appropriate confidentiality protection.

ACTING-CHAIRMAN MULVEY: Now, I'm not sure to what extent it's the strategic costs that are at issue here or it's the operating costs which go into the URCS calculations which are at issue.

But it did strike me that at least some of the internal railroad cost data, if it's not strategic cost data, are more of the accounting and operating cost data, I think, what is being talked about primarily, although I'll have to talk more to the staff on that.

But you would feel comfortable with a Protective Order, that would certainly be required here so that even that accounting, internal accounting data or operating data would also be kept confidential.

MR. WEICHER: We believe that the Board has sufficient confidentiality protections and the right kind of thing you set up, as you've done in other individual proceedings, to protect the raw data that is also sensitive.

What I don't think we want to have this turn into, we have enough litigation, we're not þ this process of developing URCS shouldn't necessarily turn into a fishing expedition to be able to go through our raw data and try and figure, oh, this might be fun to go after, that might be fun to go after.

We think that would not be a proper purpose of this URCS rulemaking or wherever it goes.

But that data, the basic data of what we spend, where we spend it, the accounting data, the physical parameters, we believe that that is something that needs to be looked at for URCS. We accept that, we understand that, we believe that's correct.

And that can be protected through the proper form of confidentiality similar to what you've done in other context usage commitments that if you're going to retain a consultant or, you know, things are going to be looked at by people including at the STB and so forth, it should be segregated and Chinese walled, as it were, from the use for that purpose and not be a repository for þ I hate to use that legal term þ fishing expeditions to go like whoa, what could be found.

But, yes, at that level.

ACTING-CHAIRMAN MULVEY: Let me ask you a broader question for a moment here.

What is the downside of maintaining the status quo, of not doing anything right now and just letting URCS continue to use URCS as it's currently formulated?

Is there a downside to that for the regulatory process and the railroads and shippers in the longer term?

Ed?

MR. HAMBERGER: Well, I've got to say that we do not have a consensus at the AR that endorses the testimony you heard from Mr. Weicher and Ms. Rinn.

In fact, I believe one of the railroads, Norfolk Southern, has filed a written statement that believes that it is premature for the Board to determine whether or not the existing model should be replaced.

So, their view is that any improvement in inaccuracy that is likely to result, should be compared to the likely cost of developing and implementing such modifications.

So, I guess at least from one of our members, the view is that your question needs to be analyzed a little bit further before, you know, we can come to an answer.

MS. RINN: I think that there are real costs, but we may not be þ well, we cannot quantify them until we've done an analysis and determined to what extent URCS is not doing an accurate job of doing it.

My view is the successful outcome of a review of URCS will reasonably measure the total variable cost of the individual rail carriers, and do a better job of allocating those costs among types of activities and types of traffic.

To the extent URCS currently doesn't because of problems or limitations with the equation forms, with the fact that it's relying on older data, the fact that it regresses a significant percentage, but not by any means all of our costs, means that you probably are misstating the costs for certain types of traffic.

My assumption is that the end result would be there would be some movements that would find that they're having higher costs. There are going to be other movements that are going to find that there are lower costs.

Unlike Lake Woebegone where all the children are above average, it seems to me that every time I encounter a customer in a regulatory proceeding, they're convinced that they're the ones who are below average and URCS isn't accurately costing it that way.

I believe that to the extent we are not correctly capturing all the costs and allocating those costs, it means that we are making business decisions and decisions where we try to comply with the Board's regulations and the expectations.

But if the regulatory costing system is at odds with, it does not reflect our current operating patterns, that basically puts us into an untenable position that we may be making rational business decisions that are at odds with an obsolete regulatory costing system.

And I'm fully prepared to accept that if the URCS review is done properly, some movements will have higher regulatory costs, some will have lower regulatory costs, but I'd like to have more accurate regulatory costs.

ACTING-CHAIRMAN MULVEY: What you're saying, though, that even though you're making rational business decisions, there may be irrational rates in the sense that they're reflecting regulatory costs as opposed to economic costs.

Is that a fair assessment?

MR. WEICHER: And if we're going to be pressured þ if we're going to be pressured in the regulatory arena to make economic decisions, then the regulatory policy should be based as much as they can on current economic conditions we're facing.

ACTING-CHAIRMAN MULVEY: And sound relationships, not ones that are dozens of years old.

So, Ed, you want to weigh in on

that or are you þ okay.

Chip?

VICE CHAIRMAN NOTTINGHAM: Thank you. Thank you, panel. Welcome.

Ms. Rinn, you brought up the issue I touched on earlier with the first panel on road property investment variability. I think it sounds like an important piece of this puzzle.

For many, many decades as you know, and as you mentioned, the Board has without -- to my understanding without much underlying data or research, has used a 50 percent attribution to fixed costs, 50 percent to variable costs.

My understanding is, and we'll see maybe the next panel can further educate me on this, that it's pretty hard to find any other business out there that owns a lot of real property that actually assigns a 50 percent fixed cost accounting concept to that property. It's typically anywhere from 70 to

90 percent.

What could that do, for example? Obviously, if in fact that 50/50 split is outdated, as I believe your testimony indicated it may well be, presumably then when we go to look at our statutory threshold for jurisdiction to the STB, for example, whether or not a rate is at the 180 percent of revenues compared with variable costs, but your variable costs are being suppressed because you can't get credit for all the real property you have, your road bed, et cetera, if we were to change that and go with what I believe is what the consensus that we hear from the economics community, is it fair to say that one outcome could well be far fewer shippers being able to be eligible for relief, rate relief, before the STB?

MS. RINN: That answer is going to vary from railroad to railroad. I believe that actually we have a large percentage of taking our PRB customers nigh at random, are not capable or eligible to bring a rate complaint right now because; one, many of them are competitive. They're served by two railroads at the origin, and they're served by two railroads at the destination. Therefore, there is effective competition and they can't bring it.

Other customers that we have are already below 180 percent on a revenue-to-variable-cost ratio basis.

Thirdly, all other things being equal, if you change nothing else in URCS and the variability on the roadway investment was increased above 50 percent and no other changes happened, obviously our URCS variable costs would change.

How that would affect different customers is going to be hard to say, but nobody is suggesting that that would be the one thing that you would look at. There would be other things that would be going on.

It could be that with intermodal

costs it's generally conceived, considered that intermodal is under costed. So, if costs are shifted to intermodal, that means that they may be shifted away from other types of traffic.

So bottom line, you cannot quantify it. And one of the things I learned the last time when we worked on doing the review of URCS, is that you may have a concept about how something is going to turn out, but it turned me into an empiricist.

Until you actually do the analysis with real data, you have to be careful about reaching premature conclusions.

You certainly use your judgment and experience to form the questions to be asked and how to go about answering those questions, but don't assume that you know the answer ahead of time.

MR. WEICHER: May I?

VICE CHAIRMAN NOTTINGHAM: Please.

MR. WEICHER: May I comment on that

one?

I don't want to confuse myself or go too far into the weeds because I know there are experts far more in this, but there's so many things going on here in the question you raised you properly, and road property isn't necessarily real property in all context. There's more to it than that.

There are issues here that need to be addressed in the replacement cost or the current cost that are different or perhaps easier to address than in the revenue adequacy replacement cost proceeding you elected not to proceed with. There were things there going on about what's used and useful and what's the real property.

But when we're talking about the variable side of it, we have such a long history of what's happened here. As Rail Form A converted to URCS, the industry went from what used to be called betterment accounting where it expensed all kinds of things, some of which are now capitalized. You've got depreciation in there.

I don't know where the dust settles. And I defer to an economist on ultimately the right way to come out with it, but we have sort of a Band-Aid on a cast through things that should probably be updated.

It is true that I think we believe that ultimately there's a higher degree of variability than the old studies would suggest for elements not of real property, but of things that are categorized as capital and depreciated. And those things haven't been looked at in a long time.

