UNITED STATES OF AMERICA

SURFACE TRANSPORTATION BOARD

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PUBLIC HEARING

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IN THE MATTER OF:                : Docket No.
                                 : EP 665
RAIL TRANSPORTATION OF GRAIN,    : (Sub-No. 1)
RATE REGULATION REVIEW           :
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Wednesday,
June 10, 2015

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

The above-entitled matter came on for hearing, pursuant to notice, at 9:29 a.m.

BEFORE:

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ANN D. BEGEMAN, Vice Chairman

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(9:29 a.m.)

CHAIR MILLER: Good morning. Very nice to see everyone here. We've been really excited. I think I can speak for Ann and me when I say that about having this hearing. I am Deb Miller. I am serving as the Acting Chair at the Surface Transportation Board. I think many of you will know my fellow commissioner, Ann Begeman, who is up here with me today. I want to thank all of the panelists who will be participating in this hearing. We really do recognize and realize you have travel issues, the time and energy it takes to get all of your materials prepared, can be a very big lift and we know that and appreciate it. I think we have important policy issues before the Board and the only way we can make really valuable informed decisions is by hearing what you have to say and having the opportunity to engage and so we're really pleased to have this chance today.

As I'm sure many of you know, being

active watchers of issues before the Surface Transportation Board, we're having another hearing in July on the issue of revenue adequacy. I could imagine that when we announce this hearing and the hearing on revenue adequacy, there may have been collective groans that went up from the community. In fact, I think I might have heard a few even sitting in my office. I know in the past there have been times when the Board has started proceedings, held hearings and then our stakeholders, after waiting patiently, saw the Board do nothing. I want to assure you, that is certainly not our intention today. I certainly view this hearing as a means to an end and that end would be a resolution of this proceeding. But it's not just this proceeding that the Board is likely to be looking at.

A number of the proceedings that have been initiated at the Board and are currently open as well as the issues we'll be looking at today, have a lot that is in common. I think when we want to look at these proceedings, which would include issues like exempt commodities, reciprocal switching, grain rates and the revenue adequacy issue we'll be exploring in July, that because of the common issues that they share, we want to think about all of these issues together and jointly.

It would be my hope, as many of you may have heard me say, that we can come out of this summer's hearings looking at all of those issues together and come back with a comprehensive package of approaches that will make sense for how the Board moves forward in the future on a number of issues. It's too early, of course, to say what the Board will do but what I can tell you is that I've got some ideas; I know our staff has some ideas and I'm confident that Vice Chairman Begeman has some ideas as well.

So, we may find that in the next few months we'll be looking at making significant changes to our processes and looking at a lot of Board reforms. Perhaps what we'll find is that things are going pretty well based on what we're hearing from our stakeholders and learning through the pleadings you filed and the testimony we'll be hearing and perhaps all we need to do is make a few tweaks or do nothing. But one way or another, what I want to be sure is, is that we have a resolution to the issues that are before the Board.

So, my goal today for this hearing, for myself at least, is to become much more knowledgeable on these issues and to have a much better understanding at the end of the day about how our rate processes apply to grain shipments. What those issues are both from the perspective of those of you who deal in the agricultural industry as well as those of you who are in the railroad industry. In my year at the Board, I've had many opportunities to meet and engage with agricultural shippers and based on those conversations, I certainly understand how important consistent, reliable rail service is at a fair price in order for those businesses to flourish. But it's also important to hear from the railroads and understand the issues from their perspective as well.

We all know that there are challenges dealing with the grain markets and it's not necessarily easy to be the one who is serving those markets either. Certainly, since the passage of Staggers, when we saw a railroad industry literally on the verge of collapse, going to one that's strong and healthy today, we're all very vested in ensuring that the continues to be a strong and thriving railroad industry. Still, it's clear from the conversations that we have with grain shippers from the meetings we have in our offices from the things that are filed before us, that many grain shippers do not feel they have fully received the benefits of Staggers and have concerns and so that's why we're here today. I'm curious to hear more and will be listening very attentively and Vice Chairman Begeman, would you like to make a statement?

VICE CHAIR BEGEMAN: Thank you Deb.

I'll be relatively brief. First, I want to certainly thank the Acting Chairman for holding this hearing today and I welcome all of the witnesses who have taken the time and effort to join us today and give us their views on what I consider to be a really, really important issue.

The AG community has had some deep frustrations with the agency's rate methodologies since they were first created. Despite the efforts that the Board has taken to establish a process for small cases as Congress directed, we hear the same message that our methodologies, even the most simplified 3B methodology, is unusable for a grain shipper. We heard that message yet again during the rate reform rule making proceeding from the National Grain and Feed Association and the Alliance for Rail Competition, among others.

I really appreciate that the former chairman, Dan Elliott, I'm not sure if he's here yet, I think he was going to join us --- yes, he is here. Hello Dan. He agreed that we could not ignore these important stakeholders' concerns and we really need to explore what more the Board can do to fulfill its statutory obligation.

The whole purpose, at least certainly my purpose, isn't to debate rates. We already know the perspectives. The shippers think rates are high and we'll hear from the industry that they're not too high. But my goal is to fulfill the statutory mandate to ensure that there is a process here that every shipper has access to in order to have their rate judged fairly and timely.

So again, I also want to thank the Acting Chairman for making this issue her very first to explore during the hearing process. I think it sends a really good signal to stakeholders, it certainly does to me, and I look forward to the hearing. I will probably have a few questions during the hearing, I guess that's why we're here. And just one more final comment.

In preparation for a hearing like this, a lot of work goes into it. I know that the Board staff put a lot of work into it and there are a couple of unsung heroes around this agency. A few that I see in the audience, Mike Smith, Douglas Plesey, Frank O'Connor, who really have such a handle on the AG component of what goes on with rail service, and I just want to publicly thank you for your service to the Board and to the public. Thank you.

CHAIR MILLER: Thank you very much, Ann, and thank you for thinking to call out staff. It certainly is true, getting ready for a hearing like this, as I'm sure in your worlds, it's been very hectic. It certainly has been in ours and I do want to say Dan Elliott, former chairman here and perhaps soon to be chairman again, Dan, if you could stand up. I'm glad you could be here today. Come on. Thank you for coming. I think it's really great you have time in your schedule to be able to be here. It will be important to hear the issues.

Now, before we get started with the testimony, let me do kind of the standard procedural points so everybody is kind of prepared. I want those who will be testifying to know that we have the lights up here. Your testimony is timed. Everybody has been sort of assigned roughly a time, generally what you requested, and I know it can be very difficult but we'd like people as best as possible to stay within their timeframe. We have a long list of those who will be testifying today.

Just so you know, what's going to happen is the yellow light will go on when you have a minute left in your testimony and when you see the red light, that's going to be a signal to you that your time has expired. We would ask that you move as quickly as you can to wrap up your testimony and if not quickly enough, then I'll push the button that sends a mild electrical shock to your seat. No, I'm just kidding. No electrical shocks in the room. But, at any rate, we ask that you be as mindful as you can be in the thick of giving your testimony. So a couple of things. If you're scheduled to speak, please be sure that you've checked in with the clerk who is at the front of the room. I want to remind speakers, as I'm trying to remind myself to speak clearly into the microphone. Not only does it make a difference in terms of the ability of all of those in the room to hear what you're saying but we are recording this and so we want to be sure we capture all of your words because we know how good and interesting they're all going to be and then for those who are both with us today as well as those who might be watching. We will be placing this hearing on the STB website a few days within the close of this hearing.

In the unlikely event that we have a fire alarm or there are other events requiring evacuation, we ask that everybody proceed to these doors in the back of the room and then exit this building through the front doors that you came through. There are specific instructions posted at the back of the room for assembly and notification should we have any issues like that and of course, as we would often do, we remind everyone if you haven't already done it, to please turn your cell phone off which is a good reminder to me because I don't think I've turned my cell phone off yet so I'll do that here in just a minute.

I want to remind all of the parties, we're going to be leaving this proceeding open for fourteen days after the conclusion of the hearing. If there are additional pieces of information you didn't have a chance to provide or you realized later you wished you would have, you'll have an opportunity to do that. If you have rebuttal information for things you hear today, you're welcomed to provide that as well.

I want to say one final thing before I turn it over to our first witness, we weren't able to get it all done today, but for those of you who have regularly participated at the Board, I want you to know that we have some improvements coming that we're very excited about. Hopefully, if nothing goes wrong, the next time you come here for a hearing, there will in fact, be wifi available in this room. We're looking at improving and enlarging our screens. I don't know about you all, I just know when I'm in this room, they are simply not big enough for me to see the materials that's on them. So hopefully, for any of you who are back for our revenue adequacy hearing, you'll see some improvements in the hearing room and we're very excited about it.

We're going to get started now. I'm very pleased that we have with us today Dr. Richard Schmalensee who is Dean Emeritus from the MIT Sloan School of Management. He has just completed chairing a policy study for the Transportation Research Board that has to do with the STB, how we regulate in the rail industry. Dr. Schmalensee, please come to the table and thank you for being here.

DR. SCHMALENSEE: Thank you Madam Chairman for the opportunity to testify this morning. I think we will try to set up some slides. I'll be reporting on some of the results, the findings and recommendations of a study that a number of us have just completed for the TRB, an arm of the National Academies of Science, Engineering and Medicine. The study was formally released twelve minutes ago. It's available on the National Academy's website and there are summary descriptions at the back of the room.

This study, there we go, was requested by Congress in 2005, funded in 2013 and completed as we said just a few minutes ago. We were asked to talk about rate and service trends post-Staggers, particularly since 2000 to look at the performance of the regulatory regime and to make recommendations for the future role of STB. I'm going to focus on the last of these just in the interest of being relevant to this hearing. The study process is familiar to those who follow TRB studies. We were briefed by lots of people. We reviewed the literature. We did an unusual amount for one of these committees of statistical analysis of the waybill data, the carload waybill sample and other data and, of course, we deliberated.

One of the key findings, as I said we were asked to talk about events post-Staggers and I guess I would summarize our findings in that respect by saying that this is just not the same industry in almost any respect that confronted the authors of Staggers. It was being bailed out. It was financial shaky. I think many observers, particularly many economists, thought that when regulation was relaxed, prices would, of course, rise since you had financially distressed firms. In fact, as everyone knows, prices fell dramatically particularly over the two decades after Staggers because ICC regulation had restricted the industry's ability to innovate. It restricted its ability to consolidate traffic, to negotiate contracts, to match up with shipper needs and on and on. So the industry became much more efficient.

While rates have risen recently, they are still below the levels of the 1980's. This slide mentions one change post 2000 that I want to emphasize that's particularly relevant to today's hearing. The use of contract carriage of non-exempt commodities has risen sharply since the year 2000. 2012 was the latest year for which we have data and a lot of that has to do with coal. If you look on the left, that pie chart shows that in 2000, coal accounted for just about half of the ton-miles moving under tariff. By 2012, coal's use of ton-miles of coal under tariff went from about half of all coal ton miles to just about 5 percent. So coal traffic shifted rather dramatically over this relatively short period, from tariff to contract. That did not happen, for what we have there is the total of grain, oil seeds and food and kindred. It didn't happen. About 70 percent of that traffic by ton-miles moved under tariff in 2000, moved under tariff in 2012.

Thus, this hearing is particularly relevant because when one considers the reasonability of tariff rates, one is increasingly considering the reasonability of rates charged to grain, oil seeds and the shippers of food. So, I want to focus on the rate relief process and our findings and recommendations with the background that we're not thinking much about coal anymore. Really, we are thinking about the particular characteristics of these other shippers, grain, oil seeds and food.

The current process, as I think everyone in this room knows, has three steps. There is the initial screen based on the relationship of the rate charged, the tariff rate posted to variable costs as determined by the uniform rail costing system universally referred to as URCS. If a rate exceeds that 180 percent threshold, the next step in the process is an inquiry about whether the market involved is dominated by the carrier at issue. Assuming that hurdle is cleared, there then becomes an inquiry into the reasonableness of the rate using either the stand alone costs process, the first process devised or the simplified SAC or the three benchmark processes.

It's important here to note that our committee, as I think most people retain the objectives of Staggers which is to have an industry with adequate revenue. That is to say not to treat it as a public utility but to treat it as an industry governed by the marketplace. But also to make sure that we respect the Staggers goal of protecting shippers against unreasonable rates, particularly in settings where those rates are driven by market dominance.

Our first finding relates to this first step in the process, the 180 percent of variable cost test. If you read our report, this is perhaps the point on which the committee felt most strongly that the URC system attempts to estimate something that is not defined as a matter of economics and thus produces inevitably estimates that are arbitrary and unreliable. Costs are omitted, railroads points out that the cost of bearing the risk of shipping hazardous chemicals don't show up on their income statements and thus don't show up in URCS and it's not a surprise that many hazardous chemicals move at rates above 180 percent of URCS. Determining what's fixed and what's variable and what fraction of a locomotive is variable and what fraction is fixed is essentially arbitrary. Allocating common costs among the traffic involved is inherently arbitrary. We have plenty of examples of that.

There are odd features that go beyond arbitrariness as that second set of bullets indicates. Some kinds of traffic, particularly short haul traffic have rates systematically above this threshold, above 180 percent of URCS variable cost and 20 to 25 percent of traffic year in and year out moves at rates that the system says are below variable costs. That, of course, doesn't make any sense.

If you take it literally, that means that railroads are moving 20 to 25 percent of their traffic in an out of pocket loss. The key part that we would stress is this can't be fixed in the sense that you can't reform the procedure of deciding what's fixed and what is variable and allocating costs among elements of traffic without producing an arbitrary outcome.

Now, to step back, it's not hard to see why when Staggers was passed, the authors wanted some threshold to determine the eligibility of shippers to challenge rates and this was, you know, you could do it and if I were sitting in 1980, it's not clear, I would have done anything different. But it's not 1980. We now have plenty of rates that are determined under competitive conditions and those rates, we submit, can be used as a benchmark and those rates as a benchmark make more economic sense than essentially arbitrary estimates of variable costs and I will come back in a moment to how we might do that. The second finding relates to the second step in the current process and that is the market dominance hearing or the market dominance assessment.

Now, we understand why the Board has

excluded evidence on product and geographic substitute ability. That's complicated evidence. But of course, excluding a category of evidence that suggests market dominance is not present is clearly going to bias decisions. It just is an economic or a logical matter. That evidence can be difficult to process, of course, but I've done a fair amount of anti-trust work over the years and one observes the Department of Justice and the Federal Trade Commission dealing with evidence of that complexity routinely and simply in informal proceedings. In quasi-judicial or judicial proceedings, of course, evidence of this complexity is hard to deal with. In informal proceedings, not that difficult. Time limits, we suggest, ought to replace exclusion of categories of evidence.

Sorry, I went past one. All right. I need to go back. Excuse me. Manual intervention. The third step in the process is either the standalone cost test or one of the simplified procedures introduced later. Our committee suggested, concluded, found that those should be replaced. It's important to understand that given the Staggers Act's enabling of shipper specific contracts, railroads and shippers have every incentive to move all traffic that can be profitably moved so that you don't have here the sort of classic monopoly loss problem that you have in regulating electric power or telephone that gee, if the price is too high, there will be too little volume. There is not that loss problem.

The regulatory issue here seemed to us to be inherently about fairness. And the standalone cost tests embodies one notion of fairness that if I'm paying more than the standalone costs then I'm subsidizing somebody else under public utility regulation. The standalone cost test comes out of public utility regulation. It comes out of telecom debates in fact in the 70's and comes out of a concern that prices to high encourage inefficient entry not as we understand it a live issue in rail today.

It seemed to us that the simplified procedure, and the fact which the slide doesn't state but everyone knows, well it sort of does, that this SAC procedure has really not been useable by small shippers particularly by grain shippers that ship to multiple destinations. Maybe one reason why there is less contracting for those shippers but in any case the SAC procedure, we were told, about five million dollars a case is not useable by small shippers. The simplified procedures are simpler but they make use of URCS and if that's fundamentally flawed, simplifying by making more use of a fundamentally flawed measuring stick is not, we submit, a move in the right direction.

So let me say what we suggest be done instead and I will preface this by saying almost everything I'm about to describe almost certainly required legislative change, which is good news or bad news depending on your point of view but our task was not to think about what's feasible but to think about what should be done. So we proposed using the competitively determined rates that I mentioned a few moments ago as benchmarks. The report describes how we do that but the fundamental notion again, is a fairness notion that it ought to be the case that a shipper in a market dominated by a single railroad shouldn't have to pay a rate that is too far out of line with rates paid by shippers in competitive markets for similar shipments.

So, we can look at statistically, we can model the determination of rates in competitive markets as a function of shipment characteristics. We can then ask what does that model predict for rates in non-competitive markets and what that graph shows for farm products is it happens, given our data, the ratios of actual rates in non-competitive markets to predicted rates in those markets. Predicted on the basis of the model of competitively determined rates. Now you will see that a reasonable fraction of the actual rates are less than the predicted rates. Those are the rates represented by the mass to the left of the vertical line at 1. And that's, of course, because it's a model and it doesn't fit data precisely and we don't, we aren't able to precisely predict all competitive rates. That's a worthwhile caution because it says that many of the observations to the right of that line where the actual rate exceeds the rate predicted under competition, are there simply because the model is like all models, imperfect. So we wouldn't propose that all of the tariff rates to the right, be treated as subject to detailed examination. That is to say, treated, as if they had passed the URCS test, the 180 percent test. But the farther out you go, the more likely it is that what's happening is serious use of market power to raise rates.

Our suggestion is this sort of modeling can be perfected. Our report contains what we consider to be a proof of concept using waybill data and other data that are readily accessible and a lot of work. Two of the members of our committee produced a model of competitive rate setting, applied it to non-competitive markets and such a model can be tested, can be refined, can be debated but those are technical questions. The policy question is what replaces 180 because 180 is an arbitrary number. There is no economics to it. I assume it was a late night negotiation.

To use this approach, one needs to come up with a replacement number to say that rates that are twice the competitive or three times the competitive prediction or one and a half times the competitive prediction or 180 percent of the competitive prediction if you like that, are subject to challenge.

This approach, a few points about it, we advocate this to replace the URCS test and this could have not been done when Staggers was written. There weren't rates that you would say are determined under competition in an efficient rail system. We have such rates now. The threshold, what replaces 180? It's a policy decision. If you set it too low, you place revenue adequacy at risk. If you set it too high, you risk not granting rate relief to people who ought to get it. There is no magic number. It's likely to be controversial but like the determination of 180, it can be transparent.

Appendix B of our report, thanks to a lot of work by two members of our committee, has detailed analysis and a proof of concept. It is not the last word but it suggests that you can do this credibly and we think it's much better than SAC. For the second and third stages, the dominance test, the dominance proceeding before the STB and the standalone cost test for reasonability if dominance is cleared, we propose again in the interest of reducing costs and proceeding expeditiously and not excluding relevant evidence, we propose moving to arbitration at that point. If the screening tool is appropriate, one doesn't have to rely on stringency at the second and third stages to preserve revenue adequacy. Arbitration can be informal.

We propose it to be behind closed doors with confidential results so we don't set precedent. It can be fast, it can be economical, and it can consider complex evidence. We propose this be final offer arbitration, baseball style arbitration, because experience has shown that promotes settlement because of uncertainty about the arbitrators decision. It also promotes the parties making reasonable offers because unreasonable offers are unlikely to be accepted.

Now, one reason why we have some confidence in the merits of this recommendation is the Canadian experience. Now this is not to say the Canadian experience is a panacea or we should imitate all aspects of the Canadian experience but in Canada, a shipper doesn't have to pass any sort of screen to be entitled to arbitration. A shipper can raise its hand, get rate arbitration or get service arbitration even. The Canadian system, as we can tell, has not involved a lot of cases even without a screen for eligibility. Most of those have settled and while nobody likes to be at the mercy of an arbitrator, the system proceeds without five million dollars of case costs and it proceeds in a manner that makes it accessible to small shippers and it proceeds without the need to exclude evidence in order to move on a timely fashion.

We think dominance does need to be part of the arbitrator's task but there is no reason why an arbitrator can't, like the Anti-Trust Division does, consider complex evidence with a time limit. We also think there is no reason why the kind of cost evidence that would undoubtedly be brought forward in this sort of arbitration can't be considered.

Again, the Canadian experience, while not perfection and not necessarily something we want to imitate in detail, suggests that this approach is workable and can be done in a timely, expeditious, relatively inexpensive fashion.

I would mention, since I still have a

green light, two other aspects of our proposals and then of course, I would welcome your questions. I know you have before you a proposal by NITL regarding reciprocal switching and we discussed reciprocal switching at our deliberations. We did not take a position on the NITL proposal. We did observe that Canada has reciprocal switching everywhere if you're within 20 kilometers of a switch point.

We didn't reach a conclusion on that proposal or proposals like it but it did seem to us that in the context of arbitration, that it would not be unreasonable to allow either side to propose reciprocal switching as part of its final offer. A railroad might say well we think our rate is terrific but if you really think it isn't, we will allow for switching at a certain price and let you negotiate with the other railroad at the switch point or the shipper might say I don't want to rely on you at all, I want switching and I'm willing to pay X for it. We think that if you get to arbitration, it's not unreasonable to have that be part of either party's final offer.

With elimination of the URCS test, there is no longer a concern that this might lead to a rate below 180 percent of variable cost. Again, putting it in through arbitration and not a blanket nationwide policy removes concerns about fee schedules, distances and so forth. That would be part of the arbitration. The second point up there that is relevant here, of course, it's more relevant to your next hearing but I'm here today and if you will permit me a few moments to just round this out, we recommend eliminating the annual revenue adequacy determination described by the Board itself as a mechanical process, pass/fail grading.

Our reason is twofold, first, the prolonged use of this process that looks on its surface like public utility regulation, compare the cost of capital, to learn the cost of capital, suggests to some on both sides of the debate that perhaps there out to be a cap of some sort based on this kind of comparison of returns with cost of capital. We think that's inconsistent with Staggers. We think it's impractical and we think it's not the way forward. The second reason is there is good reason why the railroad industry needs to be looked at closely in terms of revenue adequacy, in terms of competitive conditions, in terms of exercise of market power. The annual revenue adequacy determination is not such a look.

Our recommendation is that the annual exercise be dropped but that the Board be tasked with periodically, let's say every five years, issuing an in-depth report on competitive conditions, revenue adequacy, long-term prospects and so forth to assess whether you know, the policy we have is producing the results that we want, which I don't think and we don't think the annual revenue adequacy determinations do. With that, I will pause and thank you for your patience.

CHAIR MILLER: Thank you very much,

Professor Schmalensee. I suspect there are lots of people in the audience right now that wish they had the opportunity to ask you questions and if we could do that, we could probably just spend the rest of the day peppering you but fortunately for Ann and I, we get the opportunity to ask some questions and I would say that those of you who are in the room, we did have the opportunity yesterday, Dr. Schmalensee was kind enough to come up and give us a preview of the report so we have had an opportunity to already ask a few questions but I certainly find that I come up with other questions every time I hear you go through this analysis.

There are just a couple of things I want to clarify. You've talked about the issue of market dominance not restricting categorical evidence but using time limits and that works better in an informal proceeding. When you talk about informal proceeding, is that another way to say arbitration? Is that really what that means?

DR. SCHMALENSEE: That's what that

means in this context. Yes ma'am.

CHAIR MILLER: Okay. I just wanted to be sure that there weren't other ways you all were thinking about it. One of the other things that I was wondering, when you talk about SAC and you say, really the purpose is really more to determine fairness than to efficiency. Is one of the reasons why the committee concluded that there is no economic justification for the use of SAC because the analysis is a fairness analysis, not an efficiency analysis? Am I drawing too many connections from what you said?

DR. SCHMALENSEE: Well, it's my lack of clarity I'm afraid. I think the approach we take is fundamentally a fairness approach as is the SAC approach. So that's not, if you could do SAC inexpensively and quickly and it could be made accessible to small shippers, you could argue that this is one definition of fairness. The comparison with competitive rates that we propose is another. Ours is very quick, however. The arbitration is very quick and an arbitrator will naturally be concerned with issues of fairness. The SAC test is a particular measure of fairness. We could have a long discussion about its properties. It's not obviously the right one here. I could see why it was done when Staggers, after Staggers was passed when confronted with a railroad industry that you know the costs are too high because of the legacy of regulation then to say well, let's look at the costs of an efficient alternative that just serves you and fairness says you shouldn't be subsidizing other people.

Of course, without a rate of return constraint, it's not clear there is a subsidy but you shouldn't be paying more than a standalone cost of an efficient system. That makes a certain amount of sense but there is no theorem that says that's the way to do fairness. I could see why it happened when Staggers was passed. I think experience has shown that it's unwieldy and not the only way to think about fairness.

CHAIR MILLER: Certainly it is

unwieldy, no question about that. I have a final question and then I'll turn it over to the Vice Chairman, but I want to go back. In terms of the issue of revenue adequacy, again, this is maybe my interpretation of what you said and that is that really where we are, 35 years post-Staggers, is that there is no real purpose served by the revenue adequacy test and the approach that's been suggested by your committee of doing more of a five-year in depth analysis as much as anything, is a way to continue to monitor whether or not we're continuing to see you know, a good competitive market but not really because revenue adequacy is needed in the regulatory process? Again, am I going too far in interpreting the panel's recommendations?

DR. SCHMALENSEE: No, I don't think you're going too far. I think the notion that the Board should revise its process if the industry is found to be revenue adequate, which kind of lurks from earlier statements; I think it's too mechanical in a way. Nobody asks, is

General Electric revenue adequate this year? You look at businesses over the business cycle. You look at long-term prospects. You look at a variety of things in judging the health of an institution or an industry.

Now, we were not tasked with assessing the methods used in the annual review. We did have discussions about them but at the end of the day it seemed to us that what's happened after Staggers, 35 years after Staggers as the industry has invested and innovated and reinvented itself, is it looks a lot more like a normal industry than it did with Staggers.

CHAIR MILLER: Uh-huh.

DR. SCHMALENSEE: When Staggers was passed, you could see why you would want annual revenue adequacy determinations because are we going to have to bail them out again? It was clearly on people's minds and logically on people's minds given how much had been spent. That's not on anybody's mind today as far as I can tell. The industry is making substantial investments. The industry is expanding capacity. So the notion of, do they have what they need to live and if they do, maybe we should tighten the regulation, seems counter to the thrust of Staggers at the end of the day.