VICE CHAIRMAN NOTTINGHAM: Mr. Weicher, obviously one of the more important statutory provisions that we are mindful of constantly here at the Board, is that 180 percent revenue-to-variable-cost threshold set in statute by Congress.

I've never been able to get a full

understanding in the legislative history as to what research and detailed kind of data underlay that assumption, but presumably it was a product of legislative compromise.

And it was the best minds at the time, and the right positions in Congress felt that was a solid number to assure railroads a reasonable return. And at the same time, assure that shippers would have reasonable access to rate relief.

I'm assuming, though, that that number had to have had some basis in URCS or the understanding of the cost of railroad þ business cost of running a railroad at that time.

If we were to completely redo URCS, should we, you know, first if you could speak to that assumption whether I'm even remotely, possibly on the right track, but if þ and, Mr. Hamberger, I'll ask you to weigh in on this too because you have extensive experience working with the legislative branch in having worked up there as counsel to the Transportation Committee in the past and in your current job.

How do we þ if we were to just announce tomorrow that we have miraculously reworked þ or let's say it's five years from now þ URCS and we have a new and improved URCS, we've changed 20 or 30 components, and all of a sudden one way or the other either of a huge increase in numbers in percentage of shippers now have access to the Board's rate relief process or a big decrease were to happen, how do we work that with the Congress?

Does it really undercut that 180 percent threshold they put in the statute based on data at that time?

MR. WEICHER: I'd be happy to comment on that. And some of these will be more personal views from the legal standpoint, from a regulatory standpoint from where this comes from, but I've heard the stories over the year of 180 came from.

And I don't know the ultimate answer except I'm told they looked at a bunch of stuff and somebody picked a number. A number that they thought would keep the industry from going bankrupt or permit it to have some flex.

What averages, what gizmos, what aggregations they were looking at are not clear to me.

Having said that, you do have a statutory framework here and the direction to have this regulatory costing system. And I'll make, if I could, a hypothetical distinction because I don't want to use commodities and then that suggests there's þ that quickly goes into the political pressure side of it.

But your directed þ your predecessor agencies were directed to have a variable cost system and a numerical threshold.

That's the law. Congress has to change that if they do. I do think if you went to a completely sort of like the Chairman's initial question, I believe it was, of do you go piecemeal, do you go completely þ if you came up with a completely different thing, and there are other things people suggested including in the recent studies that Christensen did and others, you know, as opposed to what was variable costs, then I do think you either have to do some massive adjustment or þ or maybe you can't do that without Congress telling you you're not going to measure variable costs, you're going to move, you know, measure revenues per ticket and ton somethings. That doesn't mean that might not be a better way, but that might go too far.

Now, having said that, let's say over the last 25 years in measuring variable costs derived from the basic accounting data of a railroad, it turned out that when you were looking at the costs ascribed to multiple-car widgets moving as opposed to multiple-car chunks of concrete as compared to something in a completely different vehicle, gosh, these allocations are wrong. They don't make any sense.

I don't think you're freezing in time who's over 180 and 180 under today, and that you therefore have to correct and say, anybody who's under this old system þ- no. If the system is wrong, and you fix it, and you reallocate it, then you try to stay true to the intent of the statute. And maybe you do some correction factors, and I think some of that was done when the accounting systems changed, but that would be the right thing to be doing.

If they're in the wrong buckets and there's still fundamentally variable costs, you stay with the theory of the system and that changes that some are under 180 and some are under þ over 180, which is probably inevitable if you do anything to it, but that's the proper function of keeping a current variable cost system.

Go too far and reinvent the wheel, then you got, I think, legislative issues.

VICE CHAIRMAN NOTTINGHAM: Mr. Hamberger, do you have any thoughts for þ

MR. HAMBERGER: I was going to defer to the expert, Louann, first, if she had anything she wanted to add.

MS. RINN: I have nothing I want to add.

MR. HAMBERGER: Damn.

(Laughter.)

VICE CHAIRMAN NOTTINGHAM: Let me expand on that for you, Mr. Hamberger. Work with me on my hypothetical.

Let's assume þ

MR. HAMBERGER: Can we write that down as "Darn," please? Thank you.

VICE CHAIRMAN NOTTINGHAM: Let's just assume, hypothetically, that a comprehensive review of URCS is undertaken and it does significantly change one of the fundamental underlying assumptions beneath that 180 percent threshold and significantly alters the population for the percentages of shippers who have -- either up or down, we don't know which, that have access to the Board, to our rate relief process.

How as an expert communicator with the Congress, would we be wise to think about building in a window of time for that new process to actually kick in, give the Congress some kind of notice that, gee, you might want to, you know, just look at this, you know, don't be surprised when, you know, we're going to hit the switch on January 1 of next year, or do we just þ should we just activate it and then let the chips fall where they will?

Part of this is þ it's a two-step partnership, almost, with the Congress. They set up a very important test based on, in some part, on our longstanding costing data. And we can change that data, but someone is going to have to explain to the Congress what that might do and what they might want to consider.

Any thoughts on that?

MR. HAMBERGER: Well, I don't want to presume to tell you how to deal with your authorizing committees, but it does strike me that Rick has it pretty well right.

And in fact, I was just thinking how eloquent the Chairman was after we testified and you said, Mr. Chairman, that there's so much at stake here. There's so much at risk here we've got to get it right.

And it's not a matter of resources. We have to just look at it, make the proper allocation, make the proper allotment. And I would argue along those same lines to take a look at replacement costs because that is an issue that also has to be taken a look at, and that there is nothing magic about what percentage of shipments are above or below 180.

The question is what do the economics lead to? And that's þ so, do you want that to be as transparent and factual and scientific as possible?

And then that's where, you know, obviously --- Mr. O'Connor was speaking earlier quite eloquently also, about project management. That's not my field, but I think he had an excellent point that communications is key to any successful project management and I would think that, you know, Congress would be one of those constituencies that you'd want to communicate with.

But to me, it is a matter of þ and Louann said it, you know, you don't know what the bottom line is going to be. Some will change variable costs for different kinds of shipments.

ACTING-CHAIRMAN MULVEY: If indeed you change the variability calculation, the presumption would be that a larger proportion of costs would be variable and would be in the denominator in the RVC equation.

If you included þ if you switched

to replacement cost instead of book cost, that would also inflate the variable cost component of the RVC equation.

MR. WEICHER: Well, it wouldn't inflate it. It would þ

MR. HAMBERGER: Actually, you didn't give it the proper þ

ACTING CHAIRMAN MULVEY: I'm sorry.

MR. HAMBERGER: Yes.

ACTING CHAIRMAN MULVEY: But the point of the matter is it would have an affect of likely meaning that less traffic would be eligible to come to the Board under the 180 R/VC Rule.

Would you accept that that would be the likely outcome?

And I think what the Vice Chairman is saying is should that therefore engender that the Congress take a look at whether or not that is a proper threshold?

I mean the Christensen study that was done for us last year suggested that the

180 R/VC ratio is not very predictive of captivity.

So, would you want to comment on that?

MR. HAMBERGER: Well, it þ I'm turning into an empiricist here with Louann. I'm not going to project what it might mean in any particular case.

But if one is going to go take a look at whether or not 180 RVC needs to be changed, one could argue that RVC itself, you know, may or may not be the right, no matter what the percentage is, RVC may or may not be the right measurement.

And so to me, we're talking about a whole, much broader discussion at that point of what the entire regulatory regime should look like.

I think what we're talking about here is operating within the context of what we have, how do we make it better and how do we make it more economically sound?

And so, I don't think at this point it warrants going back and trying to determine whether or not RVC is the right approach or whether or not 180 is the right number, rather get into the projects of taking a look at if you decide to go forward on URCS. And also, of course, replacement costs.

VICE CHAIRMAN NOTTINGHAM: I guess just getting back to the line of questioning, the reason I just bring this up is not to get too hypothetical, I just - I worry that folks who probably aren't here in the room with us today, but who care to some degree about the STB and these related issues, most of them, I hazard a guess, would believe that updating and reviewing URCS is nothing but a good government, kind of housekeeping accounting update that doesn't really impact Congress that much. It's sort of our þ just making sure our data is kind of up to date.

When we have an opportunity, when the opportunity arises to actually explain, well, it's very likely that whatever comes out of this process is going to dramatically impact one way or the other, we don't know, some key underlying assumptions, I mean that message needs to go forth, so I wanted to use this hearing, frankly.

Thank you for þ

MR. HAMBERGER: Well, if it þ

VICE CHAIRMAN NOTTINGHAM: -- playing the foil, but I wanted to be able to get the message out. Because I think right now it's just being looked at, oh, the Board has this obscure housekeeping, good government thing they want to do. That's great. Fine. Not enough people in the right places.

People outside of this audience are actually realizing where this is likely to go, up or down.

MR. HAMBERGER: I guess just coursing through my thought here is an analogy in another hearing that I appeared at speaking of arcane issues before the Board, was whether or not we should go from DCF or to CAPM.

And I, you know, at that point, I believe the Board decided we don't know where that's going to take us, but we've taken a look at what is the proper and appropriate way to measure the cost of capital, what is done in other agencies, what's done on Wall Street, how should this be done, it needs to be updated and, you know, could have gone either way.

Still don't know what it, you know, the long-term impact of that will be, but you went forward and implemented what you thought to be the right decision without saying, well, how's this going to impact one side or the other and, you know, should we do it because it might have an adverse impact on the number of cases at 180.

I mean you just did what you thought needed to be done. And so, I would argue similarly in these areas that that would be an appropriate way to go.

VICE CHAIRMAN NOTTINGHAM: Thank you.

Mr. Weicher, getting back to the topic of who has the best, most accurate, most comprehensive data on the costs of being in the railroad business and operating a freight railroad, would you agree that today probably the Class I, the current Class I railroads in U.S. and Canada have the best data and information on the costs of operating a railroad?

MR. WEICHER: Yes, and the basic data is our data of the cost and the operations expenses.

VICE CHAIRMAN NOTTINGHAM: I'm very, believe me, very protective of proprietary information, business secrets.

At the same time, the Board has --- one of our most sweeping authorities is to look into the business operations of the railroad and have access to data that we need to get our job done.

We try extremely diligently to do so without allowing any collusion or any other improper commingling of information or sharing of information among parties that shouldn't have it.

But it does seem to me if we have general agreement that the Class I railroads are in possession of the most comprehensive and most accurate data on the costs of railroading in the U.S., and we're about to embark on a multi-year, multi-million dollar taxpayer-funded journey to try to figure out whether we can come up with something parallel to that, almost as thoughtful as that, wouldn't it be helpful to the Board to figure out a way to both protect everyone's proprietary interest, never share with one railroad another railroad's cost accounting system, but actually say, you know, a group of distinguished, respected people have walled themselves them off, looked at the seven Class I's and said we're not going to say anything about any of them, but on average amongst the seven, this is what the average numbers look like and then -- address those thoughts if you could.

MR. WEICHER: Certainly. I think there's a distinction here between the data and the expenses and what we spend where. In the dialogue we had early on about þ I heard the term "costing methodologies" or "strategies" and so forth.

There's a þ we recognize, and this is what the R-1 reflects and what URCS and, before, Rail Form A drive off of, what do we spend on the track, on the equipment, on all the þ on the crews and all þ this is real information and clearly a Uniform Rail Costing System has to be derived from that information.

The place that has come up in litigation and similar to the comment Louann made that goes into a different area, is when you start talking about systems or methodologies or basically strategies, you can have in a given commercial environment such as the present downturn, you might think of what's a þ what you'll take on the next car traffic or how you approach your business model in different commodities, in different markets, in the short-term, in the medium-term, quite differently than you would think of a 25-year coal move or somebody locating a new plant. There þ and there's a lot of commercial elements that go into that.

Those are not data. That is proprietary business systems, thoughts. They can change from time, they can change by commodity, by business condition.

We don't think that should be a model or a source for how a regulatory costing system should be developed.

The regulatory costing system we have here which it's time to update, is supposed, I thought, I think, to think of what are you going to do on a consistent, regulatory basis as a regulatory system as fixed, as variable, at unit cost for locomotives, for fuel.

Therefore, you are entitled and should have access to þ it's still confidential, you know. What do we spend on this piece of railroad? If you get that, you know, last year maybe somebody really clever could figure out what it's run rate over time is going to be, but that data belongs in this process.

How we think of our business climate today, last year, next year for commodity X versus commodity Y, we respectfully think it should not be part of this process, if that's a distinction that makes sense.

ACTING-CHAIRMAN MULVEY: I think that's a good distinction. And I think that Ms. Rinn's example before of the þ of going from the five-man crew to the two-person crews, that there were going to be cost impacts, and those cost impacts were proprietary because that was a strategic decision, was a good one.

Some of the strategic decisions are really more revenue and demand-based than they are particularly cost-based.

I think we are talking about costs that are operating costs and that are, while they're confidential, are necessarily the things that are going to be necessary for the Board to know about if it's going to develop an URCS system that more accurately reflects what the true cost of railroading is today.

Do you have any more questions on this?

VICE CHAIRMAN NOTTINGHAM: Just one last question. Thank you, Acting-Chairman Mulvey.

Maybe each of you can take a shot at this if you care to. If you care not to, that's fine too.

If we were to decide to approach

this project by first putting out notice and comment þ or advance notice and comment to get more comment, we þ several of the witnesses, and I believe you did, Mr. Hamberger, talked about kind of limited time. I think we announced this hearing just a couple weeks ago. It's a pretty sweeping topic and arguably the stakeholders wouldn't have had enormous cause to anticipate a hearing.

It's not like when we had a hearing on the common carrier obligation. It probably doesn't take most of the people in this room a few months to gather their thoughts on the common carrier obligation. That's an issue that's been around for, you know, but, you know, this is something that the Board hasn't looked at in years.

Anyway, so we hatched this hearing on you pretty quickly. People said there hasn't been enough time for all the information to come forward for this hearing.

I note that a couple of the bigger

consulting firms that most of the large stakeholders here rely on who I'm told are arguably the most expert on URCS, aren't witnesses today for whatever reason. Maybe they needed more time.

But do an advance notice of proposed rulemaking or some other type of notice and comment to get more thoughts about how we would proceed with this massive project.

And then I wanted to get your thoughts and reaction to this approach: We retain a highly-qualified firm through a competitive procurement process to actually scope the project, to set up this is what þ introduced all the stakeholders, kind of take an approach similar to what the Christensen group did on their study last year, and come back to us in a reasonable period of time with here is our proposed plan, here are the big items that need to be addressed, here is a structure and a process and, by the way, here is a budget and a timeline.

And then we put that out for bid probably with the understanding that the first firm wouldn't be eligible to be the lead bidder on that on the bigger job.

Does that þ then we can go to Congress with actually a real budget, a real timeline, show them a real thoughtful project scope, and don't have to go back to them year after year saying, gee, that four million we guesstimated back in 2009, that was a guesstimate and it's now nine.

Because that just gives me bad flashbacks to highway projects that were really important, the people were so anxious start, and they never wanted to go communicate with anybody what the actual cost was going to be.

And reputations and entire agencies' reputations can get impugned that way, and I just don't want to see us fall into that trap.

But any reaction to the type of approach I just described?

MR. HAMBERGER: I notice, Rick, you did mention ANPRM and you approach it like -- again like Tom.

It's nothing that we had actually talked about as an industry, but that certainly sounds like a logical þ one logical way to go.

Doesn't necessarily, you know, have to be the only way. But, you know, getting þ scoping the approach obviously makes some sense.

MR. WEICHER: I agree. I think the þ as we had suggested, I think there is a role in here for an ANPR. And in the type of sequence you suggested, I do think it's important that the -- and I'm not saying the Board would do this, but it not sort of abnegate its core responsibility to set the policy directions of this thing through a consultant.