Staggers was about making this into an ordinary, maybe wholesome or not, healthy industry. We can debate wholesome if you'd like. But healthy industry that yes, still needs regulatory oversight because it has inevitably a fair amount of market power and is an important industry but Staggers pointed toward light-handed regulation not public utility style regulation and the annual revenue adequacy looked to us a lot like public utility regulation and periodic, say five year examination of the industry, looked a lot like let's inform policy and see if we're in the right direction and do we need to make changes. It just seemed to serve, that seemed to be the right purpose today. Are we on the right track? Not turn the crank, yes, no, revenue adequate, not revenue adequate.

CHAIR MILLER: Thank you very much. Vice Chair Begeman?

VICE CHAIR BEGEMAN: Yes, thank you very much. I think you have a lot of people needing some air in the room. Thank you for getting us out of the group-think mentality, that a lot of times we get sucked into when we start dealing with these issues and rate case methodologies. You certainly have made clear that much of what you're suggesting is not in our power to do without legislation. But one of the questions I wanted to ask, you mentioned that because of the change in coal shipments, you did not include that element in your process as far as what you were developing. But, even if you had, would you have come out with a different outcome?

DR. SCHMALENSEE: No, we would not. I wouldn't say that we excluded them, it was just that we noticed that you know, almost all coal now travels under contract. My sense is, and I think the sense of the committee, without being able to document it, is that one reason why, a couple reasons why contracting coal is easier than contracting in grain but an important reason, we suspect, is that there were all of those coal cases which sort of set bounds on what kind of rates might stand up. That makes negotiation a little easier. We didn't exclude coal from our consideration, the approach we proposed would apply as well to coal as to anything else. But coal shippers appear willing to enter into contracts and thus not be eligible for a reasonability determination.

VICE CHAIR BEGEMAN: Thank you for correcting my impression because I thought you said that you weren't thinking about coal anymore, but it had a different meaning?

DR. SCHMALENSEE: No ma'am. It was just to point out that the composition of tariff traffic has changed but what we proposed would apply to all tariff traffic.

VICE CHAIR BEGEMAN: On the modeling that you had on the screen for the farm commodities of the different pyramid, if you will.

DR. SCHMALENSEE: Right.

VICE CHAIR BEGEMAN: Was that just illustrative or was it actually based on the waybill data?

DR. SCHMALENSEE: It was based on the waybill data. It was based on the waybill data plus data on, and I don't remember the name of the database, but it provided locational information so that we could assess is there barge competition nearby and so forth. It was based on the real waybill data.

VICE CHAIR BEGEMAN: So it was where the traffic was, what was moving, if there was competition, and what the distance was?

DR. SCHMALENSEE: Yes, we started with contract or exempt traffic, where there was rail competition nearby or barge competition nearby. We treated those as competitive benchmark rates modeled how they depended on shipment characteristics such as distance, number of carloads and so on and so forth, and then used that model to say well, if this other shipment, this tariff shipment without rail competition available, what would that rate have been if it had been competitive in line with these other competitive rates and of course, the model is not perfect. It can't be perfect. So there is modeling error.

As opposed to URCS, we're at least trying to predict something real, that is to say the competitive rate not something imaginary like variable costs. So, that was based on a rather extensive analysis of the waybill data done by two members of our committee with staff help. Again, we don't, let me be clear, we don't say take Appendix B, write it into the legislation and use it. The point of Appendix B, which is where the analysis is done, is to say this approach is feasible. It can undoubtedly be done better than we did it, but it's feasible.

VICE CHAIR BEGEMAN: And as far as the "punch line" of arbitration, did you have opinions on whether or not it's something that could be done within the Board, or actually, should it be outside of the Board?

DR. SCHMALENSEE: We resisted the usual academic temptation to reorganize the federal government. My understanding is, again, I'm not a lawyer and nobody involved is, but that it would be --

VICE CHAIR BEGEMAN: That's okay, neither are we.

DR. SCHMALENSEE: I'm not sure --

VICE CHAIR BEGEMAN: It's a feature, not a flaw.

DR. SCHMALENSEE: I'm not sure the Board has the authority to hand off decision making to an arbitrator. If it did, then it could. If it doesn't, then it can't.

VICE CHAIR BEGEMAN: But if the parties would agree to it, they could.

DR. SCHMALENSEE: Oh, if the parties would agree to it, then perhaps it can. We don't propose mutual agreement to be the test. We just propose that to be what you do at that point. In part, based on prior cases, would save an enormous amount of person hours at the Board to be able to do that.

VICE CHAIR BEGEMAN: Well I guess we're sort of left with trying to fix the unfixable, at least with this proceeding. Thank you for that. But if you have any ideas on what we could do, we still have a mandate, we have an obligation.

DR. SCHMALENSEE: You do and it is a difficult one and it's a little bit of an unwieldy mandate which was part of the point that we tried to make and I wish we had been able to come up with, given your statutory authority, here is the obvious way forward but we didn't impose that constraint on ourselves and I don't want to make something up here as I sit here.

VICE CHAIR BEGEMAN: Well, thank you very much.

CHAIR MILLER: Thank you. We appreciate your being here today.

DR. SCHMALENSEE: Thank you for your time.

CHAIR MILLER: Okay, we're going to move to Panel II and ask that those who are on Panel II come forward which includes Deputy Under Secretary Gary Woodward and from the Montana Department of Agriculture, Benjamin Tiller and Mike O'Hara from the Montana Wheat and Barley Committee, I think. And for those of you in the audience who might need to do some planning or thinking, we'll continue to monitor time and make sure it still seems sensible but we believe we will likely take a break for lunch after Panel III and before Panel IV. Okay, thank you. It looks like we're ready to begin. So Deputy Under Secretary Woodward, I'll turn it over to you.

MR. WOODWARD: Great. Thank you Madam Chairman. Madam Vice Chairman. I'm going to start out this morning doing something that I was told I should never do at the beginning of a meeting and apologize. I woke up this morning and realized that my allergies had given me a swift kick in the pants and so my throat is a little scratchy and my voice is coming and going but I will do my best to project as well as I can this morning so that you all, and the folks at home can hear me. Again, Gary Woodward, I'm the Deputy Under Secretary for Marketing and Regulatory Programs at the United States Department of Agriculture. It's a mission area at USDA that encompasses the agricultural marketing service, which has as part of their mandate, the task of monitoring US transportation systems as they relate to agriculture.

I'll join the Chairman and the Vice Chairman this morning in pointing out the good work of staff and I want to thank Arthur Neal and his team at AMS who are sitting behind me for their yeoman's work in this area. They are the real policy experts on these issues and so I want to thank them and highlight their work on behalf of US Agriculture. The US Department of Agriculture does appreciate the opportunity to present testimony at this hearing and sincerely thanks the Service Transportation Board for investigating ways in which rail rates challenge procedures can be made more accessible for grain and oilseed shippers.

The USDA believes that it is critical for these procedures to provide effective protection against unreasonable freight rail transportation rates where there is an absence of effective competition. For too long, most agricultural producers and shippers have been left with no practically accessible means to challenge rail rates, much less seek redress. It is telling that no grain or oilseed shipper has filed a rail rate challenge using any of the Board's processes since the McCarty Farms case was decided in 1997. This is not because there have been no complaints about rates, instead the USDA believes that there have been no rate challenges mainly because the Board's procedures are too lengthy and expensive for virtually all agricultural shippers. The cost of bringing a challenge is only part of the issue.

Equally important but as easily quantified is the constant changing of rules and procedures within the current rate challenge system. This makes the outcome of any rate challenge very difficult to predict and undermines the shipper's willingness to take part in such a system. Any newly proposed processes or amendments to existing rate challenge procedures are likely to be met with skepticism by agricultural shippers if they believe the new process will not be consistently applied and therefore subject to unattainable preconditions. A consistent process also establishes credibility, not only will it encourage greater shipper participation but it will also lessen the need for litigation and/or rate challenges by shippers as time goes on.

In the opening comments of this proceeding submitted last year, some rail carriers argued that the possibility of litigation before the Service Transportation Board served to prevent rate increases in areas where competition is not as strong. Litigation only serves as an effective check, however, if STB's processes are consistently applied. This also underscores the importance of designing and effective and accessible rail rate challenge procedure for grain shippers and producers in order to ensure its credibility as a check against unreasonable rail rate increases. USDA believes that effective regulatory mechanisms are critical to rounding out the rail transportation policies complimentary directive of allowing competition to establish reasonable rates. Therefore, USDA encourages the Board to purposely seek simplicity, practicality and consistently in developing alternative rate relief methodologies for agricultural shippers and their unique needs.

USDA believes that the most promising ways for the Board to encourage greater use by agricultural shippers of a specific rate challenge procedure are through one, significantly lowering the costs associated with the procedure; and two, demonstrating a commitment to a predictable set of outcomes through the development of a process that is simple to use and easy to understand. USDA believes a formula based procedure using data that is easy to obtain and deterministic in nature, would have wide appeal to agricultural shippers. Two such procedures have been submitted for the Board's examination in the course of this setting. The AG commodity maximum rate methodology proposed by the National Grain and Feed Association and the two benchmark tests proposed by the Alliance for Rail Competition. Both of these alternative methods adhere to the criteria of simplicity, practicality and consistency.

Additionally, their inclusion into treatment of railroad revenue adequacy make them strong candidates for challenging rail rates moving forward as the regulatory environment increasingly incorporates this concept. To compliment formal processes, USDA has also encouraged mediation and arbitration in its opening reply comments. A major benefit of mediation and arbitration is that they have the potential to offer rail rate challenge procedures that are less time consuming and lower cost than formal Board processes.

In addition, these informal processes foster direct business discussions, facilitate an informal resolution of many issues before they require formal procedure. If broadly utilized by the nation's shippers and railroads, mediation and arbitration systems could offer agricultural shippers greater access to rate dispute settlement mechanisms that have a reputation for being fair, easily understood, accessible and affordable. Examples of these types of arbitration systems that already exist include the National Grain and Feed Association's rail arbitration system and the Montana BNSF mediation arbitration system. These systems have not been broadly used for rate disputes because railroads have generally been unwilling to arbitrate rates.

In addition, the scope of these

systems cannot handle all agricultural rate disputes because of limitations on shipper membership, geographic application and commodity. Nevertheless, they serve as good examples of how such systems can effectively resolve disputes and foster good business relationships. As a practical way to advance fairness for agricultural rate disputes, USDA believes that the Board should actively assist in facilitating the expansion and creation of the mediation and arbitration system. Such system could be the most promising and viable procedure for the average agricultural shipper who may not have the disposition, inclination or time and money for a formal process. At the same time, the use, expansion and success of mediation in arbitration is contingent upon the Board encouraging railroads to use them when handling rate disputes.

As a result of decades of efficiency improvements and recent, but consistent rate increases, the railroads are now earning approximately their cost of capital as documented through the study by Christiansen Associates and there is no doubt that the rail industry today is in far better financial health than it was in the immediate post-deregulation period and it's in everyone's interest for railroads to earn sufficient returns on their investments to be able to maintain, improve, expand and safely operate their extensive and expensive infrastructure and rolling stock. USDA realizes that gains in efficiency, improvements in service and investments in infrastructure would not be possible without the financial success of the rail industry. Yet, railroads are national monopolies and the rail transportation policy requires the board to maintain reasonable rates where there is an absence of effective competition. Producers with few transportation options such as wheat farmers in remote areas have the highest rates and bear the brunt of any rail service disruptions. Look no further than the rail service problems of 2014 to see numerous examples of grain and oilseed shippers who lacked competitive transportation options. As a result, inadequate competitive transportation options, those shippers faced skyrocketing costs, which in some areas widen the grain basis and depress the vignette prices that farmers received. Ultimately, this lowered incomes as producers absorbed much of the increased transportation costs. USDA recognizes that policy changes should not reduce railroads ability to invest in a network or to grade service.

Furthermore, the USDA does not believe that every rate increase by a railroad is unreasonable or that railroads necessarily charge noncompetitive rates to grain and oilseed shippers in general. The ability to charge such rates exists in noncompetitive markets, however, and this warrants careful consideration of prescriptions by the Board. This is why the rail transportation policy requires the Board to maintain reasonable rates where there is an absence of effective competition and why development a workable rate challenge process for grain and oilseed shippers is so important.

As its core, this proceeding is being held to establish a means for challenging rail rates for grain and oilseed shippers who have neither competitive transportation options nor access to regulatory relief. Once such processes are established, this objective of the rail transportation policy will have been met. Going forward, the task will be for the Board to decide the merits of the rate challenges that are brought forth. With that, I will end and say thanks again for allowing me to present the views of the US Department of Agriculture here and I thank you all for your interest in American agriculture.

CHAIR MILLER: Thank you and thank you for being with us today. Mr. Tiller?

MR. TILLER: Thank you, Madam Chair. May it please the honorable members of the Board? My name is Benjamin Tiller and I'm here today representing the Montana Department of

Agriculture. The Department's mission fits squarely within the subject matter of VP665 and we appreciate the Board's recognition of these important issues to America's farmers. With me today is Mike O'Hara. He is a farmer from Fort Benton, Montana. He's a member of the Montana Wheat and Barley Committee and he is the former Chair of Montana's Rail Service Competition Counsel. I appreciate the Board giving him the opportunity to speak today on short notice.

I'd like to preface my comments with an assurance that the Montana Department of Agriculture is not here today as a rail critic. We appreciate the services that the railroads provide and understand their critical role in our AG economies. Positive communication between the Department of Agriculture and the BNSF has increased considerably since the service collapse of 2013 and we commend them for those efforts. I will speak on four principal issues today. First, I will give an outline of Montana's rapidly changing AG economy. Next, I will discuss the difficulty Montana's small elevators face when negotiating rates and service with the railroads. Next, I will explain how not having an accessible appeal option directly affects the producers. Finally, I will offer the Department's suggestions for meaningful changes.

Montana produces 5.2 million metric tons of wheat per year. 75 percent of which is exported to foreign markets. Nearly all of that reaches the export terminals via rail. Recent shuttle facility development by private industry throughout the state has made it more efficient for the railroads to deliver this grain to port. Despite these efficiencies, however, we have not seen a decrease. We've only seen increases in shipping rates per bushel since the mid-2000's. The increasing costs of shipping grain in a system that is increasingly more efficient is concerning to the Department. More concerning, however, is how substantial developing agricultural industries in our state are facing an ever widening pricing differential.

Montana, last year, became the number one producer of pulse crops in the nation. Most people know pulse crops as chickpeas and lentils but they also include various edible dried beans and peas. Since 2000, Montana's pulse acreage has more than doubled and our data indicates that it's going to double again in the next five years. This rapid development means more productive farms and a greater abundance of highly nutritious food for the rest of the world. Unfortunately, as these crops gain marketability, shipping costs are quickly becoming a market deterrent. Smaller elevators that lack negotiating power handle most of the pulse crops in our state. This lack of negotiating power stems from the absence of a meaningful regulatory threat and that's why we're here today. Pulse crop volumes might, in the future, justify shuttle shipments but today's volumes don't support it. This is why the smaller facilities handling these crops continue to pay higher rates and suffer greater service problems than the larger, more established wheat trades.

This hearing could not have been timelier. On May 1st, new BNSF rail rates went into effect for the State of Montana. The new rates will decrease the bottom line on Montana's farms in three concerning ways. First, BNSF eliminated the differential between domestic and international shipments. The new rates are in excess of both the domestic rate which was traditionally more expensive and the international rate. To put it another way, shipping on the cheap route on May 1st this year was more expensive than shipping on the expensive route the day before. Second, BNSF eliminated the fuel sir charge and incorporated that expense back into the tariff. The rates from Shelby to the PNW are roughly equal to what they were this time last year. Unfortunately, the fuel sir charge on April 30th of 2014 was 38 cents per mile. On April 30th of 2015, it was 9 cents per mile.

In essence, BNSF has captured as

profit what used to be a fuel expense and taken away the oversight the STB has over fuel sir charges. Montana's farmers are no longer receiving the benefit of 63 dollar barrel oil. Finally, and most concerning is that the differential for less than shuttle rates, those cars that will carry the bulk of those pulse crops that I talked about at the beginning, have increased at a rate far greater than the larger shuttle shipments. This pricing differential is a market deterrent. Montana farmers should not be forced to grow wheat because the rail enjoys maximum efficiency to ship it. Smaller elevators should not be forced by unreasonable rates to bear the entire cost of expanding to shuttle operations before the industry can support the investment. The BNSF will tell you that these rates are getting higher because moving smaller units is simply less efficient. If the increase of shuttle and non-shuttle rates was on the same trajectory or there was some indication that the system as a whole was getting less efficient then this argument might make sense.

However, as private industry shuttle facility investment has continued to make the rail system more efficient as a whole, BNSF's prices continue to go up. Increased efficiency in one area should not cause another area to become more inefficient. This is counter to the railroad's constant refrain that efficiency on the network is efficiency for all. This pricing differential and the disparate trajectories of the increases likely has less to do with efficiencies and more to do with carrier preference. It runs contrary to the railroad's common carrier obligations. The railroads often dismiss, out of hand, potentially cost saving solutions from the industry. For example, even if various small shippers were to organize a 110 car train from various locations within our state, what the Department has termed a reverse DET or Destination Efficiency Train so in effect it's an origination efficiency train. The railroad won't offer the discounted DET rate and we haven't received an explanation for why this train is less efficient to move than the reverse. Smaller shippers are discouraged by these rates but they have no recourse.

First, they fear retaliation. Our small elevators struggle weekly with inconsistent car deliveries. For example, they will order three cars a week yet consistently get twelve cars every four weeks. Is this because of crowding on the rail system or is it because it just makes more economic sense for the railroad to deliver all of those cars at once? In any event, it is cheaper to deliver all of those cars at once and those savings are profit to the rail. But rather than risk retaliation by challenging the service, these small elevators simply scramble to try and fill these cars and they have to pay the demerge while they're sitting there. Retaliation is a large and real fear for these smaller shippers. Second, they fear the cost of the rate case. We've heard it twice today. The STB estimates a three benchmark proceeding would take approximately eight months and cost $500,000. A standalone cost case would cost more than 5 million dollars. Small shippers can't take that risk when there is virtually no precedent guidance. But the small shippers aren't the ones suffering here.

When faced with the risk of retaliation or the cost of a rate case, the common sense solution is to simply pass the cost off to the customer. Remember, the customer is the farmer, the Mike O'Hara's of the world. Large shippers face a similar conundrum. Are they meeting their duty to the shareholders if they chose to litigate over a rate that they could simply pass off to their customer? And the farmer has no power. He possesses a massive volume of a product with an expiration date. His market influenced is limited to the next time his loan payment is due or the next time he needs somewhere to put his new crop. The Department has some ideas to help solve these issues.

At a very minimum, standing to bring

the case must be granted to the real party in interest. I can think of no other judicial or quasi-judicial proceeding in which the entity that doesn't suffer the harm is the only entity that can bring a case. The farmer bears that cost of shipping and should have the change to challenge those rates. Second, parties must be allowed to aggregate their claims to take advantage of economies of scale. Montana farmers move their grain from the same terminals on the same rails and are charged the same rates. When the real parties in interest can prove they are similarly situated, they should be able to bring an aggregated claim. This would increase efficiency for the Board and protect the rail from constant piecemeal litigation. Then, state Attorney's General should be allowed to bring cases on behalf of shippers and producers. This policy is sound because the state need not fear retaliation. It can act on behalf of others without regard to shareholder profits and it has the resources and transportation expertise to effectively pursue a just remedy.

Rate cases shouldn't be the only remedy available. Binding arbitration should be explored and it is with Senate Bill 808. Others in this proceeding have suggested an arbitration system based on the NGFA model. This may be a good place to begin but modifications are necessary. The NGFA calls for choosing three arbitrators from the industries in the dispute. What this means is that one industry in the dispute will always have a majority on that arbitration panel. We recommend the arbitration panel include a member of the STB Board or governmental magistrate and we think that will work, especially if this Board is expanded to five members. Then add to that panel, one member from each of the industries.

Second, appeals from the arbitration should be limited to those grounds in the Federal Arbitration Act and expanded to also include situations where the arbitrator's conclusions of law are clearly erroneous and where the findings of fact are not supported by substantial evidence. Without such limitations, arbitration will simply become an expensive first step at an even lengthier litigation process.

Third, arbitration must be subject to time limits. An arbitration decision should be rendered within six months of the filing of the case, except in instances of extraordinary circumstances.

Finally, the Board could consider mandating arbitration for certain cases to bring the parties to the table. Obviously this might require a legislative change but it could serve as an effective deterrent to abuse of pricing on smaller shipments. For the sake of discussion and for the sake of discussion only, the rule could require aggregated claims with a value of less than $500,000 brought by fewer than 15 farmers to be subject to mandatory arbitration.

If an arbitration mandate is considered, we would encourage further hearings to explore the appropriate jurisdictional limits.

Others have supported final arbitration. We've heard that already today. We're hesitant to join them because inevitably the railroad will always have more information. The shipper will be incented to request only a minimal concession for fear that the railroad's offer will receive deference because it owns the data and professes expertise on its own rail system.

Montana's farmers are in an unenviable situation right now. Commodity prices are low and they have no power to effectively negotiate or appeal the rail rates that are eating up a considerable portion of their margins. The Department of Agriculture is confident that today's conversations will provide the Board with the information it needs to make meaningful changes. We believe that the solution begins with allowing producers to bring claims since they are the ones bearing the cost of transportation, allowing parties to consolidate their claims to increase the efficiency of the process and developing a binding arbitration system. Mandatory in certain situations perhaps where decisions are made by a balanced panel of arbitrators.

You will hear later that BNSF is investing 6 billion dollars this year and it spent 5.5 billion dollars last year in capital investments. If these investments are working, why is the price to ship our smaller volume yet very high potential and high value crops, increasing at a faster rate than the increase on other commodities? Is it because their investments discriminate against these small shipments that fall within the common carrier obligation? Until there is a cost efficient way to challenge these rates, there will be no way to know. With that, I would like to turn over the remainder of my time to Mr. Mike O'Hara. Thank you.

MR. O'HARA: My name is Mike O'Hara and I would like to thank you for giving me time today for this testimony. My testimony will be specific to Montana grain growers and more specifically to our farm. My grandfather, Oliver O'Hara, arrived in Fort Benton, Montana in 1912 in a box car on the Great Northern Railroad with his life's possessions and the dream of making a life of homesteading.

Today, my wife and I have a family partnership with our two sons in the same area that my grandfather homesteaded. Located in Choteau County, we are in the heart of the largest production area of quality milling wheat in Montana. Our farm has been predominately raising wheat for the past 45 years until five years ago. We have diversified into oilseed, pulse crops and malt barley because the profit margins had more potential. Our farm will be paying $150,000 freight on its 2015 wheat crop. The wheat production on our farm that freight is to deliver it to the West Coast for export to our foreign customers.

With the current price of wheat for this marketing year, we show a 70-cent bushel profit after our production costs. This is close to the break-even cost reflecting an average crop year, not taking into account the risk of drought and other perils that agriculture faces every day. The crops we have diversified to currently depend on single car tariff rates. These new markets are being threatened as a result of the higher costs of transportation.

All these costs are passed on to the farm reflecting lower prices. As freight rates rise on the smaller shipments, how long will the profitability remain in these crops? How much time do we have until margins of these crops are as tight as wheat currently is? As we innovate into crops with more profit margin, those profits are being taken by higher freight rates. Thank you again for this opportunity to share our story and the effects it has on our family farm depends on our livelihood. Thank you.

CHAIR MILLER: Thank you Mr. O'Hara. Thank you so much for being with us today. We really appreciate that. Vice Chairman Begeman, do you want to start the questioning?

VICE CHAIR BEGEMAN: Yes. Mr. Tiller, could you tell me what role has your agency had, or what understanding you have of the arbitration process that, I believe it's with Montana, certain Montana farms, or a group in Montana has with BNSF and I'm sure that Mr. Miller later can be more specific from his perspective. But what has your experience or your constituent's experience been with that?

MR. TILLER: Yes ma'am, Vice Chairman. So there is an arbitration agreement, a standing arbitration agreement between the Montana Grain Grower's Association, Montana Farm Bureau Federation and the BNSF.

VICE CHAIR BEGEMAN: And is that a large group?

MR. TILLER: Yes. Those are two of the largest farm groups in the State of Montana especially when it comes to wheat commodities and this arbitration agreement has been in place, you know, someone else will have to fill you in on the date but it's only ever been used once and it's only effective for negotiating wheat and barley rates. BNSF has not agreed to negotiate these smaller rates that we discussed earlier today. It was used once in a rail case for shipping wheat from Shelby, Montana which is the location I mentioned earlier today to the PNW but I believe that was nearly a decade ago. So, to tell you what the perspective is, I think that the usage kind of answers that question. It's been used one time and I'm sure that that's because the rate is necessarily reasonable, I think it's because the process just doesn't work as well as one might hope.

CHAIR MILLER: Can you say more about why do you think there's only been one attempt at using it? Was that because the farmers and others who were interested just didn't think it was going to work for them? Has it been a reluctance on the part of the railroads to participate?

MR. TILLER: No, there is certainly not a reluctance, Madam Chairman, on the railroads to participate. I think the agreement is standing. If somebody wanted to arbitrate one of these rate cases, they could bring it. I think in the countryside there is some perception issues on how that's done and I think that goes to Deputy Under Secretary Woodward's comments that any of these proceedings have to have, they have to be trusted by the constituents in order to be utilized.

VICE CHAIR BEGEMAN: Well certainly, I realize that's outside of our purview. We have a job that we need to do as well, but to the extent that private agreements or private resolutions can be achieved, I'm all for it. You know, every now and then, actually fairly frequently, we hear the comment that the Board needs to clarify standing for the growers or farmers. Can I ask, why don't farmers think they have standing?

MR. TILLER: Madam Vice Chairman, I think our request is for clarification on that issue. As you look back at the federal court opinion in McCarty Farms, you will see that they do mention that they are in fact, suffering this harm. However, I think that this concern about whether standing actually exists is more of a fear of having to litigate that issue at the beginning of a case. Because it isn't an entirely settled precedent. So you know that that's going to be one of the very first dispositive motions filed by your opponent in the case and I think that's probably the deterrent there and that's why some clarification would be helpful.

VICE CHAIR BEGEMAN: And since we kicked the hearing off with sort of, kind of, putting the law aside, how best can the Board accomplish a fair process or fair rate methodologies? Is arbitration your preference? What would your silver bullet be? I'll really ask all three of you if you don't mind.

MR. TILLER: Madam Vice Chairman, I'm not sure if I could put my finger on what the Department thinks the silver bullet is. I can tell you, I mean, I am a litigator and when I look at the complexity of bringing a stand alone cost case, I don't understand how even a large group of farmers with a very large case would be able to find the representation that they actually needed especially considering you're breaking new ground. There is no precedent. As a trial lawyer, you would look at that and say well, yeah, I think you're probably right. I think the damages are there but can you make that determination as to whether or not you're actually going to have a chance to succeed? There is just no precedent and so you don't know. I'm not sure what the silver bullet is. I think that there probably is no silver bullet but what we need is some sort of access.

We need something that the people who are harmed by these rates can actually understand and that they can actually get fair representation on. I think arbitration is a good place to begin because it is more informal, it doesn't require litigators to learn an entire new area of law and procedure and they can get in there and make their cases in a much more informal setting and I think that's what's beneficial about arbitration moving forward.

MR. WOODWARD: Maybe I'll just say that for reasons of protocol and practicality, USDA is not in a position at this point to really offer specific statutory fixes that might alleviate the situation from a shipper's standpoint but I think we'd be happy to comment on any proposals that come forward at the STB's request.

VICE CHAIR BEGEMAN: Thank you.

MR. O'HARA: Well from a farmer's perspective, I think arbitration has a lot of potential because of the system with that now is economically infeasible for us to bring cases before you, so this could be a huge improvement and some place where we could have a voice of what's going on with our freight rates so --

VICE CHAIR BEGEMAN: Mr. O'Hara have you testified in Washington before?

MR. O'HARA: Have I testified before?

VICE CHAIR BEGEMAN: Yes.

MR. O'HARA: No.

VICE CHAIR BEGEMAN: I thank you for the effort that you made to come here. Many folks have heard me say, and they're maybe tired of hearing it, but I'm a farmer's daughter. I certainly know that it's not the first thing that farmers do, to come to Washington to try to get help. Really, they usually just complain a bit. Rightly so, perhaps. But they have other more important things to do than to come here and make their case, so thank you for the effort that you made to be here today.

MR. O'HARA: Thank you. I appreciate that.

VICE CHAIR BEGEMAN: Thank you.

CHAIR MILLER: Mr. Tiller, I'm curious, you made the point when you were talking about one of the things that's frustrating is that even though private investments being made in shuttle services and other things that should be making the costs more, making the system more efficient therefore, lowering the costs. You're not seeing that. You made the comment that there has been a price increase for grain. I'm not sure if it was wheat or basically the various pulse crops as well that's outpacing other commodities and I'm curious, are you all tracking that and sort of what's the basis for concluding that grain is, the price rate is going up faster than it is for other commodities?

MR. TILLER: Madam Chairman, thank you for the question. We do track that and Montana Wheat and Barley committee hired Terry Whiteside who has considerable past data on those rates. This one was easy because we had April 30 rates in our possession and then we had the May 1st rates, which were published and announced 20 days prior. So what we did is we compared. We said, what is the percentage increase on these shuttle shipments of grain? I can't site the percentages but then we compared that to what is the percentage increase of these smaller shipments and it went up higher. It went up faster and so when you graph this out, you'll see that there is a steeper increase on these smaller shipments. Remember, these smaller crops have a higher market price on average. You're looking at, and Mr. O'Hara will correct me if I'm wrong, averaging five dollars for wheat roughly and you can sell chick peas for twenty-two dollars a bushel thereabouts. Correct me.

MR. O'HARA: I'm pretty sure it's eighteen but it's still profitable.

MR. TILLER: Right. So you see, you have that more valuable commodity and you see that steeper increase filling in that space there and so as Mr. O'Hara said earlier today, when does that margin become as small as the margin is for wheat?

CHAIR MILLER: So I just want to be sure that I understand. What you're saying is, is that the rate for those carload pulse crops is going up more rapidly than the shuttle?

MR. TILLER: That is absolutely

correct, Madam Chair.

CHAIR MILLER: But the carload pulse crops are likely more expensive to transport than the shuttle services, aren't they?

MR. TILLER: They certainly are but our question is, are they getting less efficient? You know? So as the system increases in its efficiency because of these shuttle shipments, the system as a whole should be more efficient and so when you see these price increases going up, there is no real justification for why it should go up more for these pulse crops than the larger shipments. Why should it go up at a faster clip?

CHAIR MILLER: You're saying that that system is more efficient as well but you're not seeing the benefit of the efficiency playing out in the rate?

MR. TILLER: That's correct, Madam Chair. We have not seen an explanation as to why that rate should be going up at a faster rate.

CHAIR MILLER: I thought, also, you

had said when you were kind of going through your example the domestic grain, did you say it was less expensive and that it flipped?

MR. TILLER: Madam Chair, what happened is domestic grain was usually more expensive because once it got to the PNW, it had to go somewhere else.

CHAIR MILLER: Right.

MR. TILLER: So there is the operational costs of exploding that train. So that was traditionally more expensive. But, no, what we're seeing there is so we had those two different rates, when the new rates came out, those base tariffs were actually higher than both the cheap rate from April 30th and the expensive rate from April 30th and so they basically leapfrogged and so we now have the most expensive rate, which is the rate that we're stuck with now. And so a producer cannot make the decision anymore, well, you know, it is cheaper for me to find an international market than a domestic market. It's the same either way and so they've lost that kind of market advantage that they had prior to April 30th.

CHAIR MILLER: Uh-huh, I see. One of the things I'm curious about is going back to the issue of arbitration. When you all talk about arbitration, does that invariably when you say that mean binding arbitration? I mean, is it your view for arbitration to be effective, it has to be a binding arbitration?

MR. TILLER: Madam Chair, it does. Otherwise, like I said, it becomes just the first step in an even lengthier litigation process. I think that it would be beneficial too if those decisions, although they don't have precedent value, they do have informative value. I mean we have non-site opinions from the federal courts all the time and those non-site opinions they still inform us as to litigators as to what the likely outcome is and so I think you heard earlier today the professor mentioned that the coal cases, you know, those are almost all under contract now because they have some certainty from the coal cases that existed at the beginning of this type of regulation and so I think you would see that same kind of effect if those arbitration results were made public with obviously trade secret information redacted.

CHAIR MILLER: Deputy Secretary Woodward, do you have anything to add to that?

MR. WOODWARD: I would just say the USDA does feel that it should be binding but, of course, the devil is in the details.

CHAIR MILLER: Uh-huh. Did you want to ask a follow-up questions?

VICE CHAIR BEGEMAN: Do you mind if I ask another question? Mr. Tiller, back to the arbitration program that does exist between BNSF and the two Montana Associations, with respect to the wheat growers essentially, of the world of farm products grown in Montana, what percentage of your industry does actually have access to this arbitration program? 10 percent, 2 percent, 80 percent? I'm just curious, who is left out?

MR. TILLER: Madam Vice Chair, and I

know Mr. O'Hara will get into what percentages on his farm are represented by the different commodities. He can provide that to you. Wheat is the number one commodity in the State of Montana.

VICE CHAIR BEGEMAN: It is?

MR. TILLER: Yes. So most farmers, at least at some point, include wheat in their crop rotation. I can safely say, without quoting an exact percentage, that a vast majority of Montana farmers are putting wheat in the ground at some point during their rotation and if you'd like, Mr. O'Hara probably has more detailed information.

VICE CHAIR BEGEMAN: Is it the associations that have to arbitrate or is it the actual grower that has the opportunity to arbitrate?

MR. TILLER: Do you know the answer to that question?

VICE CHAIR BEGEMAN: You can answer for the record if you don't know. With BNSF here, they can answer as well.

MR. TILLER: Yes, and I know that Kevin Kaufman is here as well and he can answer that.

VICE CHAIR BEGEMAN: He's no longer with BNSF, I don't think.

MR. TILLER: No, he is not but he is here.

VICE CHAIR BEGEMAN: He does have a wealth of information, I know that.

MR. TILLER: Yes.

VICE CHAIR BEGEMAN: Mr. O'Hara?

MR. O'HARA: Specifically, through the arbitration that has been used once and I'm sure Kevin will correct me if I'm wrong when he has a chance, it was on one specific freight rate from Shelby, Montana to the Pacific Northwest. The percentage of our wheat that goes to there is zero. So, what percentage of the wheat that would be affected by that freight rate from Shelby, I couldn't answer that question because it was specifically to that point of origin. It would be not a large percentage of the wheat in the State of Montana.

VICE CHAIR BEGEMAN: Thank you.

CHAIR MILLER: Mr. Tiller, I have one final question. Just the nature of grain and the multiple origination points in many ways, destination points, make it understandable why there don't tend to be a lot of contract movements but I'm wondering is that something that you all have tried to create opportunities to get contracts for movements that more commonly have gone under tariffs? Is that even an opportunity for your farmers?

MR. TILLER: Well Madam Chairman, obviously and I'm not I completely understand your question but many farmers do contract with a purchaser at the beginning of the season.

CHAIR MILLER: I'm thinking with the railroad.

MR. TILLER: When it comes to the railroad, you will see that our larger elevators, like Columbia Grains of the world, they are contracting rates. However, it is the smaller elevators who are paying the tariff and are sometimes left with purchasing freight on the secondary market when they need it, which is an added cost and so no, it's not, they are not getting the benefit of contracted rates and it's private too. Again, back to the coal example, you don't know what a good rate is. What are other people negotiating? Until you have that precedent, until the STB has come out and said these are the rates and this is how we determined this, I mean that is really the motivating factor. That's the influence, to bring it to the table to say let's put this under contract because it's fair.

CHAIR MILLER: Thank you all very much. Thank you for being here and again, Mr. O'Hara, thank you for coming in. We really do appreciate it. It's very helpful.

MR. TILLER: Thank you for the opportunity.

CHAIR MILLER: So, Panel III, which is

the Association of American Railroads, if you could start making your way to the front. Everybody ready? So, we have Timothy Strafford, Counsel to the AAR and John T. Gray, Senior Vice President for Policy and Economics. Welcome to both of you. Thank you for being here. Mr. Strafford?

MR. STRAFFORD: Good morning Chairman Miller, Vice Chairman Begeman. My name is Tim Strafford. I'm here today on behalf of the Association of American Railroads. I'm joined by my colleague John Gray, Senior Vice President for Economics and Policy at the AAR. This morning, I will provide a brief overview of the AAR's comments in this proceeding and try to put this proceeding into historical context of the agencies previous attempts to craft rate reasonableness standards consistent with the statutory responsibilities. Mr. Gray will then briefly discuss the economic environment in which railroads transport grain products, the economic underpinnings of sound rail rate regulation and the flaws and proposals made by shipper interest in this proceeding. I'd be happy to answer any questions the Board may have at the conclusion of our testimony.

The Board began this proceeding with the stated goal of ensuring that its rate reasonableness process is accessible for railroad customers that ship or receive grain. There is a fundamental difference between ensuring a process is available, the proposals by shipper interest in this proceeding that received rate prescriptions based on economically suspect revenue desirable cost ratios and generic formulas. There is no basis in this record or any other for the Board to conclude that the transportation of grain should be subject to unique rate reasonableness rules. The AAR submits the Board's processes are accessible to railroad customers and other stakeholders and that recent efforts by the Board have made them more so. Through its rail customer and public assistance program, the Board makes its staff available to answer inquiries about its processes and engage in informal mediation efforts. Where formal rate relief has been sought, the Board has established two forms of simplified rate cases.

In the four cases decided under its simplest three benchmark process have rendered decisions within nine months. Mandatory mediation is part of all rate complaint proceedings. In response to calls from shipper groups, the Board has lowered its filing fees for complaints down to $350, well below levels otherwise consistent with its user fee policy. Also in response to requests by shippers, the Board recently increased limits on relief on simplified cases by eliminating the limit on simplified SAC and nearly quadrupling the limit on three benchmark cases. Some shipper comments in this proceeding and some of the Board's questions in the notice scheduling this hearing, refer to the concept of revenue adequacy.

For the purposes of today's hearings, there are no unique aspects of grain transportation that requires special consideration of revenue adequacy in this proceeding. The Board has already compiled a separate record in X party 722 and scheduled a two-day hearing for next month. The AAR intends to participate in that hearing and provide expert testimony on issues related to revenue adequacy.

My colleague, Mr. Gray, will speak to some of the economic principals underling sound rail rate regulation and some of the problems in shipper proposals in this record that would rely on unrestricted rate comparisons. Before he does, I'd like to briefly note some of the historical struggles the agency has confronted in judging the reasonableness of rail rates and consider some of those efforts that the court adjudged to be arbitrary and capricious. This history helps illustrate the legal standards that would apply to efforts to craft special rate reasonableness rules for grain traffic.

Prior to the legislative reforms of the 1970's, the ICC prescribed rates using its traditional pre-reform criteria. Rate comparisons with other similar movements, analysis of economic impact to the community and a determination of the railroad's fully allocated costs of moving traffic. This, along with other regulatory constraints, contributes to a railroad industry in severe financial distress.

By 1978, the agency recognized the rate comparisons were of limited value. The agency began the long effort to determine rate guidelines that would be consistent with sound economics to three and four RX and later the Staggers Act which culminated in 1985, Coal Rate Guidelines Decision. During that process, the ICC struggled to find an appropriate way to allow for the necessary differential pricing for a healthy rail system that could invest to meet customer demand. The agency recognized the need for pricing above fully allocated cost levels and tried to apply a 7 percent additive to attempt to reflect differential pricing. The courts rejected this so called 7 percent solution as arbitrary and capricious. The agency also considered judging rates based on a ton to ton-mile ratio but later recognized that such an approach did not reflect customer demand for service. Coal rate guidelines recognized the need for differential pricing and railroad rate making and a need for the rate reasonableness standards to reflect demand characteristics.

The standalone cost standards implemented reflect such principals to ensure that where a railroad has market dominance, a complaining shipper is not required to subsidize parts of the network it does not use or pay for inefficiencies. As the Board well knows, the SAC standard can be time consuming, complex and expensive. This is not necessarily surprising as railroads are networks moving a mix of competitive and captive traffic and different service and different equipment. Railroad rates used to be complex litigation with hundreds of millions of dollars at stake. Comparable litigation in the federal courts is time consuming and complex as well.

The AAR has long stated its desire to work with the agency to streamline the SAC process where possible. Railroads do not like spending money on lawyers and consultants any more than shippers do but the proposals by shipper interest in this proceeding are not aimed at improving the Board's processes but instead are R/VC tests untethered from economic theory and unconstrained by any limits on relief. Previous attempts to avoid the economic analysis of market demand and cross subsidy by applying such tests have been overturned by the courts.

McCarty Farms, the ICC tried to shortcut an economic analysis of the rates at issue and instead looked at whether the R/VC ratios generated by those rates were higher than those of the comparison benchmark traffic. The court of appeals for the DC circuit found that the ICC's approach and explanation lacked "supporting principal or intellectual coherence" and the agency "had not intelligibly explained why the tradeoff chosen was reasonable". The court concluded that R/VC comparisons not passed for recent decision-making and the court remanded the case to the ICC. Mr. Gray will address the limited value and economic meaning of R/VC ratios.

I just note, in closing, that the only instance where R/VC ratio comparisons have withstood judicial scrutiny in the last 35 years, has been their use in the three benchmark test where they have been allowed in cases of limited value in response to direct congressional authorization for the agency to develop simplified methodologies for small value cases. The agency and the courts have explicitly recognized that the three benchmark test is crude and imprecise and the Court of Appeals for the DC circuit has observed that the three benchmark process does not facilitate the search for truth and "there is good reason to believe that judgments rendered pursuant to the three benchmark framework more often than not, will be the antithesis of mathematical certainty". The only justification for the use of R/VC comparisons at all has been their limited application; put limits on relief in small cases. The Board has only justified their use by stating that most rates are set according to market forces and most regulator rates should be subject to the SAC test. With that, I'll turn things over to John.

MR. GRAY: Thanks Tim. I'm John Gray. I'm Senior Vice President for Policy & Economics at AAR and today, I'd like to put the discussion on the grain rate issues into a bit of economic context.

First, to quickly overview the rail system. Today, railroads account for about 40 percent of our nations inner city freight ton-miles and serve merely every agricultural, industrial, wholesale, retail resource base sector in our economy including both grain and grain related products. In 2014, US Class I railroads originated almost 1.5 million carloads of grain which translates into almost 140 million tons of grain. While significant, grain represents only 4.9 percent of total carloads and 7.6 percent of total tonnage for the rail system as a whole. The United States is the world's top grain producer with average US grain production from 2005 to 2014 of 533 million tons. What crops are grown where and in what quantities and how and when they are transported is determined by complex interaction with international and other market forces. The variety of forces that impact grain production consumption make it clear that generalized conclusions about grain are exceedingly problematic. Simply put, there is no homogenous grain market in the United States or anywhere else in the world.

As illustrated in AAR's written testimony, various types of grains and grades of grain have unique characteristics and are also marked by unique market volatility. Like US grain production generally, US grain exports also fluctuate sharply because they are a function of many complex market, regulatory and geopolitical factors. American grain shipper's benefit from strong competition among railroads, trucks and barges. According to 2011 USDA data, the most recent available, the truck share of total US grains transported was almost 60 percent. When compared with the just 28 percent for railroads and 12 percent for barges.

The fact that the trucks share of tons has been rising for several years, it was only 50 percent in 2006, is strong evidence of the market and of the intensity of the competition that railroads face if they wish to participate in grain markets. There is no escaping the reality that absent government subsidy shippers including grain shippers must pay for rail services they demand. Growth in this demand will provide the incentive for railroads to make the investments needed to increase the capacity in their networks but only if freight rates are allowed to reflect the true marketplace.

In recent years, railroads have been

putting more money back into their networks than ever before. From 1980 through 2014, they spend $575 billion of their own funds on renewal, maintenance and expansion of their infrastructure and equipment. Even so, much remains to be done. For this reason, expenditures have rapidly accelerated during the last seven years with almost $165 billion spent during this period.

An additional $29 billion in spending is planned for 2015. Recently, in a public hearing and in written comments to the Board, it was suggested that railroads needs to invest more in capacity to alleviate the service issues that occurred in parts of the country. We agree. However, we must always remember that the railroad's ability to commit massive funding to their network is entirely dependent on financial performance that produces the necessary cash flow and returns on investment. There is no question that the majority of rail rates, including rail rates for transporting grain, are driven by competition including competition between railroads, other modes of transportation and by product and geographic competition, both at home and overseas. This competition results in grain rates that are measured by revenue per ton mile being 29 percent lower on an inflation just basis in 2013 versus 1981. The same measure is also lower for major individual types of grain as well.

Moreover, according to USDA data from 2000 to 2013, the last year again that is available, average prices that farmers paid for most of their supplies rose much faster than the rail rates to move their grain. Some movements of grain are governed by rail transportation contracts. Additionally, over 60 percent moves on common carrier tariff rates generating revenues to variable cost ratios below 180 percent. Thus the potential universe for rate complaints by grain shippers is relatively small. For those limited instances where the Board is authorized by statute to regulate rates, economically sound regulations should seek to simulate competitive outcomes rather than artificially constrained railroad rates below competitive market levels. So what do the economics of rail regulation and operation tell us about what should be the outcomes of sound regulation should be?

First, because economies of density exist in the railroad industry, that is that the unit cost of transportation declines as traffic volume increases, marginal costs are almost always lower than average costs. In other words, the cost to a railroad with handling an additional unit of traffic is usually less than the average cost of handling each unit of traffic. Because of high, fixed costs associated with track, facilities and equipment and the need for railroads to cover their risk adjusted capital costs, railroads cannot price all their traffic at marginal costs or even an average variable cost and still cover their total costs. Any firm that cannot cover all of its costs, ultimately cannot survive.

Neither can railroads price on the

basis of average costs. Because of competition, much rail traffic moves at rates below average costs and above marginal costs. Any traffic moving at rates above marginal costs makes at least some contribution to the fixed cost and everyone is therefore better off than they would be if that traffic were not moving at all. If the rates on traffic were raised to the average total cost, much of this traffic would be diverted to other modes and would simply not move at all. That traffic's contribution to fix costs would be lost. If this happens, railroads would lose revenue than they would have had otherwise. Either the revenue would have to be made up through other rail customers or the railroads would have to reduce costs perhaps by reducing employment, service offerings, cutting reinvestments or eliminating infrastructure or by some other means.

For a sustainable rail system, it is absolutely necessary to price service differentially based on demand in order to allow the possibility of recovering their variable costs plus a fixed cost plus the risk adjust and cost of capital. Without differential pricing, the rail industry could not have achieved its tremendous gains operating efficiency and the financial health which in turn, have allowed the railroads to make their massive investments in the networks and to accommodate their customer's needs. This rate regulation principal implemented by the ICC and the Board following the Staggers Act, was not a temporary remedy to address the financial state of the industry. Rather, demand based, differential pricing was a structural reform reflecting fundamental railroad economics.

Now, I'd like to address some very specific issues in this proceeding. The proposals made by shipper groups for grain specific reasonableness rates should be rejected. Simply put, the economics of rail transportation do not change based upon the commodities in the rail car. When shipper groups, including grain shippers, complain about the stand alone cost test or other Board methodologies, they often simply don't like the result produced by sound economics. For example, when the groups that represent grain shippers talk about the SAC test being unworkable for shippers on light density lines, what they frequently are saying is that a SAC analysis will show that rates are not unreasonable.

When they say that varied destinations of grain traffic make grains case analysis difficult, the Board should consider whether a grain complaint would be significantly more complex than chemical cases which incidentally may involve hundreds of origin destination pairs that it is already considering. When grain shippers say diverse origin destination lanes make great prescriptions undesirable, the Board should consider how or if the proposals that they have put forward will solve that problem.

Let's look at a few of the details. First, the Board should not make specific adjustments to URCS without making holistic changes to the costing system. The Alliance for Rail Competition propose that the Board develop a grain cost adjustment factor because it believes that the uniform rail costing system overstates the variable costs associated with grain shipments. ARC points to the fact that URCS understates the costs of certain shipments such as the shipment of hazardous materials and concludes that URCS must therefore overstate the cost of other, non-hazardous materials. The AAR has states in other proceedings that URCS does understate hazardous material risk costs because, as Dr. Schmalensee noted earlier this morning, they are not even included in URCS. Since they are not even reported in the R1 report on which URCS is based.

Thus, in terms of URCS, the costs ARC is redistribute are really phantom dollars. In fact, the extensive use of system wide average costs throughout the regulatory regime, strongly counsels against piecemeal adjustments or favoring shippers of the 1.5 million carloads of grain versus the shippers of 15 million carloads of other commodities and 13 million intermodal units. The effect of such approach would be to lower the URCS calculation of variable costs for grain shipments presumably with the intent to artificially increase proportion of grain traffic subject to the Board's jurisdiction. However, since URCS is a closed system, the Board would then need to decide which other lines of traffic should absorb the increases of costs. Thus, the Board would ultimately be set in the position of having to artificially select winners and losers on this issue.

Second, both NGFA and ARC offer up a variance of the Board's three benchmark test and I ask the Board to use unrestricted RBC comparisons. NGFA's AG commodity maximum rate methodology takes the already crude and inappropriately used average RBC ratios for a group of comparable traffic and reduces that analysis into a formula. ARC advocates for a two benchmark test that ignores comparable traffic and therefore even the minimal primitive analysis of rail markets already embedded in the three benchmark method is worth remembering why a comparison of R/VC ratios tells you almost nothing about market demand. Economists think about demand elasticity in price terms by looking at markup over long run marginal costs. The URCS variable costs are not marginal costs, have no uniform relationship to marginal costs and can never be adjusted to, nor approximate the direction of marginal costs.

In reality, all an R/VC ratio tells you is something about the value of a particular line of business to the provider of that service. It says nothing about whether the price is that which is appropriate in the market. In the real world, two movements with the same R/VC ratio can have very different demand characteristics and reflect very different market conditions. While such a crude tool may be minimally acceptable for simplified cases with limits on relief, it lacks any sort of economic justification as a method for judging all grain rates. To make matters worse, both NGFA and ARC seek to have comparisons of challenge rates to R/VC ratios on railroads other than those handling the movement in question. The Board should reject these calls on the same ground as done in simplified standards decision. Comparisons of R/VC ratios of different carriers defeat the very purpose of trying to determine the appropriate contributions joint and common costs complaining shipper should be making. The Board correctly concluded that "the R/VC ratio of potential captive traffic of one carrier provides no useful information concerning the appropriate contribution to fixed and common costs of another carrier".

Third, as part of its formula, NGFA would have the Board compare R/VA ratios of a challenged rate to an average R/VC ratio that includes movements that are less than 180 percent. In simplified standards, the Board also concluded the comparison groups should consist of only traffic moving in R/VA ratios in excess of 180 percent in order to judge the amount of contribution to joint and common costs that the complaining shipper should be responsible for. The Board noted that "the rates available to traffic with competitive alternatives will provide little evidence on the degree of permissible demand based differential pricing needed to provide a reasonable return on investment".

In short, ARC and NGFA would have the Board take the worst possible measurement tool available, the R/VC ratio and use it as broadly and as inappropriately as possible. Finally, I would like to address the appropriateness of using RSAM as a rate reasonableness tool. RSAM suffers from several infirmities. First, the Board's annual revenue adequacy calculations dramatically understates the railroad net investment base and therefore, overstates return on investment. Second, any use of averages presents a ratcheting problem. As R/VC's above the average are moved down by regulation, the corresponding average moves down as well. Third, use of such an average fails to recognize that some movements with higher demand, are appropriately priced above the average reflected in the RSAM. Fourth, the use of the RSAM as a rate making tool would force rates below competitive levels and does not allow for the analysis of customer demand. Finally and critically, RSAM is just another form of an R/VC ratio suffering from all the same frailties and limitations as a market measurement tool as to all other R/VC ratios.