And having said that, they can serve you up something and perhaps that becomes a subject of an ANPR for the work plan or something on that order.

The process you have in place now, you þ we're glad to get an opportunity for some additional written comments after this hearing, because we have not þ and I'm not sure we will in that time period, be able to deeply address the 13 issues or þ 12 or 13 issues, but they can be commented on, perhaps some element of prioritization.

Some of them are different kinds of things. Some of them like the RCAF thing are things, well, what do you do with this and that?

They're not the same as URCS. Some like variability and multiple and single all go to the core of URCS.

But, yes, I think if you go through that, there is a role there þ we probably support somebody, I think it was Mr.

Convey, the panel type -- or your suggestion of some kind of panel. That's - perhaps that fits in the middle there someplace.

I do think it's important that something of this magnitude not sort of totally be booked out, so to speak.

Clearly, you will need that resource to get down the path, but a blend of comment and input on how they do that, I think, is important to us as well.

MR. HAMBERGER: Why don't I take it as an assignment that we'll go back and see if in the next 30 days we can come to some recommendation on process.

I don't know that we will, but we'll þ

VICE CHAIRMAN NOTTINGHAM: I would appreciate that. I'm just one Board member, but I just, you know, and I think if you put yourselves in our shoes if your credibility and reputations were on the line to properly estimate the timeline and a budget for a project of this magnitude and say your job was on the line or your performance rating was on the line, would you just kind of want to wing a number and start and hope that it all works out, or would you want to scope out the complex project and actually have a budget and a timeline?

That's kind of where I'm getting at before you embark. But if you can think of it from that perspective, is there anything you'd like to contribute?

MS. RINN: I think what you're talking about absolutely makes sense to me. We try to take the same approach every time we get involved in major litigation.

Obviously, it's complex, you don't control all the variables, but you make reasonable determinations about the types of activities, the order in which they're going to take and how you're going to source it.

And then you manage through that plan and sometimes you do better, and sometimes you don't do as well.

But the one thing I found is that by having a plan, you end up getting more done with less money than if you don't have a plan.

And that ultimately while you are clearly a government agency and due process means that all of the stakeholders have to have an opportunity to have their views heard and have access to what you're doing, at the end of the day there's a project management principle that has to be done. Which means it comes down to a smaller group that's basically focused on what's the work to be done, what's the order in which to do it, and when do we get the appropriate input from appropriate parties.

And only with that can you come up with a realistic schedule and budget.

ACTING-CHAIRMAN MULVEY: You always need to start someplace. And we're in the process right now of the STB being re-authorized and being revised actually since the first time it was created.

And that if we are going to forge ahead with this, having within the budget some monies, which based upon the best guesses, best estimates, which all estimate always are, of what it's going to cost and how long it's going to take, I do know that agencies all the time come up with a "needs forecast" for doing things that they have been charged with. Which may not bear much in the way or reality or how much analysis behind them, but that's what they think they're going to need.

And so they ask for that, and they ask for that in the appropriations and in the authorization.

So, I do think that we do need to get going pretty quickly on this. I do think that there can be revisions as time goes on. And as we see what the needs are, we can re-contract, re-forecast, either reduce or increase our request as it warranted.

I did have one question though.

We'll see in the testimony that the railroads do not use a uniform system of accounts in their own accounting systems, but they have their own systems and they translate those data into the uniform system. And this translation is said to lead to shortcomings in the accounting data upon which URCS is based.

How do the railroads carry out the development of the uniform system of accounts data that is used in URCS? And if this translation is indeed taking place, what steps can be taken to improve that accounting data being used in URCS?

MR. WEICHER: I'm not sure I'm sophisticated enough as an accountant to respond to that. I know that we have so many accounting requirements. I mean our 10-K, our R-1, these are all prepared under a variety of prescribed rules.

I don't þ beyond that I can't really address how we get from one to the other, except we are so regulated, so careful of that, that I have to believe we do our very best to follow all procedures in accordance with generally accepted accounting principles.

MS. RINN: I likewise have to make a disclaimer. I liked economics, but I quit accounting after one semester.

But my understanding is we do use the uniform system of accounts for the accounting for the railroad which of course now is the bulk of Union Pacific Corporation.

So, the financial data gets there. Now, obviously there's a lot of stuff behind that in terms of cost setters and cost codes on how you get it into the USOA.

But when you're talking about the R-1 which goes beyond the Uniform System of Accounts, there may be a greater array of interpretation of it depending on how a particular railroad has its data systems set up to record certain types of operational data, for lack of a better term, that different railroads are making different assumptions on how to take their business data and get it into the form that's required in the R-1.

And so, I certainly think that you're going to see that there's probably a range of solutions there. I'm not sure to what extent that there's really a range in the accounting data, because your Uniform System of Accounts tries to follow GAAP. Our other reporting has to follow GAAP, but I may be þ I may be missing some things where there are discrepancies or adjustments that have to be made other than railroad versus non-railroad.

ACTING-CHAIRMAN MULVEY: Maybe there's a need for more consistency that the railroads are doing it very, very similar to each other rather than major differences between the railroads.

MR. WEICHER: Mr. Chairman, I have been advised that it's conceivable depending on how far you go with this, you may need to look at the Uniform System of Accounts, you may need to think about whether things fit the same categories.

Beyond that, I don't understand þ I know there are these processes to go back and forth þ

ACTING-CHAIRMAN MULVEY: Okay.

MR. WEICHER: -- but it may be a broader inquiry, not that we're looking for ways to make this more complicated.

ACTING-CHAIRMAN MULVEY: No, neither am I. That's all I have.

Well, this panel, again, thank you very much, as always. Mr. Hamberger, Mr. Weicher and Ms. Rinn, thank you very, very much.

I want to call up our last panel. This is our third and final panel today classified as other interested parties. Mr. Gregory Breskin and Mr. Robert Leilich, Mr. George Grimes are representing themselves as experts in these matters. And then Ms. Sandra Dearden of Highroad Consulting, Limited.

So, welcome, panelists. I assume the Vice Chairman is on his way back, but I want to thank you all for coming. Nice to see you again, Mr. Breskin.

I guess you can begin making your presentation. We'll have you summarize your presentations, and then we'll go to questions.

Mr. Breskin.

MR. BRESKIN: Thank you, Mr. Chairman. Mr. Vice Chairman, when he gets back.

My first interest þ and I'm here strictly on my own. I'm not representing any group shippers or railroads.

My interest in URCS started with my doctoral dissertation in 1983. At that time, I happened to be working for the costing section of the Sante Fe Railway. And my dissertation, among other things, showed me that rail costs are decidedly nonlinear in nature.

And then I got to working heavily

with some Rail Form A numbers and some URCS numbers, and looking into the history of Rail Form A and URCS going back. And basically, the technology of the variability in Rail Form A and then in URCS, goes back to 1939 and really hasn't changed that much since.

And I'd like to speak to the two primary areas. One is non-linearity of rail costs. And my own research, some of it published, some not, some forthcoming, shows that rail costs appear to be very nonlinear, whereas the URCS variability estimates are linear. So, I would suggest that nonlinear models be used.

My personal preference is the Translog Functional Form that allows you to use multiple causal factors as opposed to one measure of output, one measure of size. And then it allows you to estimate very easily, partial elasticities.

And elasticity on the cost meaning tends to be the ratio of average cost to variable cost þ or, excuse me, average cost to marginal cost.

And you can develop, as I have done in a couple of articles which were attached to my submission, from that you can develop marginal cost estimates as well as average cost estimates.

As far as I'm aware in the literature, there is no specific definition as to whether variable costs in the rail costing framework is speaking to marginal or average variable costs. Both of them are variable, but it þ there is nothing that I have been able to find in the literature that says specifically one way or the other which it's supposed to be.

Now, from economics, we know that optimal markup pricing, Ramsey pricing and so forth all run off of marginal costs. And my personal belief is that marginal cost is what is meant by the use of the term "variable cost" in rail costing.

So, I would strongly suggest that we look at the idea of multiple causal factors including size measures, as well as operating or intermediate operating measures such as gross ton miles, car miles, train miles and so forth that have been used in some of my research, because I believe those better reflect what's actually going on when you actually move a train and develop an estimate of the actual movement of the train to the cost, as well as including the total level of activity on the railroad system. And costs will vary depending on total activity on the railroad system.

So, I would say first we need to define, or someone in the industry, the Board and so forth, needs to define are we looking at marginal costs or are we looking at variable costs. And from that point, I believe marginal cost is probably the best.

Secondly, I think we need to strongly consider non-linearities in costs.

This can be done using pulled data systems of the railroads.

When you go back to the 1939 data, we didn't have computers to do regression analysis. Now, we have computers. We can create panel data sets of both time series and cross-sectional data that can be regressed very quickly using even some very complicated regression methodology.

So, I would suggest that those are possibilities for us.

And then the last thing I would suggest along with that, is that we use definitely multi-variable regression models where we apply multiple measures of railroad activity, as well as including multiple measures of size or capital stock.

And I think that that would give a much better estimate of what's really going on in the railroad, and we can develop marginal costs which then apply to the regulatory oversight.

And I have provided several articles along with my submission that I think cover in much more detail, how this might be done.

And with that, I will leave it there.

ACTING-CHAIRMAN MULVEY: Thank you.

Mr. Leilich.

MR. LEILICH: Thank you, Mr. Chairman and Vice Chairman.

I'd like to summarize or my interest in this proceeding is based on the fact that at one time I was the project manager and lead consultant on the development of the Uniform Rail Costing System.

The original intent of my Peat Marwick Mitchell & Company staff, was to fix the known defects in the Rail Form A costing methodology.

The ICC, however, wanted to develop a new statistical approach to rail costing that more accurately reflected real costs and the long-term variability of those costs.

The study team included some of the best statistical experts in the nation. As part of the study, the ICC also wanted a new regulatory chart of accounts which better reflected generally accounting þ accepted accounting principles.

The study team from former þ from the former Haskins & Sells, had the responsibility of developing the new USOA to be used as inputs into the new URCS methodology.

Reviewing of the history of the two teams, there was tension between the PMM, my team, Haskins & Sells and the ICC on both the development of the new form, RO1USOA, and the costing methodology and myself þ in itself.

In my opinion, too many of the original proposed accounting definitions did not have the functionality that best reflected the many activities performed by railroads.

This tension ultimately led to the restoration of much, but not all, of the function definitions contained in the old USOA. Differing viewpoints among the two study teams and the ICC were never fully resolved.

The biggest flaws in URCS, I think lie in three areas; the USOA itself, the problems with statistical analysis, and even the reported operating statistics.

The USOA was never fully supported in the proposed -- the present USOA was never fully supported by the former Cost Analysis Organization formed by the AAR.

The ICC did not accept the advice and recommendations of the CAO, being wary of being accused of being in the hands of the railroad. Or as one ICC manager noted, letting the fox design the security system for the henhouse. While this is certainly a legitimate concern, I think it missed out on the value that the CAO could have contributed.

It was my feeling at that time, that more public involvement of the railroads, the ICC or the CAO and the shippers and other interested parties, could have contributed to developing a better, more accepted evolutionary approach to railroad costing than developing a totally new approach that few really liked or understand.

The old adage if it ain't broke, don't fix it, applies. A tune-up might have worked better.

I think breaking out the categories of labor materials, purchase service, et cetera, was a good idea for a number of reasons. Beyond this, only a few other accounts needed changes, and a couple of new accounts were also warranted.

To this day, no U.S. Class I railroad uses Form R-1, USOA accounting for its own use, internal use.

In many þ in all cases, the

numbers are translated by the railroads as best they can. In some ways, it's likely that some of the conversions are analogous to pounding a square peg in a round hole.

On the statistical analysis side, the second fundamental flaw is the use of statistical analyses to determine the variability of costs and production factors related to those costs.

When the concept was first proposed to me in about 1976, it seemed like a very good idea. Then, there were about 55 to 58 Class I railroads, the diversity of which theoretically formed a good basis for analyzing variability and causal relationships between costs and transportation production units.

No one anticipated that the industry would shrink to the number -- the small number of railroads that exist today.

Not surprisingly, one of the first things the study team found were high levels of statistical auto correlation. For example, there was a high correlation between fuel consumption and train crew wages.

Intuitively, this does not make sense. It does make sense to relate fuel consumption to one or more gross ton miles, freight car miles, locomotive unit miles, et cetera.

Here, however, there is yet another statistical problem in determining which factors are most directly related to fuel consumption, because there are also very good statistical relationships or auto correlation between each of these same three production units.

Some statisticians might say that if they all work, then any one of them is good enough. However, this may not work for all kinds of railroad operations.

An example here is that GTMs are much more related to fuel consumption on heavy coal trains, whereas for short, fast, intermodal trains, car miles and locomotive unit miles are more prominent.

It was a frustrating experience to try to make these statistical relationships work across a broad spectrum of railroad operations with a high degree of statistical confidence.

Marginal improvements in accuracy were burdened with complexity. The inaccuracy and details of operating statistics simply did not justify pursuing better statistical relationships.

So, if you get a correlation of 80 percent, it means that 20 percent of the cost relationships cannot be explained.

Then, there were many statistical costs that could not be nailed down, because they're heavily influenced by management decision. Track maintenance is one example, and equipment is another, and I won't go into these details.

URCS and its predecessor has been

readily criticized by many people such as the person on my left, and Rhodes and Westbrook in 1986, and many others, so it is pointless to rehash which has been so eloquently stated, or, for that matter, for me to add anything new.

For all the time, money and effort that went into developing URCS, I'm of the opinion that it does not produce results that are significantly more accurate or reliable than the old Rail Form A.

The fact that many costs in URCS are still based on the old RFA allocation procedures, including translating some Form R-1 USOA accounts back to the old USOA format, strongly suggests that URCS has not achieved its goals.

On the operating statistics side, they're not as accurate as might be desired. Though they are probably much, much better than they have been in the past, problems remain.

There is no audit or reconciliation of operating statistics. There are gray areas between switching and running. Work train statistics are likely under reported. Problems in generating operating statistics are particularly evident in the intermodal area.

Is an empty container on a flat car considered a load or empty? Is that influenced by whether the rail was getting paid to move it?

What about a loaded and empty container on the same car? Is a group of articulated cars considered one or more cars? I don't think this has been resolved. A fundamental reassessment of rail costing procedures is needed.

Well, I, like most people in the þ who do costing, use an engineered approach to cost. Most avoidable costs can be quickly and fairly and accurately determined. Given a good description of the operation and a profile of the route, simulation models can be used.

While I do support the merits of discontinuing the use of single-point variabilities, URCS' more sophisticated statistical approach still does not consider that costs by category may have different degrees of variability, or that changes in variability may not be linear with changes in volume, as Greg pointed out.

In short, I believe that a more down-to-earth, practical oriented approach to railroad costing is desirable.

ACTING-CHAIRMAN MULVEY: Another minute.

MR. LEILICH: It should be easily modified as specific circumstances might warrant.

I am confident that if knowledgeable costing people from the industry, shippers, the STB were to work together in a public forum, then a more flexible, more workable costing methodology more easily understood could be developed.

If nothing else, I base my proposal on my many years of rail costing and successfully negotiating many contracts or resolving disputes. I will not cover the response to my specific issues, because I think they're well documented.

ACTING-CHAIRMAN MULVEY: Thank you.

Mr. Grimes.

MR. GRIMES: Thank you. It's a privilege to be here. The subject I'm going to talk about is capital inputs with respect to URCS.

As a young railroad engineer, I was often perplexed by the way we segregated our costs into capital on one hand, and then to expense on the other. We had a budget for one, and we had another budget for the other, yet they were really for the same kind of activities.