In conclusion, I would ask that the Board continue to rely on sound economics and its established processes as a basis for judging the reasonableness of all rail rates including grain rates. Thank you.

CHAIR MILLER: Thank you both very much. This is perhaps not fair because I know you only heard this morning from Dr. Schmalensee but as you were talking about RSAM and R/VC being very crude, I'm just wondering how much his description of URCS being flawed and really unfixable resonated with you and if you'd care to comment on that as an economist?

MR. GRAY: I would comment that I fully agree that URCS is flawed. It's very flawed. As I discussed with them actually before the meeting, I disagree with him on the fact that it is unfixable. But it is not fixable in the form in which it exists today. It would take an enormous amount of work, probably almost as long as it would take to change the statutes around it to create the type of modeling that would reflect, be able to properly reflect density in the rail system, that would be able to deal with the location specific issues around the rail system. It would take a tremendous amount of additional data to do that. So, I'm not sure that the fix is practical but I disagree that with enough money, that it couldn't be done.

CHAIR MILLER: One of the things I'm curious about is the issue of arbitration that was raised by the folks from Montana and their interest in seeing more things arbitrated. Again, it was an interesting theme that you saw in Dr. Schmalensee's presentation when you look at the use of SAC and the complications of that process versus arbitration. What's your reaction to the viability of more arbitration?

MR. GRAY: Well I reflect one of Tim's comments in his testimony that railroads are not great fans of the money that is spent on rate cases in terms of the legal fees or the consultant fees. In fact, they probably end up spending more money than the shipper community does. So a methodology that permits some acceleration of the process is attractive to us. What we object to is not arbitration per se. It is what I would call compulsory arbitration. We feel that arbitration if it is going to exist needs to be voluntary between the parties. Otherwise it's unlikely to lead to a really satisfactory solution.

CHAIR MILLER: We have the

opportunity to arbitration now though and it seems that it's rarely utilized so when left to the choice of the parties it seems like the parties are rarely willing to choose it. Is that a misperception?

MR. GRAY: I can't argue with the fact that it has been very rarely used and apparently as you say when left to the discretion of the two parties involved that it is infrequently used. I know that at least one of our members has offered from the beginning to participate in arbitration and I don't believe they've had any --

CHAIR MILLER: Any takers.

MR. GRAY: Any takers.

CHAIR MILLER: Uh-huh. That's true. Then one other question before I give the vice chairman a chance to get in here, but going back to the issue of grain rates reflecting on the testimony that we heard from the Montana Department of Transportation from Mr. Tiller, looking back to the GAO Study that was done nearly ten years ago now that talked about the fact that grain rates were trending higher than other commodity rates, I don't know if a renewal of the GAO Study would say the same thing today, but certainly we have evidence at that time and what we were hearing today from the Department of Agriculture and the Montana Department of Agriculture is that grain rates tend to be trending higher than other commodities. Again is that a misperception? Is that a fact? Why would grain rates tend to go up higher and faster?

MR. GRAY: Well, first of all I had not looked at that specific issue in preparation for this. We looked at the grain rates within themselves and noted that yes, they, for a long time they trended lower and for the last few years the revenue per revenue ton mile measurement that we have since we don't have access to the actual rates, has moved higher. Now, you know, is it something that is unusual? I think on that or is there a reason behind it? I think on that it's probably at best when you have the panel of the railroads later this afternoon to ask them about that because these things tend to be very individual. They're focused on the individual market that a particular railroad is engaged in and there are probably instances in which, significant instances in which grain rates have not trended higher at a faster rate. I don't know but that is something that the individual railroads would be much better equipped to answer than our organization.

CHAIR MILLER: Okay. You want to jump in, Ann?

VICE CHAIR BEGEMAN: Yes, I won't take too much of your time but I certainly appreciate your representing a wide group of members, which can be kind of difficult, so I'm not going to put you on the spot as much as I might want. Is your message that the status quo -- although the 3B method is perhaps inaccurate, but it is sufficient from your industry's perspective with respect to rate cases?

MR. GRAY: I think that we are always open to improvements in process. What concerns us is not improvements in the process which make it more efficient, make it better for both parties quite frankly if it is. What concerns us is taking what is already a rather delicate item like the 3B methodology, in terms of its economic validity and pushing it ever further away from sound economics. We are always willing to look at other types of proposals but again our emphasis is that whatever those proposals are and however they're developed, the ability to reflect economics that is as sound as possible is really important.

We think that the SAC method obviously it is something as Dr. Schmalensee indicated this morning, was adapted from other network industries and we think that while it is being used somewhat differently in this context, in the regulatory context that the STB uses, that it does represent a concept which has some economic validity behind it for looking at the range in which reasonable rates might fall. It does not necessarily get to the fairness issue that he was describing but it does get to a reasonableness issue in terms the market for those rates.

Likewise, the simplified SAC method retains most of those characteristics while simplifying the application dramatically but again the concept is process whatever can be done to improve that we're interested in. Straying too far from economic foundations, no. That's something that is not where we'd like to go and our problem with the proposals that are in front of you is as I said they take basically a very frail system in which the 3B methodology is economically and push it further away from economics.

VICE CHAIR BEGEMAN: Well, I will say that with this proceeding, we really invited any and all parties, including AAR and the industry, to offer ideas and put something else on the table so that we could establish a meaningful, workable process that I don't believe we have necessarily fulfilled yet, and that is still on the table. Really, I am open to any and all ideas within the law. One of the things that your boss mentioned during the House T&I Hearing in May was "speed and accuracy," and I can assure you --- and I think I can for Deb --- that's our goal as well.

We certainly aren't looking to just make something up, whatever it takes to get a case in and out. We want accuracy as well, so I'm going to state for all the parties, all the stakeholders whether you're here or listening in. I am open minded to ideas, creative ideas, maybe even like a negotiated rule making where several parties could come together with different views and see if there is something that folks could tentatively agree on or reluctantly agree on just to try to move the process forward. Thank you for participating here today. Thanks, Tim.

CHAIR MILLER: So, John, I have a couple of other questions. You said this pretty clearly I think in your testimony but I'd like to hear you say a bit more about it and that's the proposal that I think came from NGFA or perhaps it was ARC but that the traffic pool could include other railroads.

MR. GRAY: Yes.

CHAIR MILLER: And you sort of rejected that idea but, you know, I'm wondering whether if you're talking about the western railroads or the eastern railroads if you don't see enough of the same characteristics in terms of their operating environment I'm just wondering why that isn't reasonable to use them in the comparison group.

MR. GRAY: I think that one of the real concerns and large part on that is that first of all as I said, it doesn't tell you a lot about whether those two carriers are in what would be comparable markets. Even if you're only making a regional comparison, you find that the railroads in the two regions while they have some markets that are in common and can be identified in common, there are an awful lot of markets that are very different and have very different operating characteristics for them to serve those markets.

It's not uncommon that you'll have one railroad that has very different route characteristics between an origin and destination pair. It has very different means by which it has to provide the service between those locations and thus will generate very, very different R/VC ratios on what is essentially the same market, even if they may have similar prices in that market, will generate very different R/VC ratios from that market. It's kind of the reverse issue of what I said earlier where you have some instances where movements that have very different characteristics will have the same R/VC ratio. This is one of those cases where they may have the same very similar price characteristics because of the basic market they're in but will generate very different R/VC ratios so identifying the details of that is first of all it's a huge job. It is something you'd have to do on a case by case basis to even identify whether you had similar moves. When you get to the end of it, you don't really know much about whether these moves; even if you can identify them as somewhat similar, you don't know very much about whether they speak to the issue of what the contribution that particular traffic should be to the fixed cost given that the railroads' business portfolios, the total business that they have may be very different and they may be in very different positions within a market than another carrier.

So, first of all, it fails in terms of the just the technical analysis because the technical analysis cannot show you that you're going to get a similar result because of just the operating characteristics. It fails probably in terms of the market analysis and it certainly fails in terms of the portfolio business type of analysis.

CHAIR MILLER: As near as I can tell in some ways whether it's shippers looking at various processes or the railroads, I mean you hear some of the same thing, everybody's interested in simplified processes so we can go faster and it can be cheaper but when you start talking about a simplified process then depending on who thinks its disadvantageous to them, they find inaccuracies in that process that then argues that it's not going to be useful process. I'm just wondering, do you have proposals or approaches that would allow us to simplify and speed up our processes while retaining sufficient detail to be reasonably accurate?

MR. GRAY: Certainly any process which speeds up anything and simplifies anything almost inevitably results in compromise.

CHAIR MILLER: Right.

MR. GRAY: It results in compromise, not just to the parties that might be participating in it but it results in compromise of the technical accuracy and it results in compromise in the ability to use all available information in the process. So putting together what is a simplified process I guess we could cynically say, we're glad it's your job and not ours on this, but the reality is that the Board has been working on trying to develop the simplified processes so that they have at least some reasonable grounding in economics for ten years now and it hasn't proven to be a very fruitful or productive process for you.

I applaud you for the effort that you've made in trying to negotiate through this minefield, but it is a minefield and I think we can say that improving the process should be a goal but it is something that is unlikely to satisfy all parties, no matter what the proposal is. I think it is, as evidenced by the difficult time that you've had for ten years working on this project, I think it's going to be very difficult to move forward. While I wish I had some ideas that could help with it, unfortunately any ideas that I have that would make the process simpler would also unconditionally compromise the validity of the results that you would get and I think that's a lot of the concern that you're running into.

CHAIR MILLER: One final question and

I'm not sure if I understood correctly as you were going through your testimony and you were talking about the fact that the R/VC ratio really doesn't tell you anything about market and marginal cost pricing and what that is versus average price. Did I understand you to say that the marginal price is the best way to evaluate the market price or did I misunderstand?

MR. GRAY: No, no. Economics says that in a perfectly competitive world that the price that you would charge in a market would be equal to the total marginal cost. It's an economic concept that's very, very difficult to actually put into reality but it says that you would price at marginal cost. What I was saying on that was that because of the issues of density that we have where the marginal cost tends to get much lower much quicker as you add volume to the network than does the average cost or certainly the total cost, effectively you cannot sustain a railroad pricing at marginal cost. It just can't be done.

CHAIR MILLER: I said that was my final question but actually, I have one more question. Well, actually I'll just leave it there for now. I'll just leave it there for now. We'll come back to it maybe in July. Thank you both very much for being here and we'll be interested in hearing what your member railroads have to say this afternoon. We can explore some of these issues in more detail. Thank you very much. I think we will plan to take our lunch break now.

So I've been asked to remind you, which is the complicated issue around lunch, that security wants to be sure that you are aware that if you leave the building for your lunch break, leave your luggage and bags in the Hearing room so none of those have to be re-screened again because you will have to sign in again when you come in if so you can let's simplify that coming back into the building thing as much as possible. This may just be hopeful thinking but we'll try to start again at 12:30 if at all possible. I know there are some difficulties because you're going to have to leave the building and get signed back in and if that proves to be too aggressive, we'll certainly try to give people an opportunity to reconvene. What's most important is that our Panel IV members are able to be back to the building so if they're here and Ann and I are here, we'll get started. Otherwise we'll wait for them to come back.

(Whereupon, the above-entitled matter went off the record at 11:48 a.m. and resumed at 12:37 p.m.)

CHAIR MILLER: Our panel has done an exceptional job of being here right on time and ready to go so let's get started with our fourth panel of the day and it should be an interesting one when we get to hear more about this proposal that has already been discussed extensively even though we've not gotten through it yet so we have from the National Grain & Feed Association Kevin Thompson, who is chair of the Rail Shipper Receiver Committee; we have Bruce Sutherland, vice president at Michigan Agricultural Commodities; Thomas Crowley, president of L.E. Peabody & Associates and Thomas Wilcox, a principle with GKG Law. So we'll get started with you, Mr. Thompson.

MR. THOMPSON: Thank you and good afternoon. I think, Chairman Miller and Commissioner Begeman, I'm Kevin Thompson, assistant vice president and transportation lead for Cargill, Incorporated in Minneapolis, Minnesota. I chair the National Grain and Fee Association's Rail Shipper Receiver Committee which is comprised of 24 NGFA member companies from all over North America and responsible for representing the broad policy interests of NGFA member companies who ship and receive agricultural commodities by rail. NGFA commends the Board for initiating this public hearing and for conducting this public hearing to examine proposals for creating more accessible, streamlined, cost effective and workable procedures for captive gain shippers to use to challenge rail rates they believe are unreasonable. NGFA's presentation is divided up into four parts that address NGFA's submissions generally and also the technical aspects of our proposal.

NGFA member companies are major users of the nation's rail system. Rail represents a significant modal share within major geographical regions particular in the upper plains states as well as for major agricultural commodities including more than 70 percent of wheat, 52 percent of barley, 20 to 25 percent of corn and beans. US Class I railroad revenues for STCC Code 01 which are foreign products and STCC Code 20 which are food products equal 10.77 billion and 11.97 billion in 2013 and 2014 respectively. This represents 14.9 percent of classical and railroad revenues in 2013 and 15.6 percent of revenues in 2014. NGFA's opening statement in this proceeding echoed arguments NGFA made in proceedings dating back to 2006 detailing why we believe the Board's three existing rate complaint procedures simply are inappropriate and unworkable for ag commodities.

To summarize, first, pursuing a rate case under each of the existing procedures is costly, complex and time consuming. Second, agriculture commodity movements typically are not static or predictable. They typically have multiple origin and destination pairs that vary year to year as do the annual volumes. Third, market demand for ag commodities frequently changes quickly which is not conducive to the timeliness needed to process a rate case under the Board's existing procedures. Fourth, rate setting practices that establish uniformly high rates across the board for certain commodities or groups of commodities make reg relief under even the three benchmark methodology unattainable since those rules are designed to remedy cases where a shipper is singled out for market abuse. This flaw is compounded by the fact that under the current three benchmark rules only the movements of the defendant railroad may be included in the comparison group.

The NGFA commends the Board for recognizing that its current rate complaint process procedures need to change so they are more effective, accessible while rendering well reason and sound outcomes. We appreciate the recent statements to congress in that regard by acting Chairman Miller as well as former Chairman Elliott during his recent senate confirmation hearing. The NGFA shares these goals. We believe strongly that having a rate complaint process in place that is viewed by both captive shippers and railroads as being reasonably accessible will have a broad salutary effect in disciplining unreasonable rate behavior by carriers which now operate in what, at best, is a duopolistic market.

Further, we do not believe that adoption of NGFA's proposal will result in a torrent of rate cases filed at the STB. Instead, by disciplining market behavior it will change the dynamic under which commercial decisions are made outside of the Board's purview. This is not unlike the beneficial impacts NGFA has experienced from its rail arbitration rules whereby the mere existence of mandatory arbitration that works has resulted in not more arbitrations but reasonable business behavior and ongoing communications between both railroads and shippers to resolve differences in a balanced manner.

In any event, the NGFA took very seriously the Board's willingness to consider modified or entirely new approaches to replace the current rate rules that apply to captive grain shippers. We began by serving captive shipper member companies and devised a new approach that contains the following features that we believe are essential elements of any new rate complaint approach for captive shippers of Ag commodities ultimately adopted by the Board.

First, the approach must be accessible and inexpensive to administer and preferably should be based upon an objective formula to provide a form for complaints with smaller claims. In this regard, the NGFA's methodology relies upon information obtainable from the STB or available publicly and does not allow the use of other relevant factors or other methods utilized in the current three benchmark rules that at times have been injected by railroads to complicate and delay such cases.

Second, the rule must provide a meaningful constraint on the current unfettered ability of railroads to virtually dictate if they wish to the markets to which captive ag commodity shippers can serve simply through their rate pricing or other measures. The rules also should reasonably preserve rail revenues and carrier's ability to continue to invest in their networks. We believe the NGFA's proposed methodology accomplishes this by using a rate comparison approach somewhat similar to the Board's current three benchmark approach that also takes into account both revenue adequacy determinations and the current market for the type of captive traffic whose rate is being challenged.

Third, any new system must provide for expedited presentation of evidence, prompt agency deliberations and timely decisions given the fluidity and inherent changes in the US and global agricultural markets. NGFA's proposal achieves this by establishing a procedural schedule under which the Board could issue a final decision within 170 days after a complaint is filed, which we believe is a minimum time for a decision that parties could reasonably expect.

NGFA has also proposed that the new rate complaint rules apply to a broad range of agricultural commodities as opposed to a narrow subset of just grain. We recognize that our recommendations includes grain based products such as ethanol and bio-diesel. Our rationale is that the Board should err on the side of being more rather than less inclusive at this stage of the process. We note that the 68 agricultural commodities and products that we propose be eligible for the new rate challenge process are identical to those that were agreed to by the railroads to be covered under NGFA's rail arbitration rules.

Further, NGFA's proposal urges the Board to reconfirm and if necessary clarify existing rules that allow parties directly or indirectly affected by potentially unreasonable rates to seek relief. This would permit parties such as farmers who did not directly pay rail rates but often bear the brunt of railroad increases to challenge the reasonableness of the rail rates charged to captive shippers such as elevators to whom they sell their crops and to obtain refunds or other damages for their share of the increased costs attributable to the unreasonable rate levels.

Finally, and importantly, the NGFA firmly believes that new rules to judge the reasonableness of the rates for ag commodity shipments must include a component that takes into account the revenue adequate status of the defendant railroad. The Board and the industry have entered a new phase where the rail revenue related objectives of the Staggers Act of 1980 for carriers have been achieved and that the classman railroads are or nearly are revenue adequate under Board procedures. This should change the way the Board exercises its regulatory responsibility.

So NGFA's proposed methodology includes a way that revenue adequacy can be accounted for in rate reasonableness determinations. As stated in NGFA's reply comments, the Board should reject arguments to keep the status quo. These arguments ignore the ground truths that have emerged as a result of the reduced competitive options available to ag commodity shippers from the consolidation of the rail industry into regional duopolies. Simply put, ineffective and unworkable rate reasonableness rules have enabled and emboldened the railroads to extract excessive profits from captive agricultural shippers at times determining who wins and who loses and serving domestic and global agricultural markets. Others will propose that arbitration should be the sole remedy available to captive shippers to challenge unreasonable rail rates.

As the Board knows, the NGFA is a huge proponent of arbitration and as a form or resolving disputes in a knowledgeable, cost effective and business-like manner. We believe the mere existence of arbitration encourages more direct and earnest communication between parties and trying to resolve business related disputes. NGFA's rail arbitration system has been around since 1998. It was developed with the involvement and cooperation of several of the Class I railroads participating in this proceeding. But while the NGFA's rail arbitration system provides for compulsory arbitration of several specific types of disputes between railroads and rail users, we have been unsuccessful thus far achieving agreement among rail carriers to consider making arbitration of rail rate complaints mandatory despite a couple serious attempts to do so. The NGFA, of course, remains receptive to future dialogue with rail carriers on this possibility. I should hasten to add that there is nothing to preclude a rail carrier from voluntarily agreeing to arbitrate a rate dispute with a shipper now under the NGFA's existing system. The STB's experience has also been that arbitration has never been shown to be usable for rate disputes. That may yet occur someday but until then there is real and immediate need for the Board to establish new rules that are accessible to captive agriculture shippers and producers.

I also wanted to briefly address the Board's request that parties address requirement that carriers file agricultural contract summaries pursuant to 49 C.F.R. part 1313. NGFA has previously suggested in ex parte 725 that the board make summaries more readily accessible to rail shippers electronically and that the data be searchable. Also one of my colleagues at Cargill found a letter in that proceeding suggesting that the Board may be more diligent about ensuring the railroads submit the data that is called for in the regulations such as specific OD pairs instead of vague ranges of origins and destinations that are not particularly useful or informative. We will provide additional information and thoughts when we file on the record.

Now, let me turn to my colleague, Mr. Sutherland, who will discuss some of the impacts that current rate setting practices employed by rail carriers can have on the ability of agriculture shippers to serve markets and the farmer customers.

MR. SUTHERLAND: Thank you, Kevin. Good afternoon acting Chairman Miller and Vice Chairman Begeman. I am Bruce Sutherland, vice president of Michigan Agricultural Commodities headquartered in Lansing, Michigan. I am also a member of NGFA's Board of Directors and appearing today at the request of NGFA to add some current real world perspectives on the rate issues you are considering in this proceeding.

As a brief background, Michigan Agricultural Commodities, otherwise known as MAC, was established in 1976 and consists of eight grain elevators at seven locations throughout Michigan with combined storage capacity of over 43 million bushels. Our facilities annually handle approximately 50 million bushels of corn, soy beans, dry edible beans and oats. MAC also operates an agronomy business that serves our producer customers in two locations in central Michigan.

Michigan is a short line dominated state and CSX Transportation is the dominant and often the only Class I connection for our short line railroads. The majority of Michigan agricultural shippers are short line served and, therefore, captive to CSX by Class I connection we had reached both domestic and export markets served by CSX and other Class I railroads. In many ways, I regret the business related circumstances that cause me to be here today. I also am reluctant to single out one Class I railroad for attention since the rate issues faced by agricultural commodity shippers are common to all Class I railroads. However, the recent actions finalized on May 29, 2015 by CSX, essentially changed its rates for agricultural commodities nationwide provided a timely example to this Board as to why captive agricultural commodity shippers need access to a workable, cost effective and expeditious rate complaint process.

Let me provide a few specifics. CSX rates for corn and soy beans are published in CSX tariff 4315. Since 1999, very few movements of these commodities are by contract anymore by carrier choice.

In April of this year, CSX announced to the agricultural industry they had decided to simultaneously make wholesale changes to many of its common carrier rates for agricultural commodities in Michigan and other Midwestern states. This was not done on an individual customer basis but rather on a system basis. The increased their rates and the rate spread for Michigan shippers ranged from 35 to 100 percent and they are to take effect October 1 of this year. When I refer to a rate spread, I mean the geographical and cents per bushel difference between Columbus, Ohio, which is one of the base points for the CSX tariff 4315 and specific origins named in each state of the tariff. Two of MAC's elevator locations in Breckenridge and Marlette, Michigan were the most affected by this action with a rate increase of over 70 percent applied to each location. This increase added 12.8 cents per bushel to those elevator shipping costs which far exceeds typical grain trading margins. The increase forced us to immediately reduce prices by 10 cents per bushel for corn and soy beans purchased from farmer customers that do business with those two facilities just to cover the increased freight rate. Since these two facilities handle more than 15 million bushels of corn and soy beans annually this increased rail rate translates to a $1.5 million reduction in income to these corn and soy bean customers.

Unfortunately, our company is not alone. I've heard reports of other shippers operating facilities in Michigan, Illinois, Ohio, and Indiana with even more severe rate increases that result in reduced price bids to farmers of up to 20 cents or more per bushel. These increases in rail rates are several orders of magnitude greater than typically thin grain trading margins.

Consequently, if we were able to be price competitive in selling commodities to invested users and foreign buyers that we inevitably have to try to pass on the cost of impacts we can't absorb back to the farmer customers. Seldom are we able to pass such costs forward to the ultimate buyer as they have ultimate sources of supply in the grain market, which is a truly competitive market.

CSX is but one part of the overall domestic and global agricultural marketplace.

The dramatic changes in the rates have resulted in changing the competitive balance in Michigan and surrounding states and they stand to change the flow of grain that normally would occur based on the response to market demand. In some cases, the new CSX rate structure will force a shift from rail to much less efficient and much more costly truck transportation, creating more burdens on the states' highways, roads and bridges that already are at or beyond capacity, given their current condition.

We are still analyzing the effects of the new rate scheme, but it is apparent that it could result in fewer agricultural commodities being carried by CSX and a greater concentration of these commodities being moved on CSX mainline origins, to the detriment of the Michigan short lines which rely on agricultural volumes for that economic viability. Unstructured rate increased for agricultural commodities also have the harmful effect of undermining investment that we and others have made in our facilities, often at the direct encouragement of the rail industry.

MAC spent more than $35 million over the past five years to increase grain storage and loading capacity to be able to handle both the growth and grain production and the ability to ship 90 car unit trains. The latter of which was done in response to warnings from CSX about the need to make improvements to meet larger train sizes that are preferred by the railroad. Millions of dollars similarly have been invested by other rail shippers in their storage and handling facilities for similar reasons. I know of an NGFA Member Company in Ohio that invested in expanding its facilities to handle 90 car unit trains based on the implicit or explicit assurance from the Class I carrier, that the rates spread through Columbus would remain competitive and be preserved.

However, the new 90 car unit trains prices are now the equivalent to what previously applied to only 3 car shipments. This member believes the rug has been pulled out from under them. Other Class I railroads engage in similar pricing behavior but CSX provides a current example that substantiates the assertions in NGFA submissions in this proceeding about how unstructured unilateral rate increases can and do demarket the movement of agricultural commodities to domestic and export markets.

In fact, another NGFA member company reports that rail rates charged for transporting milling wheat from South Dakota through the Chicago gateway increasingly are being implemented on percentage basis which disportionately affects shippers with higher base rates. Rates were increased by five cents per bushel in January 2015 for milling wheat from South Dakota through the Chicago gateway and are scheduled for additional three cent per bushel increase effective August 1. This shipper reports that it had just invested $5 million in track and storage upgrades as well.

These unilateral rate actions can have the outcome of changing of competitive dynamics within our industry and, in fact, picking winners and losers based on a carrier's dictates and preferences on which types and sizes of facilities that it desires to serve and commodities it wishes to carry. MAC believes broad geographic areas of CSX grain origin markets will see wrenching changes as a result of these rate increases and structure, with commensurate disruptions in customary grain flows to customers.

From a global perspective, it is not unreasonable to anticipate that these increased freight costs will encourage customers particularly those near ports to pursue imports of grain from South America as a more cost competitive alternative to the detriment of US farmers and the American economy.

MAC and NGFA believe that the existence of effective and a successful agricultural rate rails rules would help prevent or mitigate some of the adverse consequences of the railroad pricing behavior exhibited by Class

I railroads.