These two accounting systems led

to some interesting conversations. For example, I once had a roadmaster call me when I was director of engineering, and ask for a carload of ballast.

I told him that we were already over our budget and couldn't afford a carload of ballast, but then I asked him to go back and check to see if he needed three. Because if he needed three carloads of ballast, we could afford that. Because three carloads of ballast met the unit of property, it made it capital, and we had room in our capital budget.

He went back and checked, and called and said he needed three carloads of ballast.

The point of this story is that from a strictly engineering standpoint, a tie is a tie, ballast is ballast, rail is rail. We all need it to run the railroad. We don't really care which budget it comes out of.

As it turns out, economists think

a lot like engineers. Costs are costs whether capital or expense.

Over the years, I began to wonder whether these distinctions and the way we segregated costs and capital and expense for accounting purposes, might have some bearing on the way we thought about variable costs and the way we thought about prices. Was something missing in our economic cost equation?

These questions led me to eventually engage in a series of studies that combined economic and financial concepts of cost. What I found was that capital and expense both represent costs that could be considered as either variable or fixed from an economic viewpoint, and should be considered in the economic equation.

Curiously, this relationship had not previously been defined. There were hints from Kahn, and Friedman, and Wilson, but nothing specific.

The research I conducted also examined the possibility that railroad capital inputs represent an incremental cost for traffic that was inadequately addressed in regulatory estimates of variable cost.

Using data from 1988 to 2002, I found that in aggregate for Class I railroads, infrastructure capital spending was largely variable with and caused by output as measured by gross ton miles on a year-to-year basis.

I recently updated my original analysis using data through 2007, to check my initial studies. And found that in aggregate, infrastructure capital spending had a variability or elasticity of over 100 percent with respect to output.

I also found that in aggregate, net road assets had an elasticity very close to that estimated for ongoing capital spending.

URCS appears to be deficient in at least a couple of ways. First, it uses depreciation instead of ongoing capital spending as an economic cost. Depreciation is not an economic cost, capital spending is. It represents money going out of the company.

Ongoing capital spending is almost twice depreciation expense, so this is not a minor error.

Second, URCS uses default variability estimates that go back to 1939, a 50 percent for infrastructure capital inputs, instead of the far higher estimates that I found based on more recent data. Again, this looks to be a significant error.

Should the Board consider modifying URCS, it should consider using ongoing capital spending instead of depreciation as an economic cost, and revise the elasticity estimates for capital inputs whether for actual capital spending or return on infrastructure investment.

In summary, railroads are immensely capital intensive, and it's particularly important to get this part of the regulatory variable cost equation correct.

Thank you.

ACTING-CHAIRMAN MULVEY: Thank you, Mr. Grimes.

Ms. Dearden.

MS. DEARDEN: Good afternoon, Chairman Mulvey and Vice Chairman Nottingham, and thank you for conducting this hearing.

Knowing that railroad marketing people do not use URCS for decision making, when I started my firm in 1996, I conceived and directed development of the rail costing model, INSIGHT: Rail Edition. And to my knowledge, it is the only rail costing model in the industry that is not based on URCS, and it is the only cost model that includes costs for Canadian railroads.

Instead, the U.S. railroad costs are based on the railroad's financial data filed in the annual R-1 Reports. And Canadian railroad costs are based on data reported in the stats in Canada Rail þ Rail Canada Report.

We first started questioning the accuracy of URCS in 2000, when a client requested parallel costing. They wanted URCS cost and INSIGHT cost. And at that time, URCS cost for the steady lanes, were generally about 40 percent higher than the cost calculated by our model.

In 2006, again a client requested URCS cost and INSIGHT cost. And for a specific problem lane, it was a high-volume lane, URCS costs were more than double the cost calculated by our model.

Now, I don't suggest that our model is perfect. However, we've done numerous projects for two Class I railroads and I've had an opportunity to compare the cost calculated by our model against those calculated by their internal management cost system, and the difference in calculations were less than $5 a car. So, we think it's a pretty good model.

Someone help me out here. Okay. Thank you.

Railroad productivity has increased significantly since 1980. Rail employee productivity is up 428 percent, locomotive productivity has increased 124 percent, productivity per mile of track is up 225 percent, fuel efficiency has increased 85 percent, and overall railroad productivity has increased 163 percent.

The next slide illustrates the improvement in railroad productivity since the Staggers Rail Act was enacted.

Some of the Board's questions and issues that were presented in the decision to conduct the hearing are pretty straightforward, so I'll just limit my comments to a few key issues.

When URCS was developed in the '80s, the objective was to develop a model that calculated system average costs. One of the questions was whether we should improve the efficiency associated with the multi-car and unit-train shipments.

Unit-trains are typically designed to address specific service and supply chain requirements of the shippers and their customers. So, the shipment characteristics with unit-trains can vary significantly.

Some of them include shipment size, age and horsepower of locomotives, use or non-use of run thru or distributive power, deadheading of crews or locomotives when trains are interchanged, and return of empties.

Empties, for example, can be returned in a manifest train service with existing capacity or sometimes the railroads dedicate engines and crews to return the empties as a unit. So, the cost varies significantly.

Because of the variations, I submit that the railroads would be significantly challenged when trying to develop system-average costs per unit-train operations.

It's possible that maybe what we should look at instead is breaking it down by commodity type. In other words, grain trains may have different characteristics than coal trains.

Also, it's been our experience that cost models in general, understate the actual savings in switching cost for multiple-car and unit-train shipments.

For example, we recently performed cost studies for moves of 75-car unit-trains compared to single-car shipments. Switching costs for the unit-trains were only 25 percent lower than for single cars. Yet, we know from experience, that the switching costs should be much lower.

The question is the same as presented in Ex Parte 681. Is the purpose of URCS to calculate system-average cost or is it the Board's objective to develop a revised system that allows inputs as shipment-specific information?

If the system is to be adaptable, then guidelines need to be clearly defined.

Questions, Issues 2 and 13 regarding the historical studies and statistical relationships, these comprise the basic infrastructure of URCS. Switching studies and other historical studies should be updated so that costs reflect contemporary equipment and operating practices.

One example of the need to review statistical relationships are locomotive fuel costs are allocated on a gross ton mile and locomotive unit mile basis.

Is the current split still valid?

Other allocations should be examined as well.

Also, the accuracy of reporting by the railroad should be confirmed as some of their data reported in the R-1 Reports appear to be suspect.

For example, we noted that costs for one þ reported by one railroad for fuel, switching fuel, was exactly the same percent compared to total fuel for the last six years.

The system to cost intermodal shipments is dated and should be revised to reflect contemporary operating practices, and I go into one more detail in my testimony that I filed.

But we noted in 1997, that the Board acted on the AAR's recommendation to change the inter-train/intra-train standard for intermodal shipments from 200 miles to 4,163 miles. Quite a difference. So, hold that thought and we'll go to the next slide.

The current I&I standard for non-intermodal shipments is still 200 miles.

Railroads have blocking and car movement histories that can be used for new studies. Since the railroads have the data, most likely this factor could also be carrier specific.

To my knowledge, there has not been a test developed to test the validity of the URCS model. Going forward, it is important for URCS to reflect current equipment, operations and cost. The Board should determine the most cost-efficient method to confirm the accuracy of the model in the future, either perform scheduled updates of the model as directed by the ICC when it was released, or develop an analytical process and schedule to test the validity of the model.

In summary, we believe the URCS model should be updated. If the Board decides to update URCS, they should confirm if URCS is to report system-average costs or if the revised model will be adaptable to shipment-specific information.

Historical studies and statistical relationships make up the infrastructure of URCS, and they should be reviewed and updated to reflect current equipment and operating practices.

The method to cost intermodal shipments is dated and should be revised. And the I&I standard for intermodal and non-intermodal should be reviewed and updated, and the Board should decide if the I&I mileages should be carrier specific.

Finally, going forward we need to develop the best system to maintain the accuracy of the URCS model.

Thank you.

ACTING-CHAIRMAN MULVEY: Thank you.