Again, we don't believe that this would result through dozens of rate cases being filed before the Board. Rather such meaningful regulatory backstop would alter the current market dynamic such that railroads might not be inclined to make such dramatic and arbitrary rate proposals in the first place and captive shippers that conclude that they are harmed by such practices would have a better chance of reaching mutually acceptable commercial resolutions for their differences.

Thank you for this opportunity to discuss some of the real world impacts that actual rate setting practices by rail carriers have had on captive shippers and our farmer customers and our markets we serve. Now I'll turn to Mr. Crowley to explain NGFA's proposal.

MR. CROWLEY: Good afternoon. Thank you, Bruce. To be effective a rail rate regime for agricultural commodities must meet certain criteria. The rules must provide meaningful constraint against the ability of railroads to unilaterally control access to captive ag commodity markets while reasonably preserving railroad revenues and incentives to invest in their systems. The rules must be inexpensive to administer and based upon an objective formula. The rules must allow expedited evidentiary presentations and expedited final decisions. Commodity producers, elevators, intermediaries, and processors captive to a single railroad at origin and/or destination have little or no ability to expand their business and to try to develop and/or sustain local communities.

If rate reasonableness rules and processes are in place for ag commodities it would allow shippers the opportunity to expand and sustain their businesses both nationally and internationally. NGFA proposes a new maximum rate approach for ag commodities. The ag commodities maximum rate methodology also known as ACMRM. I will now outline the major components of ACMRM and provide an example of how one would apply the ACMRM approach and I have some slides to help me. We've got several PowerPoint presentations. I'm not sure which one it is.

CHAIR MILLER: What's it called?

MR. CROWLEY: I don't know.

MR. THOMPSON: That's NGFA right there.

MR. CROWLEY: Thank you. That one goes up? Okay, thank you. ACMRM uses a comparison group approach similar to the Board's current 3 benchmark methodology but some of the components are different than the 3 benchmark methodology. The comparison group includes rates for shipments above and below the 108 percent R/VC cost level. The comparison group includes shipments from all railroads, not just shipments from the incumbent carrier. The shipper would select all comparable moves that meet the selection criteria for the movement at issue from a confidential waybill sample. How do you go back?

CHAIR MILLER: We need to go back, is that it?

MR. CROWLEY: Get right to the answer. Other one. Yes, that's the one. Offer ability to the issue movement will be based on the following factors. First, distance plus or minus 20 percent of the issue movement miles. Second, commodity at the five digit stick level. Third, the rail car type. Fourth, the rail car owner. And fifth, the movement type, whether the movement is originating, terminating, originated, delivered, received, terminated, et cetera.

Even though the comparison group would include movements with R/VC ratios below 180 percent, the maximum reasonable rate produced by this analysis would be subject to the statutory 180 percent floor. NGFA's ACMRM approach will not allow for the examination of other relevant factors. It takes a lawyer and a consultant to handle it. The ACMRM also makes commodities specific adjustments to reflect each Class I carrier's revenue adequacy standards. This is accomplished through the development of the Revenue Adequacy Adjustment Factor or what we call RAAF.

The use of the RAAF addresses two flaws in the Board's 3 benchmark adjustment approach. First, the RAAF approach takes into consideration the amount of issued commodity traffic and allocates the burden of helping achieve revenue adequacy to those commodities that provide the most revenues; and two, it removes the overweighing of the railroad's historical financial performance by using the most current financial data reported to the Board.

The RAAF is calculated as follows: The formula you see up on the screen is the formula used to develop the RAAF. We'll look at this formula as its laid on the screen and then we'll show you an example of how it works, but it's basically broken into two parts. The left side of the RAAF takes into account the factors that are readily calculated by the STB. The factors on the right, and when I say on the right, I mean to the right of the time sign, are factors that are drawn from either the confidential waybill sample or from ex parte proceeding.

Using the Union Pacific 2014, I've calculated an example of the application of the RAAF for STCC 01132, which is corn. Coming down the left hand item column, the railroad industry cost of capital, the return on investment, the investment base and the tax rate, all four of those items as you can see in column two are available and calculated by the Board. The values for these numbers in 2014 are shown in column three. Lines five, six and seven on this slide are assumed numbers. We did not have access to the 2014 UP data from the waybill samples so we assumed these values for purposes of this slide. Line 8 is the first part of the application of the formula we were just looking at. Line 9 is the application of the second part of the formula.

When these two parts are combined, the RAAF for UP for STCC 00132, corn, is -12.5 percent. The way the formula works, a negative number means the carrier is revenue adequate. A positive number means the carrier is not revenue adequate based on the Board's current standards. The RAAF fits into the overall ACMRM formula and the application of that formula is shown in the example on the screen. For purposes of this example, all of these numbers are hypothetical. I have included, as part of my written comments in this proceeding, actual examples of the application of the ACMRM using the highly confidential waybill sample so you can look in that testimony, that file testimony and see real world application of how this would apply, but for purposes of this example, it's all hypothetical.

Now let me walk you through the application of the ACMRM. The first thing we do is identify the issue movement parameters which are the top six lines on the slide. First is the commodity at the five digit STCC level. For purposes of this example, we're using corn, STCC 01132. The distance in miles. For purposes of this example it's 120 miles. Total revenue per car and the variable cost per car are shown on lines three and four. Variable costs are calculated using the URCS Phase III model. The revenue to variable costs ratio is simply dividing the rate by the variable costs and the jurisdictional threshold is the application of the 1.80 ratio to the variable cost on line four.

Now the comp group, based on the criteria that was previously outlined, we would search the confidential way bill file and find all movements that meet the selection criteria for all railroads regardless of the revenue cost relationship and identify them. For purposes of this example, we have assumed there would be comparable moves on the Union Pacific, the BNSF and CSXT as shown in column two of the bottom table. The distance based on the criteria is plus or minus 20 percent around the 120 mile issue movement parameter and the distance in column three falls within that bracket. The revenue per car in column four is the revenue appearing for each of those movements in a confidential waybill file.

Next we identify the RAAF or the Revenue Adequacy Adjustment Factor for each carrier for corn. This RAAF would be calculated for each carrier for the particular commodity that's the issue movement and those numbers appear in column five. For purposes of this example, we have assumed as I explained a moment ago that the Union Pacific was revenue adequate and at an RAAF of 12.5 percent. You can tell the revenue adequacy by the negative sign. BNSF for purposes of this example is also revenue adequate as you can see the negative sign before the 4.2 percent and CSXT is considered revenue inadequate because there is no negative sign and again these are based on the current revenue adequacy procedures.

We next apply the Revenue Adequacy

Adjustment Factor to the revenues and the results are shown in column six. It's simply taking column 4 and either increasing it or decreasing it for the Revenue Adequacy Adjustment Factor. We then compare the adjusted revenue to the variable costs and again based on Ag Phase III for that movement as it appears in the confidential waybill file and get the adjusted RBC ration appearing in column eight. This is done for each movement in the comparable group.

We then go to line seven and take the simple average of the RBC ratios appearing in column eight for lines A through J. The simple average in this example is 185.5 percent. We next adjust or calculate the rate based on this adjusted RBC ratio by taking the variable costs of the issue movement which appears on line four and multiplying that value by the 185.5 percent. The result is $742 that appears on line eight. We next identify the maximum reasonable rate, which is the greater of the number we just calculated on line eight or the jurisdictional threshold appearing on line six. In this case, in this example the adjusted RBC ratio produced the maximum rate.

I'd like to change the subject slightly and talk about corporate structure and railroad revenue adequacy. Current STB rules and policies allow the railroads latitude in what subsidiaries they include in their annual report form, R1 statement. The Board requires the railroads to include in their R1 reports financial and operating statistics for the consolidated railroad entity. The decision of what constitutes a railroad and rail related affiliate and therefore, what and what not to include in the R1 ultimately lies with the parent companies of the railroads.

In addition, the STB in its role as regulator of railroad economic issues in the US has chosen to require railroads to report only their US based operations. The Canadian National R1 report filed with the STB covers the prior Grand Trunk Western and the Canadian Pacific covers the prior Soo Line. For ROI purposes, return on investment purposes, we suggest that the Board change its policy and require the CN and the CP to report on their entire corporate structure. The chart on the screen demonstrates the difference between the ROI for parent CN and CP versus the ROI for subsidiary, Grand Truck and Soo and I'd just like to walk you through that chart.

On the left side of the chart is the Grand Trunk and Canadian National ROIs. The blue is the Grand Trunk and the green is the Canadian National, which we estimated based on filings at the SEC made by Canadian Nationals. You can see in all years shown the Canadian National as a parent had substantially higher ROIs than the Grand Truck Corporation.

On the right side, it's a similar analysis for the Soo Line and the Canadian Pacific. The interesting thing here is the 2014 calculations. In 2014, there is no return on investment for the Soo Line because the R1 report of the Soo includes the write down of the sale of the DM&E.

While that write down had little impact on the parent, as you can see at 16.1 percent estimated ROI for the Soo Line portion of the parent there is no return. It's actually a negative return. That concludes my comments and I'll turn it over to Mr. Wilcox.

MR. WILCOX: Good afternoon, Chairman Miller, Vice Chairman Begeman. Thank you for the opportunity to be here today. With the remaining time we have on our panel I was going to address a few legal aspects of the NGFA proposal and one of the other topics that you mentioned in the May 8 hearing notice, that in particular being the 49 C.F.R. 1300.5 regulation on notice of grain rates.

CHAIR MILLER: Could you maybe talk more directly into the mic?

MR. WILCOX: Is that better?

CHAIR MILLER: Yes.

MR. WILCOX: Okay. So I'm going to

address three of the points as times permits. If I don't get to all of them, I'll include it in our supplemental comments since you're keeping the record open but we want to get to your questions, so, the first point is that NGFA included in part four of its opening submission a thorough review of the Board's authority to adopt a separate rate rule scheme for a group or a class of commodities and then to also adopt a rule scheme along the lines proposed by NGFA. This authority derives from Section 10701(d)(1), 10701(d)(2) and the rail transportation policy. The original D.C. Circuit opinion in McCarty Farms which you heard about earlier today from a couple panels affirmed that the agency has very wide latitude and discretion when adopting rules to the test of reasonableness of rail rates.

In June of last year, the D.C. Circuit, when they upheld the changes in ex parte 715 to the rate rules confirmed this broad authority and that under 10701(d)(3) and that the simplified approach under that section can be used regardless of the value of the case. The court rejected the argument of the railroad that there's no statutory mandate to use SAC once the case reached a certain value and in response to some of the testimony you heard earlier today from the AAR Panel on the 1993 McCarty Farms opinion, we explained, this is pages 18 to 20 of our opening evidence, the reasons why that opinion or the reasons that the court relied upon in that decision are no longer applicable to the current facts or NGFA's proposal and, in fact, certain parts of it were overruled by the opinion in ex parte 715.

In that case, and we go into it in detail in the opening, the Court, D.C. Circuit, placed a very heavy emphasis on the fact that BN at that time was revenue inadequate and that the STB or ICC at that time needed to ensure that BNSF, or BN became revenue adequate and the Court in that case also looked at I think looked at two or three coal cases involving multiple origins and destinations and then concluded that grain oriented cases could be brought under the SAC case with the multiple origins and destinations and it's been many years since that decision. We still haven't seen a grain SAC case so the Court's rationale for deciding for not upholding an ICC in that case has been superseded by time. And the NGFA's arguments on authority at the end of the day were really not strongly refuted by the railroad commenters.

In essence, they only argue that the STB can't adopt a rate methodology of the type proposed by the NGFA, that there is no statutory authority to preclude you from doing it. They are arguing that STB shouldn't and that the Board should adhere to the status quo and in doing so they are ignoring a key premise of the NGFA's proposal which you heard about from our panel so far is that the STB's rate rules, you know, now must factor in that the Class I railroads are revenue adequate or nearly revenue adequate and that changes the past focus on differential pricing, extreme market pricing, SAC concepts.

The Board is addressing those issues in EP72 as was mentioned earlier today but it shouldn't ignore revenue adequacy in this proceeding and so NGFA's approach was to include revenue adequacy, some concept of it or some way to account for it in their proposal.

The second point is that some of the railroads in their comments have resurrected the argument that because NGFA's proposal, its methodology utilizes RBC comparisons that all ag commodity rates will be ratcheted down immediately to the 180 percent jurisdictional threshold. The STB and the D.C. Circuit put that argument to bed last year in the EP715 appeal opinion, at least as to the 3 benchmark and our methodology is similar to 3 benchmark.

In that case, the Court agreed with the STB that ratcheting would not occur under the 3B rules because in those cases relief would be limited, an avalanche of cases would be required and the Board can reassess if it looks like they're being flooded with cases and the rates are ratcheting down, the Board can reassess its rules and then the last point was that there was a need to balance any ratcheting concerns with a need to give shippers with smaller claims a way to challenge rates.

The third issue is NGFA and you heard testimony earlier today on the issue of aggregating of claims and standing. NGFA feels very similar to the Montana witnesses you heard earlier today about how you're finding a way in a ag rate proposal to aggregate claims and to allow producers and other parties who don't directly pay the rate but feel the brunt of the rate to bring claims. Notwithstanding the railroad parties and their comments do not disagree that parties indirectly affected by rail rate increases could file a complaint under 11701(b) but they argued that standing would be determined on a case by case basis. I believe it was Mr. Tiller who, earlier today, pointed out a good point. That this, would required cases be filed in order to establish the rules on standing, so you'd have to litigate to whether you have standing, which is a deterrent to bring in a case. So the guidance from the STB on the parameters of standing, would be helpful in that regard rather than requiring someone to bring a case to you to determine whether standing can occur.

The other issue is whether parties who indirectly suffer from rate increases can receive reparations. The general rules they establish that the party who paid the rate to the railroad is entitled to reparations but the ultimate test is whether there is injury, in fact, or pravity to the railroad in terms of assessing the rate and paying the rate, so in that regard the railroad's again saying no guidance from the STB is needed but the Board and effective parties could explore in a rule making whether and how various parties affected by railroad rate increased in the agricultural markets could establish the necessary injury.

In fact, the big issue we've heard

today is the fact that producers often bear directly the past through from rate increases but there are other players in the agricultural market that do feel the brunt of the rate increases indirectly.

The final point was to address the 49 C.F.R. 1300.5 rules. The Staggers Act contains many provisions that are specifically geared towards protecting shippers of agricultural products and that's broadly defined. One of the provisions in the Act that protects agricultural shippers and is 1149 US Code 1110.1(d) and that requires more information on rates and service changes but it also includes references to proposed as well as actual rate increases. This, at least, applies a longer lead time of notice to ag commodity shippers than the 20 days' notice that appears in 1110.1(b) and in the Board's regulations under 1300.5(d) they require that any scheduled changes must be published in a manner that provides timely notice to subscribers.

A current area of uncertainty is

whether rate changes for agricultural products are subject to the same 20 day notice requirement for other rates in 1110.1(b) or whether 1110.1(d) and the Board's regulations create a longer timeline of timely notice, which is be a more fact specific inquiry so what notice is timely in one set of circumstances but maybe it's not timely in another. The latter approach could help situations where shippers have made significant capital investments based on representations by the railroad of certain rate levels and certain investments were made. If you have a longer lead time for rate increases in those situations, it could help mitigate capital investments being stranded. If sufficient notice is given, then maybe the investment's not made or maybe there's some way to mitigate the damages. That concludes my testimony. I'll give it back to Kevin.

CHAIR MILLER: Great. Thank you all very much. So, Kevin, I think maybe this is a question to you, although anyone on the panel would be welcome to respond to it. When you started off, if I could make sense of my notes, I think you talked a bit about the issues that are specific to grain that led to this proposal but really the suggestion here is that we have a rate relief process designed specifically for grain shippers and I would like to hear a bit more about what makes grain distinct from other commodities such that it should have its own rate relief process.

MR. THOMPSON: Well, Madam Chairman, I think the one thing is grain is not a commodity like coal that typically moves from one origin to one destination all the time. We have a lot of moving parts. They're driven by global market dynamics and because of that, spreads change, market changes and because of that, the railroads can move their rates and spread it around to dictate where grain can flow. Just from the onset, you've got multiple changes in OD Pair changes can change years that will change volumes. So really, when you look at just the commodity side of the business there's so many different moving parts. That could be regionally, that could be by commodity, it could be between eastern US and western US

There are just a lot of different things that can change year on year for ag that can be dictated by changing of rail rates and other things. Some of the things that Bruce talked about that kind of makes ag a little bit different than some of the other commodities that only flow from point A to point B, pretty much year on year.

CHAIR MILLER: Isn't that also true though for commodities like any of the chemical commodities, a lot of the origin and destination pairs are changing all the time?

MR. THOMPSON: To be honest, I'm not familiar with the chemical side so I'm probably not the best one to answer that.

CHAIR MILLER: Sure. That's fair enough. And, Mr. Wilcox, you mention the issue of ratcheting but you know that has been a concern expressed about the proposal, that in fact it would lead to a ratcheting and bringing all rates to roughly the 180 percent and you cited to a court case that said that our 3B process wouldn't likely lead to ratcheting but could you say a bit more why this particular proposal wouldn't?

MR. WILCOX: Well I can speak from experience in litigating three benchmark cases is that they are, well rate cases in general are rare and their shippers are very reluctant to bring them to begin with and so I think that the other aspect of as I said earlier if you have a rate methodology that works and that both parties know work, then you will reach a negotiated solutions that I think would most likely be above the 180 percent and then again what as D.C. Circuit said and the STD said in that case if it looked like there was an avalanche of cases, we haven't seen an avalanche of three benchmark cases and that was the same fear when we --

CHAIR MILLER: We certainly haven't.

MR. WILCOX: -- when simplified standards were passed or in the process, you heard a lot about ratcheting there as well, that if that was to come to pass, if there was an influx of all these cases, then the Board could reassess because as we said, at the outset, NGFA wants to find a solution to the fact that cases have not been brought in 30 years for grain shippers but they want the railroads industry to be healthy and so I think those would be mitigating circumstances. Mr. Crowley can speak more to this than me but in a revenue adequate industry, RSMs come down to around 180 percent or less, I think its revenue adequate situation the 180 percent. It's not an objectionable rate.

CHAIR MILLER: I want to go back, Mr. Thompson, I think at the end of your testimony, you brought up the issue of the ag contracts which was one of the things we were interested in pursuing, I mean just getting an understanding about how useful or helpful those are and so I just sort of want to confirm. I take it from your testimony that you would say yes, it's important that they're out there but the current way they're being posted is not so helpful, so if that requirement is to remain in place we should change some of the requirements in terms of what's reported and then how it's posted. Is that a correct understanding of your comments?

MR. THOMPSON: Yes, by and large. Basically, it's just the formatting of the way that when they're posted if we could somehow do a better way of sorting it out and then finding out specific, because some of the way the OD pairs are reported they don't, they're not specific to the origin or destination. They're in groups and it really doesn't give you any information on what that is and sometimes not even what the commodity is, so I guess just a little bit more transparency and specificity on really what those contents are.

CHAIR MILLER: So I think if I'm understanding you correctly, there are both things that the STB could do in terms of how we're posting it to make it more usable but also ways that the railroads could change the information they're providing that would make it more usable.

MR. THOMPSON: That is correct. I think there is only one or two of the Class I's that aren't really reporting them in the granularity to where you can actually see what the contracts are.

CHAIR MILLER: Uh-huh.

MR. THOMPSON: So I think ---

CHAIR MILLER: So perhaps we could look to the ones that are being reported in a more granular method and use that as an example of what would be useful?

MR. THOMPSON: That is correct. Yes.

CHAIR MILLER: Can I ask you a sort of a related question but on the issue of tariffs. One of the things I've been interested in is if you're looking for a tariff for a specific commodity, is that an easy thing to find? I mean what do you have to do to find out what the tariff is for a commodity?

MR. THOMPSON: Basically so every Class I railroad website has all the tariffs listed so basically all we do is go into the website and then search basically by commodity and then you can sort through the tariffs there. Some of them are pretty user friendly, some of them are not but it's all out there public for you to see.

CHAIR MILLER: And generally, if you need to know what a tariff is, you can find that information without problem?

MR. THOMPSON: Oh, yes. Yes, typically without a problem.

CHAIR MILLER: Okay. All right. Thank you. Ann?

VICE CHAIR BEGEMAN: Thank you very much, and I'm going to apologize in advance because my questions are all over my head and all over my papers. If I don't get to them now, I may shout some into the audience towards you later. If I could start with you, Mr. Thompson, although you're all welcome to fill in the hot seat a little bit, help me understand how your proposal helps a grain shipper across the board? I mean, does it help Cargill to the same extent it helps Mr. O'Hara, who was on the previous panel in Montana? Is it across the board fairness or is it somehow more orchestrated for larger grain shippers?

MR. THOMPSON: No, no, and I think that's kind of why we went down this path is because being as for formulaic as it is and being able to look at defendant care and other cares, you're really going to get the subset of everything that's out there. This should have the same impact on a small shipper versus any larger shipper so really it's an all-encompassing approach. We were looking for something fast, easy and fair and this is what we came up with to achieve that goal.

VICE CHAIR BEGEMAN: Does a large grain shipper typically ship under tariff or do you perhaps also ship under contract or is it kind of a mixed bag?

MR. THOMPSON: It's a mixed bag and it depends on the products. By and large, the western US on corn and beans, they do still ship on tariff. In the eastern for example, the eastern railroads we still negotiate contracts for soy beans and in the case of corn it's done by the destination so it varies by railroad and it varies by commodities.

VICE CHAIR BEGEMAN: Mr. Crowley, if you could help me a bit with your charts, they are actually really helpful. I appreciate that you clarified that things are hypothetical as far as some of the railroad data. Let's start with the fact that the comparison group would include movements both above and below 180. I'm trying to understand what sort of criteria or what safeguards, that's not quite the right word that I mean but, because we want to have a fair process. I wouldn't feel comfortable putting something out that allowed every comparison group to be at or below 180. So what is the criteria --

I guess the factors of A through E -- the distance? Commodity? What is going to constrain your comparison group so you can't just go to 100 percent to get your comparison?

MR. CROWLEY: The way the procedure works is you don't have a choice. You have to take all of the movements that meet the criteria so in the example on the text it was 120 mile haul of corn so all movements between 96 miles and 144 miles of corn regardless of the R/VC ratios are in the comp group.

VICE CHAIR BEGEMAN: So they're not selected?

MR. CROWLEY: They're not selected. It's a given. You've got to take them all.

VICE CHAIR BEGEMAN: Okay.

MR. CROWLEY: That, in our opinion, is the relevant market for corn that goes 120 miles.

VICE CHAIR BEGEMAN: Tom, this may be a question for you, but I know that you do not care for "other relevant factors", at least with respect to 3B. I guess, I'd like to hear a bit more from you. It seems, in my opinion, from my experience with one of the cases, that ultimately settled, because 3B is crude, but the relevant factors did allow some reality to be brought in by either party.

MR. WILCOX: Well, the issue has with other relevant factors and I may know the case you're referring to is that I think that the original intent of the 3 Benchmark rules was expanded upon by the defendants in terms of with the aim of putting burdens on the complainant and what it ---

VICE CHAIR BEGEMAN: By burden do you mean costs?

MR. WILCOX: Well, yes, the 3 Benchmark methodology is designed to be simple, cost effective and that was directed towards the smaller shippers but the other relevant factors component of 3 Benchmark at least in the last case we've seen was really expanded into some realms that involved expert testimony, costs that raised the estimate of what are, or the expectations of what a complainant would pay to have his rates litigated to be greatly expanded in reality and that puts a chilling effect on subsequent 3 Benchmark cases. Our proposal again, the emphasis is to try to find a way to get a decision done quickly. As we also said, in terms of market dominance, we proposed that the Board use its current, well the traditional market dominance rules as opposed to the limit prized, but that it be done on an expedited basis. So that in essence is the reason why we did not include other relevant factors, was to make sure that the understanding that the result and the process would be somewhat crude like through Benchmark but also to get a faster result and keep the costs down.

VICE CHAIR BEGEMAN: Mr. Thompson, and Deb, you are welcome to interrupt and ask a question, I'm kind of free flowing, but could we go back to the beginning of your testimony? You mentioned the NGFA's arbitration process, and there's been some discussion, some outreach, with respect to allowing rates to be arbitrated. Did I understand that correctly?

MR. THOMPSON: So today in our real arbitration system we basically arbitrate everything but rates. All right, so rates are not included but as NGFA we would be very open to have those discussions. What would have to happen, we would have to have all the member Class I railroads agree to a mandatory arbitration system.

VICE CHAIR BEGEMAN: And why would they all have to agree? Could one just volunteer and let's say, I don't want to even make a hypothetical, one carrier said we'll arbitrate. Could you not just allow your member to proceed?

MR. THOMPSON: Yes. So if a railroad came and agreed to arbitration with a member company that could happen.

VICE CHAIR BEGEMAN: Okay.

MR. THOMPSON: As long as they were both members.

VICE CHAIR BEGEMAN: Okay.

CHAIR MILLER: Can I slip in there because I'm hoping I'm understanding this correctly, but I think under the Board's arbitration procedures there is one railroad that's agreed to arbitrate and I don't think any shipper has stepped forward to take them up on it.

MR. THOMPSON: Yes --

VICE CHAIR BEGEMAN: But not rates.

CHAIR MILLER: But not rates. Thank you.

MR. THOMPSON: So I will say that with that being said we have been approached within the last six months by a Class I that wanted to have open dialogue about the potential of starting up the rail arbitration process again, or not the process but the discussion, so we have entered into discussions with one. We were having ongoing discussions but now, you know, to make this happen we have to reach out and get the other Class 1's to agree to go down that path as well and today we do not have a standard process for rate arbitration, so we would have to come up with what that would look like, what the rules would be, you know, what are we going to arbitrate against, so we would have to have some work to do but, you know, we really would want somewhat of a good understanding that most of the railroads or all the railroads for that matter, would want to enter into NGFA arbitration for really for us to really put a lot of time and effort to go forward on it.

VICE CHAIR BEGEMAN: I say take what you can get and if one will do it, start your program.

MR. THOMPSON: Well, what the problem is we have a lot of members that are captive to other railroads.

VICE CHAIR BEGEMAN: I know. I know. It's just that I assume it's a large railroad. I mean if it's a short line I can understand your hesitation.