Chip, do you want to go first on this?

VICE CHAIRMAN NOTTINGHAM: Thank you. I just was going to ask a housekeeping question partly because although, Ms. Dearden, you're a very familiar face here, I haven't had the privilege of hearing the other witnesses testify.

Are you each here, to clarify, on your own dime, so to speak, or is anybody compensating you to be here today? I'll just ask each of the, just for the record, each of the witnesses.

MR. LEILICH: My wife has given me a budget to come here.

MR. GRIMES: I'm here on my own time and my own þ at my own expense. And I'm also staying with a family member to be able to reduce that expense.

MR. BRESKIN: I have to admit that my university said that they would cover the cost of my trip here. Other than that, I'm on my own.

ACTING-CHAIRMAN MULVEY: That's common procedure. If you're testifying before the Congress or before an agency, the university usually will pay for those expenses, but you're not representing anybody who's a party to this.

MS. DEARDEN: I did not ask my clients to pay for this, because I'm just passionate about this particular subject.

That's why I'm here.

VICE CHAIRMAN NOTTINGHAM: Thank you. There's not necessarily a right or wrong answer. I just, for the record, it's helpful to know. Thank you.

I really don't -- this has been very informative. I've looked through both the testimony and some of the attachments that some of you had submitted. And I will defer to you to take the lead, Dr. Mulvey, with this panel, doctor to doctors, and I'll just enjoy listening and learning.

Thanks.

ACTING-CHAIRMAN MULVEY: Thank you, Chip.

One of the issues that has come up is that in doing statistical studies going forward now with only having seven North American railroads, five domestic ones, Class I's anyway, is that the universe has gotten too small for þ unless we find some way of disaggregating it.

We heard earlier about up in Canada they use divisions of the two railroads.

Mr. Breskin, you talked about mixing time series and cross-sectional data and doing that to up the number of observations.

Can that be done? I mean you'd have to do a Chow test, I would think, to show that the groups belong to the same universe, correct?

MR. BRESKIN: There are a number of tests that you can do. In the process, you will want to use some dummy variables to indicate shifts from railroad to railroad. Which also can be brought into the costing methodology in that the underlying technology is probably the same, or we can expect that the basic technology would be the same railroad to railroad, but there probably are shifts in individual expense categories that will differentiate one railroad to the other, and you can take that into consideration.

Yes, trial test is one of the possibilities.

ACTING-CHAIRMAN MULVEY: Would you also accept that using divisions as opposed to different years would also be an approach that might take care of some of the problems of using the multiple years where you might have, autocorrelation and other difficulties showing up, relating to the independence of the observations?

MR. BRESKIN: A lot of my research I have not found too much problem with auto correlation. There is a little bit, but it's not unworkable.

The use of the dummy variables, the shift parameters seems to take away a lot of that auto correlation that occurs.

One of the problems of using divisions, and this comes back to the fact that if we go back to 1931, there were a lot more Class I railroads. So, you could use a cross-sectional dataset and you still had some limits.

Now, when we're down to seven railroads, most of my recent research I go back to 1984, and have a separate dummy for each railroad. When mergers take place, it becomes a new railroad and the previous two would cease to exist. They'd go to a zero in the dummy variable. And I find that that has worked relatively well.

As well as the use, as I mentioned earlier, I've been using five measures of intermediate operating; gross ton miles, car miles, train miles, locomotive horsepower miles and switching hours, and along with a couple of capital measures and a couple price indices.

And I found that that extensive dataset still gives me something in the neighborhood of 250 degrees of freedom to work with which is þ it seems to be sufficient for statistical inferences.

ACTING-CHAIRMAN MULVEY: Right.

Anybody else want to comment on that?

Dr. Grimes, you mentioned that in your analysis of the autocorrelation between fuel consumption and wages, is that also þ is that related to the fact that wages are mileage-based in this industry as opposed to being hourly-based?

MR. GRIMES: Forgive me. I don't think I submitted a þ

MR. LEILICH: That was mine.

ACTING-CHAIRMAN MULVEY: I'm sorry. That was you. I'm sorry. All right.

MR. LEILICH: We simply made the observation that it existed, and it is certainly true that locomotive wages are based on train miles, but there are also variables.

You can have a one unit-train, a train with one locomotive unit or ten locomotive units, and the pay difference is not all that great between the number of units versus the number of miles that the crews run, but I'm sure there's a huge difference in fuel consumption between a train of one unit and a train of ten units.

But when you get all through and you take all the numbers at the end of the year, run them through their regressions, that is masked in the relationship between þ that we found, between fuel consumption and crew wages, was just as good as gross ton miles, car miles and locomotive unit miles.

So, I'll let the expert here discuss how to resolve it, but that's what we observe by PhDs from one end of the country to the other who are really good at what they're doing.

I'm an engineer, practical nuts and bolts guy, not a statistician. So, I just had to sit back and revel at what these guys were arguing about and try to understand it.

MR. BRESKIN: From what I've found, and I kind of go on the assumption that the railroads are using the appropriate amount of horsepower for how fast they want to run the train and the trailing weight. And I find that for as you change horsepower miles relative to trailing weight, you'll tend to get a faster train the same way as if you want to drive a car faster, you tend to use more horsepower.

And the combination of having four or five independent variables, allows them to work interactively so that you can have gross ton miles. And gross ton miles in an articulated piggyback train, is going to be significantly different.

One gross ton mile isn't the same as a gross ton mile in a coal train, and you're going to use different amount of locomotive horsepower to pull those, and part of that's dependant on the speed.

But my assumption is that the railroads are trying to balance the number - the amount of horsepower in general over their whole system with the amount of trailing weight as well as the speed that they want that train to run.

So, I'll leave it at that.

ACTING-CHAIRMAN MULVEY: Mr. Grimes, care to chime in on this?

MR. GRIMES: Well, you know, I would say that that's basically true. Having been in the railroad business, is that generally speaking the faster you want it to run, the more power you want to put on it, but you're limited to a certain degree by obviously the characteristics of the road, if that's what the major question was.

I would point out that any particular factor that you want to study has many, many, many factors in the real world that might affect it. So, if you're running a þ and I'm more of an engineer than an econometrician, so forgive me here.

But the questions is, is how many variables do we want to throw into this equation?

ACTING-CHAIRMAN MULVEY: Well, the economist's argument would be all those that are significant and all those that are for explanatory power without, again, getting into autocorrelation or multiple þ at any rate, both Greg and Sandra, both of your models, from what I can see, represent a real departure from URCS.

I mean basically your models could actually be used to replace URCS and take an entirely different approach.

Would you see that as being something that could be done at somewhat less cost?

There's been talk about today about how expensive it might be to redo URCS and to redo all the engineering analyses and the econometrics, et cetera.

But with your approach adopting a translog cost function, or your approach with your model, would that be a substitute for

URCS or would it be in conjunction with
redoing URCS?

MS. DEARDEN: I think it has potential. I think if that was going to be posed, I would like to reconfirm because our model has been in place since 1997. I'd like to reconfirm all the components in there and make sure it's accurate because, like I said, I don't suggest that it's perfect.

But it is based on the railroad's own data, it also seems to match the costs calculated by their management cost system, so I think it has potential.

ACTING-CHAIRMAN MULVEY: Are your calculations linear or nonlinear?

I mean do you wind up with the elasticities that vary with output or is it linear?

MS. DEARDEN: It's probably linear.

ACTING-CHAIRMAN MULVEY: Probably linear?

MS. DEARDEN: Yes.

ACTING-CHAIRMAN MULVEY: Greg, yours is nonlinear?

MR. BRESKIN: Mine is definitely nonlinear. And I have a couple of þ one primary that I use a single equation, the translog equation, that ends up with about 150 variables, including quite a few dummy variables, but about 55 are actual causal variables.

Does it give costs? I think it gives reasonable costs. And if I could do it by myself, it can't be terribly cost ineffective.

Would it be a replacement? I don't know.