MR. THOMPSON: No, it's a large railroad.

VICE CHAIR BEGEMAN: Mr. Sutherland, could you please clarify something? I think I may have misunderstood your discussion of a certain rate increase that your state has recently received from a Class 1 carrier. I thought that what you said was -- now I can't find my notes --- but that it was going to lead to more traffic on that carrier's main line and off of the short lines.

MR. SUTHERLAND: Right. Right. We felt that at first analysis it certainly looks like short line origins with the new rate structure will be at a significant disadvantage to main line carriers, or main line shippers because of the rate spread now at rail cost is much, will be significantly more than perhaps what the truck difference would be out of an origin that would be in a short line area moving to a main line point, so it puts that short line shipper at a disadvantage in the new structure to a main line shippers.

VICE CHAIR BEGEMAN: Are you saying

basically, that as a shipper you'd be induced to trucking your grain to a location where it can get picked up on the main line?

MR. SUTHERLAND: That or a farmer customer may see, because of increased freight costs and the bid difference has gotten so wide, that they can afford to actually now truck beyond your short line shipper origin to a main line shipper because unfortunately of uncompetitive situation from a price standpoint.

VICE CHAIR BEGEMAN: Mr. Crowley, I'd like to know if you have an opinion on some of the earlier comments? The TRB's first comment with respect to URCS, and then kind of contrast it with Mr. Gray's comments that it's actually fixable, but it certainly would cost us. Do you have an opinion on this?

MR. CROWLEY: I have an opinion. I'm not quite ready to bury the URCS formula. I think it is outdated. I think it should be updated and I think we've been advocating that for a while. The regression analyses that form the basis of the variable cost calculations were performed back when there were a lot of railroads. There aren't a lot of railroads today and so I think what you'll find ----

CHAIR MILLER: Is your microphone on?

MR. CROWLEY: It's not on?

CHAIR MILLER: I'm not sure.

VICE CHAIR BEGEMAN: Maybe pull it closer.

MR. CROWLEY: How's that? There's fewer railroads today obviously than there were when the regression analyses were done that have formed the basis of the variable cost calculations in URCS and so I think at a minimum that should be done. It's a formula. Any formula you can tinker with and you can make it as expensive as you want it be to update it. To update the regression package, I don't think that's necessarily a big deal. It's not totally inexpensive, but not a big deal. There is one thing that I did agree with that the AAR witness, Mr. Gray, stated, so I think I'll share that with you. There was only one and that is I believe he said that we should factor in density in these calculations and I agree with that. Density was a part of a rail form A which was the URCS predecessor and it was captured through a curvilinear regression equation which was eliminated when URCS came along. URCS is based on just a straight line regression, simple regression analysis, so if you're going to update URCS consider the curvilinear or density impact on the variable cost calculations. Did I answer your question?

VICE CHAIR BEGEMAN: Yes.

Now I just lost my train of thought, please excuse me for a second.

When you walked us through the proposal, it struck me that although it certainly is easier to understand than trying to have you explain to us the SAC process, or at least to do a flow chart of the SAC process, it sounds to me that we would still need consultants to review the cases if you need your confidential waybill data. But then since you're a consultant, maybe there was something behind that. How simple is simple?

MR. CROWLEY: When I was asked to put this simple proposal together one of the criteria wasn't to eliminate the consultants so.

VICE CHAIR BEGEMAN: Uh-huh.

MR. CROWLEY: So I kept my job. It is simple and it is straightforward. I don't even, I think if you follow the rules that we've laid out I don't think you need either party. I think the Board staff could do this without having either party involved.

VICE CHAIR BEGEMAN: Right, and we just need the permission or the confidentiality request. You'd have to get permission to use the waybill.

MR. CROWLEY: The staff would not need the permission. They could just solve the equation themselves. They wouldn't need either the railroad consultant, I just put myself out of business, or the shipper consultant to make these calculations. There's theoretically nothing to argue about. Follow the rules and you'll get the answer. Do it quickly, simply, cheaply. We just made it cheaper.

CHAIR MILLER: I was curious and I guess in some ways you're now reflecting on this. I don't know if I would have asked the question if it hadn't been for Dr. Schmalensee this morning basically throwing cold water on the relevancy of a revenue adequacy finding and really talking about quite a different process and obviously built into your formula is a factor related to revenue adequacy and I'm wondering what the consequences of using or not using the factor, if you just got rid of that factor what would end up happening under the formula?

MR. CROWLEY: There'd be one less calculation for each probable move. That would be about it. It would depend on the revenue adequacy status of each of the railroads in the comparable group. If they were revenue adequate the revenue comes down on the comparable moves and the R/VC ratio for the comp group comes down as well, so if you took that calculation out they were all revenue adequate railroads then the result would go up and the opposite would be true if it's the other way. So the revenue adequacy adjustment factor protects both sides, both the revenue adequate side and the revenue inadequate side.

CHAIR MILLER: Mm-hmm.

MR. CROWLEY: In the comp group calculations. So you probably heard this, this morning in the AAR panel basically disagreement with the idea of including other railroads in the comparable group and I guess primarily arguing that, you know, no matter how much alike they may look they're not alike enough to include. I'm just wondering what you all would say about that?

MR. CROWLEY: The railroads are amazingly alike, especially now that we're down to four big ones and a few small Class 1 railroads and I think you can see that by looking at the URCS formula that nobody likes except me.

URCS will tell you on a total system basis, the total variable costs that it calculated and the total fixed cost, which are these common costs that they were talking about, common or fixed costs. If you look at the relationship for each carrier you'll see they're very, very close.

In other words, the fixed costs of one carrier's basically the same percentage as another carrier so what they have to recover is basically the same thing. Now the other point is that this cross carrier idea, I know the Board hasn't necessarily liked it in a lot of these analyses but they use it, the Board, you guys use this cross carrier idea in the revenue accuracy calculation. You calculate the cost or capital for an individual railroad and then you compare it to the railroad industry cost capitals based on all the railroads. So we get inputs from all the railroads to compare to an individual railroad. We're not doing anything different here in this approach.

VICE CHAIR BEGEMAN: Do you care to

comment on ARCs proposals, the 2B approach. Since they're going to testify later and you won't be back, you're welcome to give comments now.

MR. CROWLEY: I think that obviously that the NGFA approach is superior to the --

VICE CHAIR BEGEMAN: We know that.

MR. CROWLEY: Yes.

VICE CHAIR BEGEMAN: We knew that.

MR. CROWLEY: I'm glad you do but I do think the ARC approach is better than your 3 Benchmark approach so if you don't like our approach I'd go with ARC before I'd go back to 3 Benchmark.

CHAIR MILLER: Do you want to say more about why you think the 3 Benchmark would be a better approach than the 2 Benchmark?

MR. CROWLEY: It's the other way around.

CHAIR MILLER: Sorry.

MR. CROWLEY: I think ARC will take care of all that for you.

CHAIR MILLER: Okay. I misunderstood

you, or I didn't listen carefully maybe. So Mr. Thompson, did you say or now am I confusing this with what I've read, is it your proposal to broaden the definition of grain so it would include ethanol and other?

MR. THOMPSON: Correct. Correct. Basically what we were proposing is that of the 68 commodities that would mirror what we use today in our trade rules, so everything that's in our what we use in NGFA today would be in there which does include ethanol and the bio-diesel.

CHAIR MILLER: So could you maybe say a bit more about that because it seems on its face that shipping ethanol or bio-diesel is very different than shipping corn or shipping wheat?

MR. THOMPSON: I guess when we looked at it we looked at ag products and when we looked at ag products it was everything that evolved around that. I guess I'm not quite sure what the dynamics would be versus shipping the ethanol. I mean obviously you've got the tank car side and the regulations and everything that goes along with that, but basically I mean you still have, you'd still have your OD pairs, you know, a lot of the ethanol is in contract form so to us it's another commodity. We're not really looking at this so much as a hazmat or a different product versus what we're doing on the grain, corn, beans and wheat side of things.

VICE CHAIR BEGEMAN: Okay. Well I just really wanted to thank you for the effort that your association went to, to heed our call and make a recommendation that we could explore and perhaps tinker with or do more than that. I know there was a cost in time and expense, Mr. Crowley. Thank you for the effort that you've made to help us get to the goal that we have.

MR. CROWLEY: Thanks for the opportunity.

CHAIR MILLER: Thank you all very much. Very interesting. Okay, we're ready for Panel Number Five, which includes Union Pacific and BNSF. Welcome. Mr. Miller, are you leading off here?

MR. MILLER: I am.

CHAIR MILLER: Okay.

MR. MILLER: If that suits.

CHAIR MILLER: You bet.

MR. MILLER: Is this on or can you hear me?

CHAIR MILLER: Do you have a red light?

MR. MILLER: There we go. Thank you very much. Chairman Miller and Vice Chairman Begeman, thank you for the honor to speak here today. My name is John Miller, group vice president of agricultural products, BNSF Railway. I have been with BNSF for over seven years now and prior to that I spent 25 years in various management roles in the grain industry on the shipping side. Again, that you for the opportunity today.

As the lead Class 1 rail carrier of agricultural products, we are continually investing to maintain and expand our network, our grain network. Our customers are responding to market opportunities with significant investments in BNSF grain facilities which I'll describe in a bit. The massive combined investments between railroad and shippers suggests a very strong belief in our ability to deliver commercially competitive rates for a liable grain service over time along with the expectation that when more investments are needed to meet demand for service we will respond.

In my remarks today, I will give a brief overview of the BNSF grain business and our record of innovation which is well known to this agency and the stakeholders here. I will describe the virtuous cycle of investment by both BNSF in our agricultural business as well as by our customers on our railroad. I will address some of the concerns we know that some of our customers have about the rate process as well as outlining the innovative steps BNSF has taken on its own to address its customers' concerns. I will take some of my time to address several of the issues raised by the groups and our customers that have been in testimony today.

Before I get into the detail on our grain system, I would like to address a couple of issues from this morning. I'd like to speak for a moment to the small shipper. To the small shipper that feels that he or she does not have access to the rate relief, that feeling is justified. We always advise our customer to come call us at BNSF, at marketing to voice his concerns about the market rate. We get feedback about the markets all the time. Our shippers are not shy about telling us when the rates aren't competitive as well as when there are also working opportunities that benefit us both. We treat that trust with great care. If he has already done that or is not satisfied with our response and still feels he has a rate concern, then the process allows them to address it to the STB. Is that process flawed in terms of taking too much time or costing too much for the small shipper? Yes. We agree. This is exactly why we listened in Montana and after multiple discussions with Montana grain growers and the Montana Farm Bureau, we agreed upon a comprehensive solution which I'll refer to a little bit more in detail later.

This is why we are also willing to consider a different solution to rate complaints brought before the STB changing the process but not changing the methodology. To this small shipper, I would say we have already made a proposal to the NGFA to use the current NGFA arbitration base system for practices to be tailored to STB complaints for rates. The organization which has the largest membership of grain companies today has the tools to lead an effort to get a faster and less costly process for you and the railroad alike.

While we are waiting to hear back from NGFA, we are willing to support them in the effort to bring all railroads into the solution to get to the point where you do feel like you have better access to market based solutions to address your rate concerns.

Another issue that I feel like I've got to address up front is, and it was mentioned earlier today, and is that this notion that customers out there today are reluctant to raise rate concerns or rate complaints because they feel retaliation. Personally I'm offended by that. We've heard that over time in the past and from my standpoint and our staff at BNSF and all of our employees at BNSF, it's not true. I cannot disagree with somebody of the way they feel and they may feel that way but today the notion of retaliation at BNSF is a personal affront to us and it's just simply not part of our culture and that's not how we run our company.

To the contrary, we have robust open discussions about rates with customers daily. In fact, we encourage the give and take with our customers about how to capture and market opportunities. Our customers again, aren't shy about telling us when they don't work. We encourage that. That tells us what works and what doesn't work. It's part of that daily discovery of what the market is for us. We are constantly assessing market dynamics to address those issues and how they may be raised.

Okay, let me get on to the slides and talk about the breadth of our marketplace. More than half of our whole grain shipments moved to export markets. The export market is increasingly important to our grain shippers. Grain shippers need efficient transportation to participate in these export markets. As I will discuss in a moment, the investments we have made to improve the efficiency of our rail network have been critical to the success of US farmers in this important export sector. For domestic consumption, we also transport a significant amount of grain, mostly wheat and corn, while our export destinations tend to be concentrated in a discreet number of large export facilities, our domestic grain shipments are delivered to a large number of widely dispersed domestic destinations including feed lots, ethanol plants and flour mills.

Let me move next to BNSF's investments in our network in general and in our agricultural network in particular. As I said, we are in a virtuous cycle of investment in our agricultural business taking the revenues we earn and investing it right back into our network. We have made enormous capital investments in the system-wide infrastructure. In 2014, we had an all-time high capital budget of $5 billion and actually spent $5.5 billion. BNSF plans to exceed that in 2015 investing $6 billion. I know this slide is hard to see but we take this to customers all the time so we thought we'd include it. Our 2015 capacity project plan includes a number of critical infrastructure projects across our network, many of which benefit agricultural shippers. Many of BNSF's more recent capital expenditures have concentrated on the northern corridor where much grain traffic moves and the breakdown of 2015 capital projects shows continued investment in areas of our network that our grain customers rely on which of course, include this northern region. These capital investments and our physical plant will provide permanent capacity that will benefit every business sector. Our investments extend beyond just track. Our grain shippers benefit from the additional system-wide investments that BNSF made in 2014 and 2015 in locomotives and personnel. BNSF also made significant investments that directly benefits its grain shippers including over $1.5 billion in investments in our own fleet of grain cars.

Our rail service is improving as a result of these investments. We have seen strong velocity in our agricultural business reflected in a return to historical trip per month shuttle figures and key lanes and minimal past dues across our network. Those investments and resulting velocity gains have brought reliability back into the grain system. I will also note we are currently storing over 7000 BNSF grain hopper cars as a result of slackening demand at the moment which can simply highlight how cyclical ag really is. Over time our innovative programs and investments have enabled producers in many states to access destination markets whether they be overseas markets, Mexico or domestic markets like California.

As a result of BNSF's innovations efficient transportation and reasonable rates, grain shippers made significant investment of their own and built their grain facilities on BNSF. BNSF's grain shuttle train program is a prime example of the improved efficiency in the supply chain that has resulted from innovation and investment. BNSF's written testimony and our prior submissions describe in detail our shuttle program, which grew out of a recognition by BNSF and our shippers that competing with other grain exporting countries required increased efficiencies across all elements of the supply chain. The number of grain shuttle facilities built on us has increased dramatically over this time frame. It went from 69 shuttle origins in

2000, a few years after the grain shuttle program was initiated to a total of 229 BNSF served shuttle origins by the end of 2014. More importantly that represents an estimated $2.2 billion in investment by our customers since the shuttle program started.

The number of unit and gathered train ethanol facilities built on us has also increased significantly over the same timeframe representing an estimated $2.1 billion additional in customer investment. The number of uni-train fertilizer facilities built on us over the same timeframe has increased significantly with another $750 million in customer investment. These investments by our customers on BNSF's network reflect the partnership that exists between BNSF and its grain shippers.

Let's turn now to the nature of the grain markets and this is important. Contrary to some of the claims made today, the constant drumbeat of market economics has resulted in reasonable and competitive rates across our network for BNSF agricultural shippers. The market reality is that we have to keep our rates competitive to keep the business. The key feature of grain transportation is that grain must move by truck to a grain elevator at the very beginning. Since it moves at the first instance, a grain producer can often direct the truck to deliver the grain to multiple elevators as a first step in the supply chain or even to other local end users. An important characteristic of grain markets is the existence of strong and widespread geographic competition. There are several types of geographic competition that affects rail rates. For example, in this slide, a grain shipper in Aberdeen, South Dakota has the option to ship to multiple markets on BNSF. Each of those destination markets you see there are also buying from multiple origins including origins not served by BNSF providing a multitude of competitive options.

With respect to export markets, BNSF must consider rail rates for transportation of grain to a particular export facility based on alternatives available to shippers at other export facilities including foreign competition. For example, corn from the upper plains moving to the P&W competes with corn from the corn belt transported to New Orleans via barge into foreign markets. A key reason that we do not have rate cases is the fact that our rates are reasonable. As you can see in this slide, the constant pressure of competition in grain markets has resulted in reasonable and competitive rates across our railroad for agricultural shippers. There have been few rate cases precisely because these market mechanisms have worked so well.

BNSF sets rates based on market conditions, not on regulated costs but I know this agency often focuses on revenue to URCS variable costs when it analyzes rates so as shown in the study submitted by our outside experts, our grain rates are low on a revenue to variable costs basis. BNSF believes that these shuttle RVCs are overstated in fact for the shuttle side because they do not reflect the meaningful loading and unloading and incentive payments that are paid to qualifying shuttle trade movements and that actually reduce the actual rates paid to transport that grain. These payments are actually left out when consultants and other third parties generate their studies of ag rates.

We regularly communicate with our customers and our customer groups to better understand the issues they face and we have developed good working relations with them. Some of these groups are set out in this slide. Our rates are reasonable but as I said when I started out we do understand that in some regions and particularly some shippers and customers in those regions do not agree and view the regulatory process as unworkable. We understand that concern and that's why we have proposed alternatives. As mentioned, BNSF established an arbitration mechanism with Montana grain producers. It is a two-tier structure of mediation followed by arbitration using predefined market based standards that take into account the complexities and competitiveness of agricultural markets.

As mentioned, we have recently offered ideas to the NGFA executive committee and our support for expanding their existing arbitration process to cover rail rates without undermining the current rate case criteria. We remain interested in discussing ideas that will provide expert based market focused resolutions that also maintain a strong incentive to continue to reinvest by all in the industry. We are proud of the level of investment we have made in our agricultural network to meet current and future agricultural demand and the significant investments our grain customers have in turn made to bring more and more of their business to BNSF.

This is clear evidence that the market is working well. While improvements in the process for resolving disputes can always be made the large industry investment and the supply chain's success story experience by US grain participants suggests strongly the overall premise is that the competitive marketplace is working efficiently. Methodologies for resolving grain rate disputes including those offered by the STB must take into account the practical realities of agricultural markets including their complexity and their competitiveness.

We believe that the alternatives proposed by others here, even if well intentioned, will create a range of unintended consequences. Some of these suggested rate setting alternatives will enhance the influence of larger market participants through either cost based or distance based rate making and will encourage volume based contractual agreements. A result would be to limit producer market and geographic access. A net decrease in competitive market based solutions. A longer term result would be fewer dollars to support rail network investment and a less responsive and resilient rail system with less ability to provide capacity. Making thoughtful changes to the process by exploring market based arbitration solutions that embrace industry expertise in a complex market environment makes sense. Making arbitrary and outcome oriented changes to the STB's existing standards by which agricultural rates are reviewed does not.

Finally, let me just address a couple of points from earlier today and then I'm done. Let's go back to earlier in the testimony. Rate increases that were mentioned earlier in the state of Montana. I have a couple of points. After not raising rates on the pulses and wheat rates across the whole system and certainly in Montana for the last couple of years, since back since 2013, we engaged the industry to understand what the market competitive rates would be this year and after announcing our wheat rate increases earlier this year, we actually pulled back part of that rate increase after discussion with the Montana grain growers and that was not mentioned. We also had a rather good and robust discussion with all of our pulse shippers and the feedback from the pulse shippers about our increase in pulse rates this year are market responsive and we have had no complaints about the price increases. In fact, the most often response we get back is keep investing in the railroad. We love the massive reinvestment plan that you have out there. Make sure that you have capacity to move what we want to move and the rates are certainly rates that the market can absorb.

As far as the standing in Montana, farmer does go through the association if they would like to file a rate complaint for wheat and barley and they can ask them to represent the farmer to BNSF and the arbitration proceedings so they do have standing. The percentage of wheat and barley that moves on us out of Montana is 90 percent of what we move, so of all the agricultural products you can certainly make the case that the farmer that moves stuff on BNSF in Montana is well represented in terms of what we move. It's a vast, vast majority of what we move.

One other comment about contracts out of Montana, there was illusion to contracts of wheat being moved to Montana and the difficulty of understanding what they are. We don't have contracts that move wheat out of Montana. They all move on tariff. They're all public and I just wanted to make sure that's clear. So, thank you for the opportunity to speak to you today. We do appreciate it. My colleague, Jim Mulligan, and I are here to answer any questions as follow-up and when the panel's done.

CHAIR MILLER: Thank you very much. Ms. Rinn?

MS. RINN: Good afternoon, Chairman Miller, Vice Chairman Begeman. I'm Lou Ann Rinn and I represent Union Pacific Railroad. Mr. Jason Hess, our vice president and general manager of agricultural products is also here this afternoon to observe this Hearing.

In my remarks today, I will explain how competition to transport grain ensures reasonable rates, how the result oriented rate tests proposed by the grain shippers have no economic validity and how such special rate rules for grain shipments would raise serious public policy concerns. Competition to move grain as resulting market driven rates explain why no grain rate cases have been brought despite numerous changes by the Board to make it easier to pursue complaints. All the parties agree that competition to sell and buy grain between nations and within the US is intense. Such competition extends to the transportation of grain. If Union Pacific's rates are not competitive to the national and global markets, someone else will move the grain and we will lose the revenue. All grain moves by truck to either a barge terminal, nearby processor or an elevator.

This map of Iowa, which has the most acres of production of any state illustrates these choices. Producers can send grain to dozens of processors, those are the blue squares, to receive corn or soy beans by truck. They can send grain to hundreds of elevators located on different nearby railroads. There are five railroads that crisscross Iowa east to west and in addition KCS and NS have haulage rights that allow them to transport Iowa grain.

Don't forget the brown triangles near the rivers representing the barge terminals. Iowa with access to multiple carriers and modes is far from unique among the major grain producing states that we serve. Illinois, Minnesota, Missouri and Wisconsin are crisscrossed with railroads with at least four and as many as six Class 1 railroads, not to mention the short lines placing most farmers within trucking distance of two or more railroads.

Likewise, they have many processors and they have barge access. Even states with fewer railroads and perhaps not as much water benefit from geographic competition and what do I mean by geographic competition? Railroads serving different origins but similar destinations compete to move grain. For example, BNSF, CN, KCS and UP all compete in the Midwestern grain states to take grain to the gulf ports. Or you have carriers that are serving a common origin competing to move grain to different destinations. We compete with trucks to move corn only we want to move them to feed processors or export markets and the trucks are going to move them to the ethanol producers.

So we have a lot of competition and that competition is basically what informs and drives the rates we charge for our customers. Because grain is fungible and because it competes in both national and international markets, our rail rates would be found reasonable if they were tested under a method that has a valid economic principal behind it and the record is going to support this.

First of all, the grain shippers admit that the R/VC ratios for grain are generally below 180. URCS admits that 61 percent of the top four grain and 69 percent of the top four grain products all have revenue to variable cost ratios below the jurisdictional threshold. Now contrary to ARC's claims, the prevalence of so many movements below the jurisdictional threshold basis is not based on a problem with URCS not recognizing the efficiencies trainload moves. URCS does recognize the efficiencies associated with grain trends.

This slide shows a hypothetical movement. The difference between the URCS variable cost per car on a trainload movement and the same car in cargo service is more than $1000 or 37 percent less than it would be in a car moving by itself but in a train. That's not just the train, it's a manifest train. So if you recalculated URCS to assign even greater efficiencies to trainload grain movements more cost would have to then be assigned to single carload shippers, ironically including grain customers, who do ship by single carloads which would increase their cost and force more of those movements below the jurisdictional threshold basis. There's no basis for making a grain cost adjustment factor and there's also no reason to think that somehow the prevalence of movements below the jurisdictional threshold for grain and grain products is a technicality on URCS and is not reflective of market reality.

For grain traffic that is above 180, the record offers other evidence that rail rates are reasonable. The shippers justify their proposal on claims that railroads are charging higher rates and capturing an unfair share of the economic rates. They assume the unreasonableness of these rates as a given but the facts say otherwise. USDA and AAR data show that Class 1 railroad revenue from grain as a percentage of farm income actually has been trending downward for the last decade and while there was an increase last year because we all know 2014 was a memorable year as much as we might like to forget it, there was an increase to only 5.2 percent. In other words, we get a nickel for every dollar of farm net income in 2014 and that figure is still below the average for the last 10 years. So rail rates may have increased but income to producers has grown faster.

Pervasive competition and market driven rates are a better explanation for the lack of rate cases by producers than problems with the STB rate complaint process. I will also add one point here that we, of course, do market different rates but we also look at if we think there's a danger zone, we look to comply with the Board standards are so we actively are trying to not get into rate cases. So we're going to claim credit for that and not blame the board.

The NGFA and ARC proposals are result oriented and they are not based on economic principals. Neither the NGFA nor the ARC proposal simplifies the 3B test. Both seek to change critical features of the 3B test with a clear goal. Rates for grain should be reduced to the jurisdictional threshold. Our reply comments and those of other railroad parties address in detail about how those proposals are merely mechanisms to drive rates down. Critically, both NGFA and ARC would expand comparable traffic to include movements with R/VC ratios below 180 and movements on nondependent railroads.

In reality, this would merely collect a large set of mostly irrelevant data points. It would not constitute a meaningful market or economic analysis. To take an example from outside the railroad world, if you were considering buying a first class ticket from New York to LA on United, you would not compare United's R/VC for that ticket with what the R/VC would be for Southwest to take you from Baltimore through Denver to LA. You don't compare R/VCs when you're buying something. You look at what the rate is. You don't compare it. The R/VC, particularly the R/VC by other firms, does not tell you anything about the transportation market for different transportation products and it doesn't tell you anything about the cost structure or what the returns are of one carrier versus another carrier. That is why this is not an economic or a market analysis.

The special way rules for grain shippers also that ignore economic principals would raise serious public policy issues. Grain shippers can't justify why they are entitled to special rules especially once they extend the scope beyond commodities grown by small farmers to include agricultural products that are processed and made by large conglomerates. Grain product originations on Union Pacific are not widely dispersed. More than 80 percent of our shipments are accounted for by only 21 origins for ethanol, 8 origins for soy bean meal and 5 origins for corn syrup. That is not the model of widely dispersed small and they don't know how much they're going to produce that was given to you by one of the advocates for the grain proposal.