I've also suggested at one point in a published article, that you simply take the current breakdowns of expense categories in URCS and then use something like the translog framework to estimate elasticities, or really partial elasticities, that will give you characteristics of those expense categories, individual expense categories relative to variation in train type. So, you can look at actual trains and define the characteristics of the train, and then take that to costs.

A single equation is obviously more cost effective. Does it necessarily give a better or worse estimate? I'm not sure that any of us know in reality exactly what the costs are. So, I guess my feeling would be it doesn't give any worse estimate.

Whether it's better or not, not knowing what the true costs are and how I can measure them, I can't really say that it gives a better estimate. But I'm pretty convinced that the multivariate, non-linear will give you a better cost estimate than the one or two variable linear model would give you.

ACTING-CHAIRMAN MULVEY: That would be the general assumption, I would think.

Mr. Leilich, you suggest that the Uniform System Of Accounts is flawed.

Do you have any specific changes you would like to see made in the USOA?

MR. LEILICH: I'm not prepared to comment on that this time. I think some of my comments if the old notes still exist and they haven't turned brittle and faded away, document some of my feelings on that. And a lot of the changes that I wanted to see made, were made. Not all of them.

I think we should not lose sight of the fact that costing is an art as much as a science, and it will always be that no matter what kind of methodology you develop.

So, I think the idea of a transparent methodology -- and I agree with the railroad's sensitivity to their own internal methodology and their - particularly the numbers they put into them.

But you've got a lot of talent there in the railroad industry. And if you were to get them together with a clean sheet of paper, what they know in their heads, I believe, can come together and develop a methodology.

None of you have probably ever seen the old Rail Form A book which was about this wide and about this high that had page after page of numbers flow here, flow there.

Well, at one time I was one of the 50 experts that really understood Rail Form A. I also understood why -- there probably weren't þ probably 49 of those were liars, because it was so difficult. But nevertheless, there was a good flow and a good methodology.

And today I think with the knowledge that we have and the data that we have, we can simplify that and still come up with a much better system.

This doesn't mean we don't need the help of the academic experts. I think we still need that in the variability issue, but there's a logic - lot of logic to costing.

And my experience has been that

from an engineered cost basis, I can build up avoidable costs that probably represent at least 50 percent or more of variable costs without argument.

Who's going to argue over crew wages for a train going so much distance or the train performance calculators that do an excellent job of calculating fuel consumption, and the equipment, we know the cost of the equipment that's assigned. So when you get that far, there's no argument.

When you start getting into arguments is, well, what portion of track maintenance should be assigned and other costs that are variable, but indirect, such as train dispatching. Well, then you could go to your statistical relationships and start adding those on.

And so with at least half the variable costs being avoidable and basically non-arguable except maybe the cost of fuel or the - my TPC model is different than his TPC

model, you get very, very close. And I've had
þ worked really well with the railroads and
the shippers in reaching agreements on those.
And so you narrow down the area
where you disagree, and then by relying on
more sophisticated methodologies to distribute
those costs that are joint and common that we
talked about here today, I think on a þ
costing would be much simpler, much easily
understood, and where people will argue on
differences is relatively small.
And you can take both sides of the
equation. Well, how far apart are they? 10,
15 or 20 percent? Focus on that and then
you've got a decision.
I have never ever had to come
before the ICC or the Surface Transportation
Board to successfully conclude a rate
negotiation. So, I've always been very
confident and comfortable with the way I and
my former firm worked with both railroads and
clients to do costing.

And if you can actually develop that kind of methodology, there might be a lot of unemployed people at the STB because nobody's coming here to argue rates.

That's a joke.

ACTING-CHAIRMAN MULVEY: Arguments keep us employed.

You mentioned some costs, avoidable costs, common costs, joint costs. It's quite interesting that an awful lot of cost analysis in economics derived out of a need to understand railroad costs.

As I was talking to Mr. Ripley when we developed his formula together þ that's an inside joke.

But this idea of how much costs are variable and how much costs are fixed is one that has gone on in railroading for a long, long time.

Mr. Grimes, you mentioned that -- the fact that we understate the variability of road investment cost. You said that it's 88 percent and, not using that but using the 50 percent factor instead constrains railroad prices and, therefore, railroad capital investment, but isn't it true that railroads have been able to attract capital even with the charge of 50 percent variable instead of a more, in your view, a more accurate 88 percent variable?

The railroads still seem to have had access to capital markets, so are they really capital constrained by having this restriction?

MR. GRIMES: I'm not going to - I don't think I can comment on their ability to attract capital. They certainly have been spending it.

But I would like to say that, you know, if you look at the period from 1988 through the late '90s, they were building, but their free cash flow was falling.

Net income was rising, the free cash flow was falling to the point where it got negative.

Now, as your free cash flow is falling, you are essentially destroying your business. They finally turn that around and free cash flow started rising again.

But I think that if you want to promote investment in this industry, you know, you've got to have a rising þ you've got to have a rising free cash flow to support that investment.

That's a policy question and I'm going to back off from answering it.

ACTING-CHAIRMAN MULVEY: Okay.

MR. GRIMES: I would like to respond to one thing that we talked about earlier, and that's the issue of marginal versus average variable costs.

When I'm looking - when I þ if I've been managing a railroad, and I have recently, I've got to be looking at my long run or my average run costs.

I've often had marketing people

come to me and say, you know, my marginal costs are so much lower, why can't I reduce the rate to get more volume?

And I say because we've got to manage this business in the medium run, and a lot of the assets are long lived.

So, looking at it on just a marginal or strictly near-term incremental basis, creates distortions when you're talking about contracts that may go out for years or investments that may go out for years.

So, I would - let me - I'm just chiming in on this argument. I think the average variability was a wise decision by the ICC in its formation of URCS and Rail Form A originally.

ACTING-CHAIRMAN MULVEY: Well, the sole idea of variable cost and marginal cost is it doesn't distinguish between the long run and the short run.

I mean we haven't really talked about what length of time we're talking about here. And in fact in railroading, the marginal costs we're talking about are long-run marginal costs, not short-run marginal costs, and that's a big distinction.

And, Ms. Dearden, you suggested that your models gave results that the railroads' costs were substantially less than predicted by URCS, whereas some of the criticisms that were heard of URCS at least from the variable cost side, is that variable costs are understated by the way they're calculated.

Can you reconcile those two observations from -- to you and Mr. Grimes?

MS. DEARDEN: Well, first of all, I think what will happen is if we do an update of URCS, there is -- some of the costs in some areas will actually increase þ

ACTING-CHAIRMAN MULVEY: Okay.

MS. DEARDEN: -- and some will go down. But overall, I think overall the costs overall will go down.

We did find in one study that we did for one client, there were a couple lanes where actually URCS costs were lower than the costs calculated by our model. So, it's not across the board.

ACTING-CHAIRMAN MULVEY: Mr. Grimes, you get a jab in.

You said that if we change URCS costs, it would probably go down, but that would assume that we continue to use book value for capital, correct?

MS. DEARDEN: Yes.

ACTING-CHAIRMAN MULVEY: If we switched over to replacement capital cost, then that would certainly not be the case, right?

MS. DEARDEN: Right.

ACTING-CHAIRMAN MULVEY: Okay.

MS. DEARDEN: I think the goal should be þ it shouldn't be a shipper versus railroad issue. It should not be what's in it for me from any one standpoint. I believe it should be þ we should develop a system that more accurately reflects what the real costs are.

ACTING-CHAIRMAN MULVEY: That's all the questions that I have for this panel.

Chip, do you have any others?

VICE CHAIRMAN NOTTINGHAM: No.

ACTING-CHAIRMAN MULVEY: Thank you very, very much. We appreciate everybody here coming today. I want to thank you all for your testimonies.

As I said before, the record on this will be open until the 1st of June, anybody else who wants to comment, and thank you all very much for coming today.

(Whereupon, this public hearing for the U.S. Surface Transportation Board was concluded at 12:48 p.m.)

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