With regard to corn, wheat and soy beans, the majority of our traffic is shipped by large companies that could well afford to bring a 3B case and they concentrate on 60 origins which draw from producers in a larger area yet the NGFA and the ARC proposals would apply to all of those. They are not making any distinction as much as they may press forward with a certain subset they are not limiting their proposals to any such subset. They want everybody to be able to use these rules. The grain and grain products customers do not appear to be markedly different than other customers in terms of the majority of traffic still moves over certain lengths.

I believe that Chairman Miller, you asked about chemical shippers. Yes, in more than one proceeding we have had the ACC and chemical shippers say that they are the very same as grain in the sense that they move to a lot of different destinations. They don't know where it's going and they're moving in carload, not as many trainload but they identify with many of the complaints you've heard from the grain customers today. But even if there were a subset of small grain customers who really were different than all the other shippers in a way that justified special rules, the rules would still have to be economically valid.

Rate reasonableness determinations require the Board to allocate economic rents between the shippers and the rail carriers. If one group of customers gets more, than economic principals justify that extra share must either come from other shippers, which would be an impermissible cross subsidy or it must come from the defendant railroad. By imposing an R/VC rate cap based on traffic moved by non-defendant railroads without regard to difference in supply/demand situations, route characteristics, cost structure, those proposals would punish more efficient carriers and discourage efficiency by all other railroads because you get hurt if your R/VCs get higher and one way to increase an R/VC is to become more efficient.

Worse, by completely detaching the conclusion about whether or not a rate is reasonable from market information from your customers on the traffic that you're originating or terminating or interchanging you're losing critical market signals about the demand and we rely on that information in order to determine not only where we need to be investing for growth but also where do we need to have crews. Do we have enough power? Are we prepared to handle the traffic? Without that kind of information, you end up not providing the reliable type of service that our customers want to have.

Thank you very much for the opportunity to appear today. I will be pleased to answer any questions and I would be particularly delighted if you would ask me a question about how the NGFA proposal will guarantee work for consultants but put my marketing people at risk.

VICE CHAIR BEGEMAN: Thank you, thank you very much. Mr. Miller, I don't want to put words in your mouth, but in case I didn't write it down quite precisely, I think what you said was that, with respect to whether or not there is a workable rate methodology for the Board that you're not necessarily sympathetic but you recognize there needs to be a process. You support a different process but not a different method. Is that what you said?

MR. MILLER: Yes.

VICE CHAIR BEGEMAN: I'm sorry. I can't find where I wrote it.

MR. MILLER: Yes. It's a good question for clarification. It's the process by which a resolution is resolved so that would be the moving to an arbitration process that again, you know, uses market based and sort of expert reviewed processes that we can agree on and we're just at the starting stages here to try to define that but those are sort of key characteristics. By methodology I'm referring to the change in methodology being proposed by NGFA in terms of just all the, essentially a soft rate cap, which I allude to in terms of the consequences which would be I think very wrong for both shippers and the railroad.

VICE CHAIR BEGEMAN: I commend you for your willingness to have the discussion with NGFA to try to establish a program with their members. What would your hesitation be to joining an arbitration program here?

MR. MILLER: It simply has to be, we have to be involved, I think since we're part of this, at the design phase, so the key is what is the design of the criteria used to decide the arbitration ---

VICE CHAIR BEGEMAN: You just want to know what you're signing up for?

MR. MILLER: Exactly. Right, so when it talks about Montana, use that as an example. Montana was carefully negotiated on both sides. I think we took into consideration what the association and farmers needed and they took into consideration frankly the market based nature of the markets and what was really quite frankly prevalent and obvious in determining rates and we came to resolution so if that could be that process of making sure what is it that we're getting into and making sure that we've got things that safeguard which we, which I alluded to or outlined in the presentation.

VICE CHAIR BEGEMAN: Did you say that 90 percent of all the ag products that BN moves is eligible --

MR. MILLER: Out of Montana, yes.

VICE CHAIR BEGEMAN: Out of Montana, is eligible for that --

MR. MILLER: Yes.

VICE CHAIR BEGEMAN: -- that arbitration program?

MR. MILLER: It's wheat and barley so it's eligible for arbitration so.

VICE CHAIR BEGEMAN: So 90 percent --

MR. MILLER: Of our ag products.

VICE CHAIR BEGEMAN: -- of your ag products --

MR. MILLER: Right. The rest are going to be pulses and small, small grains, so but wheat and barley, we move so much wheat and barley the percentage of what we haul that essentially means, referring to your earlier question earlier in the day that it is widely available to many farmers in the state of Montana.

VICE CHAIR BEGEMAN: It's more widely available than I would have envisioned. That's amazing.

MR. MILLER: Yes, and to make a follow-up comment on that, we've had, the most recent case, which was the Shelby case referred to the December of 2009 and part of the arbitration proceeding we agreed to is there's a mediation at the very beginning. That was solved in mediation and that was resulted in $165 rate per car drop at the time and didn't go to the arbitration phase because the mediation worked but what happens now quite frequently is we have rather robust conversation and frequent conversation with the groups in Montana, with customers in Montana about what works and what doesn't work so if, as a strong advocate as a former shipper and also would be NSF today, that if a procedure is known and defined and clear ahead of time and both sides believe that there is some consistency and predictability to what it will get at, it causes all sorts of great discussions. Some others mentioned that, too, but before you ever there, that's one of the reasons why you don't see any arbitration cases in Montana.

We're constantly talking and evidenced in most recent, which is May 1 rate increase we rolled back. We've got, essentially, feedback from the growers that it was not market responsive, we needed to be lower on the increases and we did and we came to a good accommodation for both. So no arbitration needed. No mediation needed. That's a discussion that ought to be had and certainly that's preferable by all of us for our customers, right, to have that constant discussion so that it doesn't, we're eliminating costs and time when we have those kind of discussions and it does work that way.

VICE CHAIR BEGEMAN: Could you comment on something that the representative from the Montana Ag Department mentioned? He stated that they were trying to put together, or they had proposed putting together, their own shuttle -- no, I'm not getting the right words for it but their own more efficient trains, but that BN rejected that.

MR. MILLER: Oh, he referred to a reverse deed. Yes, that is do you have any that origin in a way to then move then as a unit at a later time is what I believe he's referring to. I haven't talked to him specifically to see if that was what he was referring to but we've looked at that. We'll have discussions about it. It's certainly a cost inherent, shippers, what they'd like to of course have is try to do that in a way and Montana is a big state and you've got broad geography that you'd like to try to gather those facilities over but there are costs inherent to us that are part of that so you just simply cannot be the same cost base, simply the same kind of rate that you see for a pure 100 car, 110 car shuttle loader on the system.

VICE CHAIR BEGEMAN: Because you have

to pick up freight along the way?

MR. MILLER: Pick up, yes, they're assembled, moved.

VICE CHAIR BEGEMAN: It's not that it's all in one spot?

MR. MILLER: No.

VICE CHAIR BEGEMAN: They haven't moved it to one spot. You have to gather it.

MR. MILLER: Right. They're miles apart from each other; that's why they call it gathered. You'd have to bring them together and move them together so there's costs in doing that as opposed to 110 car shuttle where that loads and once it starts moving, it moves straight without stopping all the way.

CHAIR MILLER: So could you say, now I'm curious, in that proposal what were they doing then? Just like sort of lining up the number of cars and getting a commitment? I mean what was their role in sort of assembling ---

MR. MILLER: Well I think the proposal is that they would like to do that and have access to a rate that's better than the less than 100 car shuttle rate that's out there today, right, so try to create a different product. We're always amenable to those kinds of ideas but it's typically when they don't work it's because the rate that they would like to have is not the rate that we can provide for that kind of product.

VICE CHAIR BEGEMAN: Have you explored whether it would make sense to try to offer an arbitration program, a private program as you have with Montana, to other states?

MR. MILLER: We have but it's going to be difficult. Montana has got some unique characteristics. We are by and large the primary normal railroad. You've got two other railroads that do come into the southwest and the northeast but it's very small. Montana is sort of wheat and barley so it's very specific to one or two commodities, typically moves all in one direction. It's created a platform that makes it more amenable to making this kind of system work.

Other states, other railroads you need to make sure, in that case and you have to have other railroads that both buy in for competitive reasons we need to make sure we're all adhering to the same proceedings and I would reiterate that point. Even we have done that with NGFA as well as far as arbitration that we think can be better, less costly, more timely, we do think we can't do it unilaterally. It has to be done with all railroads in mind for strictly competitive reasons. To be held to a different standard than others than our competitor is not something that we believe is fair for us.

VICE CHAIR BEGEMAN: For both of you, do you think the Board has fulfilled its mandate to provide a workable rate review process for all shippers?

MR. MILLER: Again, since we have lots of discussions with folks, I think the feedback is that small shippers and I will agree with our counterparty on the table that large shippers, if they want to bring a rate case they certainly can, right? If they don't like the resources or the time to do this. It's really a case for the small shippers and that's why I spoke to the small shipper earlier. We think that there are some folks that clearly feel that way. There's no doubt about it. It's not do they feel that way or we think they might. They do. In fact, we think that we'd have to agree with them that there's a better process, a faster less costly process that we should be all striving to get forward. Not only for them, but for us. We think that's the right thing to do. We're in markets that change all the time so as for the alacrity in getting a response and clarity and consistency and predictability of what the outcome is, they're all equally important, and they need to be market based because as you know, we are in a rabid market based environment at the railroad and those things have to be taken into consideration and I'll agree they're complex but they're not unsolvable. They can be solved. It just takes sitting down and walking through the specific lane that is out there that is to be looked at.

It's important for that small shipper we think to know that they have the option. I really don't think it creates a complicated cases, I don't, but I do think it creates more discussion and it creates a chance for the small shipper to be heard or at least feel like that he can be heard and today they're not, there are some that feel like they can't.

MS. RINN: I think we're always looking for ways of improving the process. I think that the feasibility of 3B can't be condemned now based on current experience in grain cases because I will point that the last two 3B cases, one of which was litigated against Union Pacific, both involved chlorine, a TIH, so clearly you've got issues about who pays for PTC. You've got what is the risk and at least in the case that we had, which was litigated to a victory by the way by Mr. Wilcox on behalf of his client, also involved a lot but a very serious difference of opinion where UP said you've got to use other chlorine movements to determine comparable traffic and USM disagreed and they came up with a group that was mostly ammonia.

We did not make that issue up to create costs for USM and I want to make a personal record that I thought that that comment was uncalled for and that Union Pacific has a definite record of stipulating to market dominance. We have stipulated that we wouldn't win a SAC case and all we have to do is figure out what 180 percent is. We do not try cases in order to drive up costs for our opponents and I think the record needs to be clear on that. So if you take away the very unique and very serious issues in the first time either of those parties or lawyers had tried a 3B case, I don't think you can take the USM as an example or as a benchmark as to what it would cost for grain.

We move a lot of grain. We don't move much chlorine. We move more ammonia but we don't move that much more ammonia so there should not be anywhere near the issues of finding comparable traffic and because grain is fungible I just, I cannot rule out that there are no other issues but the likelihood of there being the type of contentious issues that complicated the record in the USM and the other last 3B case I think are not there, so we haven't seen whether 3B can work in a grain case and we are certain and I will make one point. There was a lot of discovery in the USM case, but it was discovery compounded by the shipper against UP. Our discovery requests were very modest because we were too busy producing all the documents we were requested to produce. Do I have any ideas right now on what we can do to improve 3B? No, but if we come up with any by the 24th we will share them with you.

VICE CHAIR BEGEMAN: We'll extend the comment period if it's necessary. Please, I know you wanted to be asked a question about how the proposal that we just discussed with the previous panel, how that would promote the consultants. Maybe you were being facetious.

MS. RINN: I was, but I'm also very serious. When Mr. Crowley was making the point that the NGFA formula is very simple to apply, all you have to do is go through the wave of data, plug it in the computer ---

VICE CHAIR BEGEMAN: That even we could do it, I think, is what he said.

MS. RINN: Exactly. However, nobody in Omaha could do it because we do not have access to the waybill data. We can only see our own waybill movements. We do not have access to waybill data on specific movements for any other railroad. Therefore, the only people who can evaluate whether or not a rate is likely to be above or close or below what the NGFA formula would tell you would be the maximum reasonable rate are going to be consultants and outside counsel and members at the STB.

Worse yet, if that system were in place today and Mr. Hess were to come to me and say these are the rates that we have in mind. Can you tell me whether or not if a rate case was brought against us we would be able to win? I would be giving him advice for forward looking. What is the 2015 harvest season where we spend a lot of time talking to our customers trying to figure out where, how much and when it's growing based on waybill data from I think 2012 is still the most recent year available for other railroads whose rates and certainly ratios we can't see.

If you want to have what I would consider the Board's objective should be for a good workable rate test standard, yes, it should be predictable. It should allow parties an opportunity for a remedy but it also has to be workable in the sense that those who are subject to the standard have the ability, particularly when you're talking about it applying to a whole large block of business, they have to be able to comply with it and that system makes it impossible. It makes it impossible so the only way I could guarantee that we would be able to comply is if we drive our rates all down to 180, which is not what I understand to be the purpose of or a proper objective of a definition of a successful rate test.

CHAIR MILLER: I'm curious for both of you. You use slightly different language but you sort of talked about market based rate setting I think is how you said that so when you're saying that basically what your railroads do is, you know, you create a market based rate. Can you say a little bit more about what that means? I mean what is it then that you know based on the market that goes into your determination of your rate?

MR. MILLER: It's constant and persistent market economics that we see every day. So today, as I saw one of the slides that you saw up there. You saw the fact that the P&W exporter competes with a New Orleans exporter every day on sales to Asia, Korea, Taiwan, Japan, three of the biggest buyers in the China shipping for soy beans. It's constant. It's an ocean freight spread. It is the spread between our rail rates going west and the barge rates going south and of course if you're anywhere close to that it's trucks going one way or the other. Certainly, it's processor demand that's pulling grain away from our rail and it's also our competitor and that's a very strong competitive environment. We're all fighting for market share.

CHAIR MILLER: So you're looking at truck rates, you're looking to see what's happening with other railroads, you're looking at commodity prices?

MR. MILLER: Sure. We get elevators that will come to us and say, I'm losing volume here. This isn't working. It's being trucked to the ethanol company, the ethanol plant down the road is outbidding us. We get that feedback all the time, so when we look at a rate increase as they may happen we consider all these sort of market complexities and there's lots of it. I mean it's just constant, so we get that feedback really every day and it is something that we have to take into account and informed and frankly our customers are very well informed on it. The shippers know what works and what doesn't work because it's just pure economics.

CHAIR MILLER: Mm-hmm.

MR. MILLER: The beauty of it is that you've got multiple markets and this is what geographic competition is all about. It isn't that you're on BNSF and ship only on BNSF and then there's no other choice. You have to compete. If BNSF corn shipper in South Dakota or a soy bean shipper in North Dakota is competing with soy bean shipper/farmer in the Delta going through New Orleans to China, they're competing with each other and that forces us to compete as well. We're volume driven. We're back to this virtuous cycle of investment. We have to have growth, which begets revenue which begets reinvestment which builds capacity and growth which revs it up all year long and year after year, so that's what we mean by market based and it's hard to explain frankly in a few sound bites and I don't mean to do that, but that's what we have to do frankly. That's what keeps it rather competitive and oh, by the way, we look at how it plays out with R/VCs it turns out that really that this works right because R/VCs are more than reasonable and, in fact, if you look at the R/VCs as you saw on the chart for the manifest shippers they're extremely reasonable. So and that's the result of this market based competition.

MS. RINN: Mr. Hess and his team are doing the same thing. What we're looking at what are the production, what are the weather reports here in Canada, in South America, in the rest of the world? Are people shifting to this? Are they shifting to that? Is there a new product coming up here? What is it costing to send it overseas? What are the barges costing? If you're talking about the pulse products in the areas we serve, ours are mostly in domestic markets. Are we competitive with truck that would either be moving it to say the Snake River and Columbia River or is it going to be competitive with trucks that are going to be moving it to processors? We are always getting information. We make our best guesses. Our customers tell us when they think that we've got it wrong and they press us for adjustments. Sometimes we agree with them and we make adjustments, sometimes we don't but we are always in a two-way dialogue with the customers on the origin end and the customers on the destination end, not to mention all the brokers who are out there who are using the same information to figure out what the markets are. It is not as simple as basically sitting in and putting a program in, in Omaha and it comes out with the rates.

CHAIR MILLER: So how often, generally I guess, we're talking tariff rates, I suppose that same kind of thinking goes into your contract negotiations but if you're setting tariff rates, is that something that gets done annually? Does it happen when you think there have been significant changes in the market conditions?

MR. MILLER: Well, and I should know we have the right to raise them on 20 days' notice or drop them immediately but we don't, the industry likes some certainty from us. We have to take that into account so we do have sort of, we do our best to certainly give them plenty of notice so typically speaking 60-90 day notice if we're going to take a rate increase. Partly that is to put it out there and then have discussions with the customers about this, does this make sense, but it's also mostly to give them some notice about what's coming, so before they make sales or purchases based upon a certain rate, they have an idea.

In some cases, we're actually talking six months ahead of time. We're notifying them of rate changes, particularly ahead of a harvest, which has got lots of volume. So typically speaking for us you'll see your rate changes once or twice a year. Now that can change, it certainly can be more frequent or less depending upon the market conditions, but typically that's what the customer sees from us and that's again varies by commodity but it's typically one to two times a year.

MS. RINN: It would be very much the same. We have, and this is based on the feedback we've gotten from our customers. I guess they're looking for something that's relatively stable in what is obviously a very dynamic marketplace for them, but we aim to give them here is the price for this season. They know when we're going to give that price but before that price is established there is discussion going on saying this is what we're looking at. What do you think? We get that feedback before it's established and it is published before the rate becomes effective. We are not rigid about that. If something happens and there has to be an adjustment again we talk to our customers and we do that. That may or may not be in the form of a tariff.

CHAIR MILLER: Your tariff rates on a

website, searchable, even I could figure out what they are?

MR. MILLER: Our tariff rates are available to all of our shippers that ship on us and if you ask us for those rates we can walk you through and explain those to you. For BNSF, virtually all of our movements are tariff based. I know that there was an illusion earlier about the railroads are different and we are virtually all tariff based. We've got very few contracts on the grain side. They're very narrow and very specific but we are virtually all tariff based.

MS. RINN: I believe they are. I have not recently done it myself but I have in the past been able to find what I was looking for on our website and I am not technically adept.

CHAIR MILLER: So, here's the other thing that I'm wondering and I thought Mr. Miller, your charts were very interesting showing, you know, the huge growth in shuttle facilities and investment made both by your customers as well as by the company and certainly and broadly, just even for the US economy, that kind of an investment has a wonderful effect. What we heard earlier today though from the folks who were here from Montana was the feeling that we're doing what the railroads have asked us to do, we're making investment but we don't feel like that efficiency that should be created from that investment then is showing up in our rate and I'm, you know, wondering what you say about that and let me add one more thing. As near as I understand it, and maybe there's a lag in the numbers, but you can see the grain rates have tended to trend higher than other commodity type rates and so I'm wondering where it seems like there is a lot of investment on from ag shippers in this world, is that efficiency then not getting played out in the rate?

MR. MILLER: I think that's a really different argument to make it that way. We are market based. I'll bring it back to that. We're marked based by commodity and how we price the rates so when someone says to me that our rate increases are different percentage than say lumber, I say we don't know what lumber is priced. I don't, what I do know is what the market is for corn and what it takes to be competitive on corn. For example, last year we took zero based increase in wheat, corn or soy beans across the US. That's a zero percent. You know, that's based upon what we felt at the time was valid and the right thing to do and this year we're taking different increases.

It's market based. It's as simple as that. So comparing to other commodities for us is something we just don't do and I don't know how to respond to it other than to simply say that. We also talk a lot about it being a right to grow so we are again, this virtuous cycle of investment, we are massively reinvesting in the railroad. That is putting tremendous amounts of money and cost back into the system. That's also the right thing to do. That's exactly what our customers want us to do. That's how we all grow. So I think the combination of being market based and making sure we earn the right to grow at BNSF results in rates that the market sees.

Again, I hate to harp on it but as we get feedback that the rates aren't valid with the marketplace or they're not competitive and if we agree we'll assess them over multiple inputs we get from the marketplace, as we did on May 1, and we'll pull them back. We pulled back part of the wheat increases, so again that's an argument that pulls me in a direction that frankly isn't the reality about how we set grain rates. It's set to the market for each commodity.

MS. MULLIGAN: I would just add to that just on some evidence that's in the record, like John said he doesn't pay attention to it but we did take the waybill sample that was available in this proceeding and we looked at the relative increases across different commodity groups for BNSF. If you look in our opening evidence under the FTI, fair fight statement, there's a chart there that shows where the various grain commodities fit in terms of percent increase versus other commodities and they're pretty close to the median in one case and then both the other two major grain commodities are significantly below that.

CHAIR MILLER: Okay. Thank you. Ms. Rinn, you used the term that, you know, if the rates are getting in the danger zone you do something about it but can you say a bit more about what you meant by that?

MS. RINN: Well, what I meant is that our marketing department, the folks in the regulating areas, if they're taking an increase and they're concerned about whether or not that, in fact, could get them into rate litigation they consult with us in the law department and we take a look at it based on what we know, what about the Board standards are, about whether or not it is and we discuss with them, you know, whether it and what our options are. I really can't go much beyond that without getting in attorney client privilege and even if BNSF is at the far end of the table --

CHAIR MILLER: They're in the room.

MS. RINN: They are competitors.

CHAIR MILLER: Thank you. And then a question that I have for both of you is one of the things we were looking at is, you know, we have this auction format for grain shuttles and grain cars, but that's a cost that then doesn't show up in the R/VC ratio and is that a flaw in R/VC? Should it be there?

MS. MULLIGAN: I can add maybe a point of clarity on that. In terms of the primary auction that BNSF participates in and that we do see revenues from in times frankly, mostly where we have capacity constrained environment like last year, so last year was a bit of anomaly for us, but as I understand it when we generate the revenues as part of our waybill sample that we pass on to the Board, we do include premiums from the auction for that period. It's not allocated down to individual shipments, but it is allocated to show traffic that participates in the auction, so it is actually in our waybill sample.

MR. MILLER: And I would just follow up by saying that last year was a rather unusual year. Historically speaking, those premiums are very close to zero or just slightly above zero in most years and which we're back to today, in fact.

MS. RINN: In our case, likewise, most of the time it's zero on the auction in terms of the revenue we get. Last year was unusual in that we did get revenue because those were viewed as very valuable. My understanding though is I don't believe that the revenue we are paid for the shuttle is, in fact, reported in the waybill data that we report to the sample because it really is an option on a train and then that customer basically decides where that train is going to be loaded and we don't know that at the time they give us the money. We also have incentives that are associated with the shuttle so we pay to the parties who load and unload the shuttle to make sure that they load it quickly and they unload it quickly so that we can keep the locomotive with the shuttle so that train is always ready to go.

So that's a cost and we don't get that is not treated as an adjustment and that's not in the waybill sample, plus if the, we have a mutual commitment on the shuttle that the customer is basically going to get that train and as soon as it's basically dropped off one load they're supposed to send it someplace else for another load. If they live up to their volume commitment we give them an incentive and we likewise don't reflect that as a net adjustment because we don't know when that, again, is happening at the time we have to report the waybill movement. So they are commercially related but from an accounting point of view, trying to match them up on time for a reporting basis does not work out.

CHAIR MILLER: Thank you. And then I'm just curious, one of the things that you said was that the R/VC ratio doesn't really tell you about the transportation market.

MS. RINN: Mm-hmm.

CHAIR MILLER: And that seemed to be, that made me think back to what I heard this morning from TRB in their report when they were talking about this alternative model where you would use market based rates or rates that had been determined in the market I guess is the way I would say to determine what your threshold was for when you could bring a rate case and I was just sort of curious when, maybe I didn't hear what you said correctly or maybe I'm still not quite understanding the proposal but I'm just wondering if that resonated with you, if that felt like that was more of a market based way to judge rates, what you were hearing the professor say this morning.

MS. RINN: I am also very curious to see that report and how they did that market analysis.

CHAIR MILLER: Yes, we don't know too much about it yet. I'm not trying to, you know, trick you into endorsing the TRB report.

MS. RINN: But I will make one

observation. In my experience when I see marketing people assessing the market and trying to figure out what's the sweet spot for the rate, I don't see them comparing R/VC ratios for different customers. What I see them doing is try to come up with something, whether' it's mills per ton mile or it's dollars, they're using something about that goes to what is the price the customer pays in the relevant market to try to figure out whether or not it's market based.

CHAIR MILLER: Any more questions.

VICE CHAIR BEGEMAN: Just maybe one or two. Mr. Miller, you mentioned that you currently have 7000 cars in storage, and again, not that we want to relive last year in any way, probably especially you, so I don't really want you to compare it to a year ago. But generally, at this point, this second week of June is it normal that you have 7000 in storage or is it, I mean you have what, 22?

MR. MILLER: 28,000 cars.

VICE CHAIR BEGEMAN: 28 total.

MR. MILLER: It's more normal than people realize. I think three out of the last six years we were near this number but it really changes. The crop size and crop demand. One is where I'm at right now is the US dollar is hurting US exports we're massive crops in Ukraine, Brazil, Russia are hurting the ability to compete because they're currencies have devalued and they've got massive crops and the farmers in the US as you've seen prices drop are holding on to it and combine that with our very strong velocity across the system and you're seeing you know, velocity actually kick assets back out so it's creating cars that are parked and we have locomotives now in storage on the system and it has changed quite fast in the last seven, eight, nine months. But we think that was led clearly by resources coming to bear on our railroad.

Velocity was our problem last year and velocity has brought us out of it. We have come back in spades on velocity and that's directly due to the investment in locomotives, people, track capacity across the system and we know that this is part of being in the ag markets. There's some reciprocality and volatility that's part of it but it's a cost that I think some folks don't really fully realize that there's some years when this happens and then ten months ago, I'm not sure anybody would have forecasted 7000 cars parked. We're offering freight today we're not getting a bid for and we're getting some customers that would like us to slow down, so we're moving too fast. It's a good problem to have. I'd much rather be in that environment.

Quite frankly, our message today in the marketplace is we're ready and willing and able to carry us, see the next big harvest come because we've got lots of capacity planned to take it and we're real hopeful that's going to be the case this fall.

MS. RINN: Likewise, we have them in storage. Last year, we had actually gotten down to the point where I think you could count on your fingers and toes the covered hoppers that weren't in service. Thank goodness we were able to lease those 1500 in January. We now have more than 1500 in storage. Partly it is in fact yes, velocity has been restored but it's also demand is down this year as compared to last year.

VICE CHAIR BEGEMAN: Well, I'll end it where I started earlier. This proceeding really isn't to debate in this forum whether or not grain rates are too high. It's really to make sure that we are meeting our obligation of having a meaningful, economically sound and fast but, a fair process. So for post-hearing comments, we are open to constructive ideas. And that applies to everyone in the room and everyone listening.

MS. RINN: Thank you.

MR. MILLER: Thank you.

MS. MILLER: Thank you, Ann. Thank you, panelists, and I think we'll take a 10 minute break before we start our next panel. When we come back it's Panel Number VI and that'll be NS, CSX, CP and CN.

(Whereupon, the above-entitled matter went off the record at 3:09 p.m. and resumed at 3:20 p.m.)

CHAIR MILLER: All right. Welcome back. I think we'll get started now with our sixth Panel and it's also a panel of railroad representatives. So we have Patrick Simonic from NS along with John Scheib and with CST we have Tim McNulty and Pat Hitchcock; with Canadian Pacific, James Clements is here and with the Canadian National Railway, Ted Kalick. So, welcome to you all. Thank you very much and we'll start with Norfolk Southern.

MR. SCHEIB: Good afternoon. My name is John Scheib and I serve as general counsel of commerce and represent Norfolk Southern Railway Company this afternoon. With me is Pat Simonic, who serves as group vice president for agriculture, fertilizer and consumer products. Mr. Simonic will open our presentation by discussing the extensive competition Norfolk Southern faces to transport grain which NS believes is a core reason why there have been no grain rate cases involving Norfolk Southern. As you've seen in the highly confidential record, NS's grain rates are such that only a small percentage of those shipments could meet the quantitative market dominance test before even considering the qualitative test. Then I'll return to address some of the issues raised in the Board's notice. All of those issues have been fully briefed and so obviously, we incorporate all our positions stated in those papers. Pat.

MR. SIMONIC: Good afternoon. As John mentioned, my name's Pat Simonic. I'm group vice president of agriculture, fertilizer and consumer products group with Norfolk Southern. Today I'll define our network and the diverse markets we serve, the competitive landscape in which we operate and some of the operating challenges this business can present and you will see that we are quite different from some of the other Class 1's. For the purpose of definition, my comments refer to the Commodity Group grain as defined by the AAR group, Standard Transportation Commodity Codes 0113 and 0114. Although NS hauls less grain than any other railroads, NS moved approximately 200,000 carloads of grain in 2014. Of those, 120,000 carloads were corn and approximately 40,000 carloads were each wheat and soy beans. That total expands to approximately 350,000 carloads when you include the AAR group grain mill products.

My testimony will briefly highlight some of a few of the ways that the different types of grain transportation on Norfolk Southern face very different market conditions and define any sweeping generalizations. First, our average length to haul for grain is approximately 565 miles. But specific movements very widely due to the variety of markets we serve. For example, we receive wheat from beyond Chicago and deliver to milling facilities at distances in excess of 1200 miles but we also handle unit trains of soy beans and corn traveling within one crude district which sometimes can be less than 40 miles. Due to the type of the market and the location of the markets within our network all offer very different competitive and operating challenges.

From a competitive modal perspective, we compete with truck, barge, imports, and other rail both directly and indirectly. The direct modal competition we face is easy to define. For example, where two competing modes serve a set of common points; however, today with customers national and international market distribution we must look much further into a supply chain and consider the impact of indirect competition, market competition as well. For example, take a hypothetical move, corn from an elevator in northern Illinois to a feed mill located 1200 miles away in a destination market where both the shipper and the receiver are both served by NS. There are a number of factors we consider when trying to ensure our customers are receiving the lowest delivered cost in the marketplace.

First, on the supply side we want to

attract as much grain to our network as possible. The farmer has a number of choices before the corn can even get to an NS served elevator. The corn can be delivered by truck to another elevator on another competing railroad or to a river terminal or to a local processing plant or it can simply be stored awaiting future sales depending on certain market conditions. On the destination side, we must take into account that we are competing with larger crops of corn being grown locally in our destination market that can be trucked to a customer. Barge and rail truck transfers that allow plants to source from other locations. Other commodities that can be substitute for corn and delivered locally by truck. And in some locations, South American imports. We must provide an all in delivered price that allows this particular feed mill to produce and price his product competitively in the markets in which he competes.

Finally, grain transportation all provides us some very significant operating and cost challenges across our network. Agriculture products are seasonal, cyclical and many of our agricultural customers are located in rural areas on our lighter density network. For example, unlike most non-agriculture production facilities we serve, grain and grain products do not always load at the same location or at the same time of day or at the same day of the week or even the same time of the year to a single common point.

Due to this, we are unable to schedule these movements and in turn plan resources in advance. So a lot of our grain and grain product shipments require on demand service which can cause a major strain on resources, track capacity, equipment and our crew base and all must be available for all the different lanes over which this customer might tender a particular shipment. Further, agriculture products move across many of our lower density lines and sometimes are the only business supporting the operation in certain branch lines, so in some cases these branch lines are subsidized by the balance of the network.

In conclusion, while this is just a cursory summary, grain transportation on NS is varied in its form and in its market. In short, Norfolk Southern's traffic does not support many of the generalizations made about grain transportation, grain rates in this docket and the Board should avoid relying on sweeping assumptions or conclusions about these markets. Those are my comments and I'll pass it back over to John for.

MR. SCHEIB: Thank you, Pat. As Pat noted, we price to the market. Nevertheless, we recognize the regulatory regime and our core principle in this proceeding is simple. It's the economics of providing the rail transportation service that matters when evaluating the reasonableness of a rail rate. The stand alone cost test is a gold standard precisely because it is firmly rooted in economics of providing the transportation service in a contestable market. In order for the Board to adopt a rate reasonableness test for grain only, that test must be rooted in the same sound economics but a grain only test would require more. It must be based on some unique characteristic of rail transportation that affects grain and only grain differently than the economics of rail transportation for any other commodity and to be clear, the relevant inquiry is not whether there's something unique about grain markets. The question is whether there is something unique about the economics of providing rail transportation services for grain shipments that should result in a different test for the reasonableness of rail rates for grain than for any other commodity.

Now, I'll turn briefly to a few of the issues in the Board's notice. First, the Board asked the parties to address whether the board should revisit the prohibition on movement specific adjustments in determining the quantitative market dominance threshold in rate cases for grain shipments. The real question the

Board is asking is whether the Board should allow movement specific adjustments in all rate cases. If grain shippers believe that the system average cost of URCS overstates the cost of their shipments, that means they also must believe that URCS understates the cost of other shipments, perhaps like coal and chlorine. Or there may be under or overstatements based on whether a commodity moves in a single car, a unit train or a multi-car service. It's simply the nature of averages like URCS uses. Some movements are actually above the average and some are below and that proposition's not controversial.

Even a shipper witness, Mr. Fauth, a witness for ARC in this proceeding acknowledges this fact when he says, "Since URCS reflects a railroad's system average cost movement specific cost adjustments can work both ways. Actual variable costs can be higher or lower than the system average." Accordingly, in order for the regulatory system to account for all railroad costs, the issue of whether to permit movement specific adjustments is simply an all or nothing proposition.

Second, we've presented substantial evidence that the specific proposals for new rate methodologies in this proceeding are all arbitrary at best and in some cases, completely unsupported. Arbitrary rate regimes have been struck down by the courts time and again over the years. These proposals in this docket like any economic underpinning, in fact, this morning when you heard about proposals, they didn't once explain the economics underpinning them and they're merely a rate cap. Finally they fail core principals, they're not economically sound and they do not account of any aspect of rail transportation that's unique to grain. Indeed the DC circuit has already expressed skepticism that grain requires a test different from any other commodity in Burlington Northern versus ICC, 985 F2nd 589. In short, the STB is not an ATM. The economics are the economics and sound economics cannot be sacrificed for the political desire of a single segment of shippers.

Third, the board invited comment on the issue of revenue adequacy in the context of this proceeding. Any consideration of revenue adequacy in this proceeding is premature given the fact that there's a separate revenue adequacy proceeding in an upcoming hearing. Therefore we're not going to spend a lot of time on it except to say that the evidence in revenue adequacy proceeding clearly shows first that the only statutory purpose behind revenue adequacy was to establish an annual benchmark to ensure that the agency was doing its job to help railroads become revenue adequate. Second the annual calculation substantially overstates whether a railroad is revenue adequate and third, a separate top down revenue adequacy restraint would function as a rate of return regulation which is the kind of regulation that is disfavored by economist and is being abandoned all the world and across the United States because of the substantial disincentives that it creates.

Finally, the board asks whether more information should be provided in agriculture contract summary in the interest of, quote, great transparency, close quote. Those reports are not filed for generally transparency. 49 USC 10709G clearly states that railroads file those summaries for only one reason, so that the shipper can bring a complaint and the board can open a proceeding within 30 days after the summary's filing based on four limited grounds. All the information necessary to achieve the only regulatory purpose is already included in those contract summaries.

Now, our point is different, no such complaint has ever been filed so in essence CSX petition about a year ago to have the board exempt from regulation, the requirement that railroads file summaries of agriculture contracts because it's not clear that these summaries are needed even for that limited regulatory purpose. Although they take substantial resources to compile, it appears shippers hardly, if ever access them at all much less review the summaries to evaluate or file a complaint under the statute. The shippers basically admitted as much in response to our petition. Although shippers may want to place more owners reporting requirements on railroads, there's no general right to transparency into the private contracts of other parties. Thank you.

MR. MCNULTY: Thank you and good afternoon. My name is Tim McNulty and I'm responsible for the agriculture and food markets for CSX transportation. We did bring a few slides with us.

MR. SIMONIC: The slides are ready and showing here on this monitor, so we just need to get them connect them to the screens.

MR. MCNULTY: Perfect. Thank you. Now, if I can figure out how to work the remote we'll be in good shape. Right here, perfect. Thank you. This first slide gives a sense of how important agriculture is to CSX's diverse portfolio. We're a $11 billion company and AG represents about 9 percent of our revenues and it's critically important to CSX over the long term. I think it may be a distance thing, why don't you just drop them for me. That would be great.

In this next slide represents again just to qualify a little bit, about 60 percent of CSX business is related to feed grain commodities and those are really what we'll be discussing over the course of the next several slides. Of those commodities really the preponderance of it is feeding animals in the southeast. About 60 percent of our business of the category we're talking about represents animal feeding. There's 25 percent that goes into processing markets which mostly soybeans or wheat that will move into a further process channel and then the balance is export grains. So 15 percent of our business is export grain. While export grain is an important commodity just the eastern dynamics don't necessarily allow for a large quantity of grain to be exported off the east coast and there's several options relative to river facilities and the lake facilities. That just makes it difficult to compete.

Just from a perspective of public versus private rates, CSX is structure only 18 percent moves under the public domain and there's really three reasons I think for that. First and foremost, we try to reach an agreement with our customers on an economics that they need to enhance their business. We understand that feeding costs are a large percentage of chicken production and rate stability is an important component of our customers in terms of how they treat their business. So we strive to reach agreement. The second benefit of that is in a quid pro quo situation, customers are generally committing some volume to us so it allows us to plan better for the harvest season. Grain can be volatile enough given crop conditions and car supplies so we have to very solid idea going into a harvest period of exactly how much grain we expect to handle from our customers.

So in addition to our contracts we have pre-harvest discussion with all of our customers relative to what they're expecting for the upcoming season and it helps balance and smooth our expectations as well as our customers' expectations. And thirdly just to kind of a little bit on that public domain, our tariff freights are readily available on the internet and what we find is they're used for a lot of different reasons, across a lot of different size companies. So even some of our larger customers will use our tariff publications to handle spot movements or to handle rejected cars, there's a multitude of reasons why someone might use our public information, so it's a very valuable tool to allow our customers to get rates quickly and to make decisions quickly relative to their business.

And our customers are large. This graph represents the annual revenues, 2014 annual revenues of a lot of public customers, and then we have a large contingency of privately owned customers too. But I think the point is that the customers that we're dealing with are very complex. Most of them have multi facilities that are either on the feed mill side or they have multiple feed mill or on the processing side and these companies have significant competition available to them and significant choices on how they're going to source their business and supply the needs of their animals.

So this one is going to be tough on you, Pat, all right, so be ready. I really want to tell the story of what Pat outlined. At the end of the day we want to feed chickens and we want to feed as many chickens as we possibly can feed. In order to do that, we really do understand that not only do you have to have incentives to build feed mills on CSX transportation but you also have to very vibrant origin elevator infrastructure and we take that balance very seriously to make sure that both of the ends of the equation make sense from an CSX perspective. In order to really have a healthy elevator system you have to have a healthy farmer that's what to sell to that elevator.

So under a perfect scenario that farmer will sell to that elevator and then that elevator will sell to that chicken, the chicken gets fed and everybody's happy.

CHAIR MILLER: That's some chicken.

MR. MCNULTY: Yes, it is. As we peel back though to one level of completely, really look at the farmer and he says, you know, that farmer has a choice, he can sell to a processing facility and in fact east of the Mississippi there's north of 55 processing facility that they have choice to sell to and most of those processing facilities, whether they're ethanol processing facilities or either they're being a corn processing facilities, they're mostly located in Michigan, Indiana, Ohio and Illinois which is the corn that we want to grab to feed those markets. So that farmer does have a choice to sell to those processing markets.

Secondly he has a choice to sell to river terminals. I mean, quite frankly the river system in our country is adequate, it needs investment but it's certainly adequate in locations that it attracts grain to move down to those situations and also the Great Lakes. There's a lot of eastern grain will move out over Toledo, Ohio. So though there are options for those farmers to sell to that, the rivers or the lakes. He has another option he can sell to another elevator. We feel that once that farmer loads into a truck it's not that hard to go to a different elevator and if goes to a different elevator than what we consider that primary elevator, it could be on CSX, it could be on the river, it could be on a competing railroad, it could be on any number of things so it's a choice.

And the real catch is, is that farmer can choose not to do anything and he can store it on his own farm facility and wait until tomorrow and make those same kind of choices. We hope that he does sell it to the elevator, but once he does again, that elevator has those same choices. That elevator can in turn sell to the processing facilities, much like the farmer, or he can sell into the river system. So all that action is taking place and we haven't even fed our poor chicken in North Carolina or South Carolina. So let's just talk about him for a little bit.

That chicken does have some choices as well. He can buy from that elevator which is what want to happen, or he can buy from another elevator. And that choice is out there for him, it could be closer for him, it could be further away, it's an option that he has. He can also buy from the river system. Several of the Tennessee, Alabama are designation river points are transfer points for grain and that grain can work into as far as east as North Carolina. The chicken also has a choice of the local crop. Now, granted there's probably not enough local crop to feed all the chickens in the southeast, but improved faming practice really have shown that over the past ten years that local crop has increased 30 percent so it is significant and it's significantly growing.

If the chicken doesn't like that local southeast grain, he also has the option to call on his closes port and feed on South American grain. And over the past three years South American grain has come in through Wilmington, through Norfolk, through New Orleans and even through Tampa in drought situations. So to think that we can control whether that happens, I think is a little bit difficult to do because economics will dictate whether that grain is imported through South America and it's been happening. All those complexities are at work and all we're trying to do is again, make sure that that chicken can thrive and grow.

But what really keeps us up at night is that chicken relocating to another area, whether that be a different feed mill in the southeast or a feed mill closer to the corn supply which cuts out rail altogether or even worse, is if moves internationally or moves to another source. All those we feel are capable of occurring.

CHAIR MILLER: Tim, excuse me, I'm wondering could you let that chicken know that we need more eggs and it should get busy laying and stop doing so much grain buying. It's like focusing on the wrong things right now.

MR. MCNULTY: We'll do our best. Just one other thing, if you look at this complexity and how this completion translates into the market I think here's a great graph that shows are receipts for CSX at 170 percent. I want to take one minute real quickly with the remaining about my time to address an earlier conversation from the Panel about some spread changes that CSX has made. And I want to be very clear about what that is just for the purposes of this. And origin spread change as we see it, it's a car grain pricing A plus, B pricing. The A portion of it is the origin grain spread and that's the rate from the origin elevator to Columbus, Ohio, that's the A portion. The B portion is the rate from Columbus to the designation.

The A portion of the rate which is being discussed in terms of the origin spreads represents less than 25 percent of the through rates and that A portion has not been touched by CSX in 15 years. So there have been changes to shoreline economics, there's been changes to productivity within CSX costing, there's been changes within the shoreline industry as I said and just things that have really evolved that we needed to address that. I think before you can make any assumptions on that we have to look through toll through transportation and the rates that have changed on that. So just keep in mind as we talk about origin spreads that is a significant factor.

Number two, not to confuse origin spreads with capital investment and incentives of our origin elevator or destination feed mills to grow. Because we have encouraged investment in feed mills and those investments are separate from the origin spreads. We offer anywhere from 15 to 18 percent rate discounts for facility developments through rate encouragement and we also have express load incentives that offer additional rate incentives to be efficient and load quickly and that can amount to a 2 to 4 percent of the rates. So keep those separate in your mind also. And really, what I really want to address is process, because we did change those origin spreads but we want to be very clear on the process associated with doing that.

We announced these changes back in April and we did give a 45 day kind of discussion period with our customers, with our shoreline partners to give them an opportunity to discuss with us how those changes were going to impact them, should things be done differently and we encouraged and did discuss with every major agriculture customer across CSX about how it should evolve. After that 45 day period, we did reissue the spreads and they were different than what the spread was in April. So when you talk about process I want to make sure that we're very clear that we implemented that process to take feedback from our short lines, from our customers and then secondly we gave six month notification that come October 1 is when those changes were going to go in.

People can argue that that wasn't long enough or that was too long, I don't know what the right answer to that is, but six months appears reasonable from our perspective to prepare yourself for some of those economic changes. So thank you very much, I appreciate it.

CHAIR MILLER: Thank you.

MR. CLEMENTS: Thank you and I'm grateful today to be in front of the board with an opportunity to present the comments of Community and Pacific Railway Company on its own behalf and also on the behalf of Soo Line Railway Corporation, Delaware and Hudson Railway Corporation and Dakota, Minnesota and Eastern Railway.

My name is James Clements, I'm the vice president of strategic planning and transportation services at CP. I have over 20 years of experience at CP and I think most relevant to this hearing includes more than three years in various roles in our Canadian grain marketing and sales group and another three years as the director of our US grain marketing and sales team.

Today I will specifically be addressing the proposal made by the National Grain and Feed Association in this proceeding that the board shall consider the revenue and cost of CP's combined US and Canadian system operations when determining revenue adequacy and the reasonableness challenges of grain shipments. I will note that the issues raised by the NGFA proposal and my remarks apply more generally all of the CP's business as well. In terms of policy issues, the NGFA proposal is bad policy, it focuses only on the immediately allegedly positive impacts on revenue adequacy determinations for the purposes of making it easier for US grain shippers to obtain rate prescription from the STB and fails to take into account the unintended and adverse policy implications.

Firstly, this proposal would distort the measure of financial health of the US rail operations and undermine the board's ability to regulate effectively the rail operations subject to its jurisdiction. In 2001 deliberations regarding consolidating reporting for commonly controlled class 1 carries, ex parte 634, the board recognized that due to different regulatory and labor regimes in Canada and the US which can effect cost structures and earnings of railroads and require the report their non US operations may distort the operations subject to the board regulation and to avoid that distortion the board confirmed it would continue to require reporting only on rail operations within the United States.

Secondly, the proposal makes US regulatory decisions sensitive to Canadian regulatory decision and the economic environment in Canada. If the regulatory and economic conditions in Canada create superior financial performance for the Canadian rail entity, this proposal would essentially amount to cross boarder subsidies to the US shippers. Similarly if those conditions create inferior financial performance for the Canadian rail entity the proposal would make it more difficult for the US shipper to obtain a rate prescription. Consider a situation where there is an adverse Canadian regulatory situation that lowers the rates for moving Canadian grain and negatively impacts CP's financial performance in the Canadian entity. That regulatory change could than have a negative effect on the revenue adequacy calculation for the US grain shippers and making it harder for them to obtain rate relief.

The end result is that the US grain shipper would get a competitive disadvantage, in some ways you could say it's a double disadvantage because you had a decrease in Canada and now no access to rate relief on the US side at the same time. Thirdly the NGFA's proposal could penalize and discourage corporate structures that enable railroads to provide more efficient cross boarder service and realize economies of scale. Consolidation of management, back office and other functions translates into lower cost for operating entitles on both sides of the boarder. These lower costs are reflected in the US operating entities data reported in the R1 and in turn flow through to the revenue adequacy determination.

Finally, the proposal is discriminatory as it focuses only on CP and CN. It ignores performance of the foreign operations of railroads affiliated with other class 1 railroads. A summary of the difference in the Canadian and US regulatory environments highlight the potential that Canadian could discourage US regulatory determinations under the NGFA proposal. CP is subject to differences in labor laws in Canada and the US and the differences in those laws and other regulations mean we have different work rules and separate labor agreements for US and Canadian workforces. The result is that the cost structure and nature of the operations in Canada are different from the US operating entities, likewise the potential financial and operating impact of labor disputes in the two countries differ.

The approach to rail policy and regulation in the two countries is radically different. The Canada policy objectives stress the need for competition to achieve the lowest total cost for all modes of transportation and to advance the well-being of Canadians, irrespective of the impacts on the rail industry. There is not explicit provision in Canadian legislature or supporting regulation to review and consider rail revenue adequacy. Canada tends to take a more heavy hand to regulation than the US.

Regulatory differences are evident at the technical level as well. CP does report separate ledgers of the relevant entities under both the Canadian uniformed classification of accounts, the US uniformed system of accounts and for tax treatment in Canada and the US. These differences can have material impacts on the reported company's finances. For example, in Canadian regulatory accounting pensions and other employee benefits are recognized on a cash basis as opposed to an accrual basis in the US. The US rail regulation has been fairly stable in the post staggers area. In contrast, in this same period the Canada rail regulation has experience numerous significant changes. In fact, the Canadian Transportation Act mandates regular comprehensive reviews of the act. Such a review by the federal government is currently underway and recommendations for change are due in December.

The changes could affect any component of the law or regulation and with the NGFA proposal could then flow down into determination in the US market. Most significantly on a regulatory basis the regulation of Canadian grain for the movement to export positions is done under the form of a maximum revenue entitlement. This is adjusted annually to reflect changes in input prices and also the volumes moved by the railways. There's also significant economic differences between Canada and the US, at the highest level Canada has a population similar to California and is the second largest country in the world by area. So as result we are very sparsely populated country and very heavily dependent on primary resource industries like mining and agriculture.

We also have a relatively small domestic market leading to a much more focused movement towards export markets. The other factor is there's a different currency involved and currency fluctuations can correct two types of variability. This creates changes in the measured financial report performance of CP and its entities as reported in Canada dollars, and these changes can also affect the relative competitiveness of Canada and CP based customers that are export oriented. CP's transportation mix reflects the export orientation of the Canadian economy. Similarly in the context of the NGFA proposal there are other market differences focused in the grain area. US produces eight times as much cereals, coarse grains and oil seeds than Canada does, but Canada exports a much higher proportion of those.

For example, Canada exports of these crops were one-third the value of the US exports even though there was eight time the production in the US. In our franchise we have about 290,000 car loads of Canadian grain, 75 percent of that moves to export. In the US we have about 170,000 car loads of grain and about 28 percent of that moves to export, so again you can see the significant differences.

Finally, there are issues of what I would call reporting integrity and implications that CP made artificially understate the revenue adequacy of its US operations. CP offers a highly integrated transportation service in North

America to its customers and this high degree of integration requires centralized management that benefits the entire CP network. There are functions that exist within CP in Canada that provides serves to the entire CP network and the -- both in Canada and the US. CP consistently uses the services cost method in accordance with the IRS treasury regulations section 1.482-9B to allocate head office cost that benefit the US operations. Canada has similar tax regulations requiring such allocations. In accordance with our intercompany policies, we have an internal transfer pricing committee and we follow consistent practice from year to year for the allocation of these management services cost. We have undergone tax audits from both the Canadian and US tax authorities to ensure that such allocations have been reasonable made.

As a check, we also look at the operating ratios of the Canada and US entities to ensure that they're reasonable and we will investigate any unusual variance and you might be interested to know that somewhat similar to evidence that we saw from the NGFA in 2013 the Canadian entities operating ratio were slightly higher than the US entities operating ratio. Finally I just want to make a brief comment on the jurisdiction, the proposal by the NGFA is fundamentally inconsistent with the statute authority of the STB and its mandate and the STB lacks jurisdiction over rail transportation in Canada. The NGFA proposal ignores the long term negative implications of making US shipper access to rate relief dependent on the rail operations in Canada. It's an effort to manipulate revenue adequacy and again, we think it is neither lawful or in the interest of US rail carriers and shippers. Thank you.

CHAIR MILLER: Thank you. Apparently Vice Chairman Begeman didn't hear the part about turning off your cell phone.

MR. KALICK: Chairman Miller, Vice Chairman Begeman, good afternoon. I'm Ted Kalick, senior US regulatory counsel for CN and

I'm happy to be here this afternoon. CN joined in the comments today of the AAR and a we ago many of the comments of our rail colleagues with regard to the importance of maintaining sound rail economics as a basis for evaluating reasonableness. CN is here today like CP to address the question raised by the board in its notice of quote, whether the board should consider the revenues and cost of Canadian carriers full system operations to include the parent company and subsidiaries when determining revenue adequacy and rate reasonableness challenges of grain shipments.

Just to make a couple of points and a contextual point at the outset. Echoing Mr. Scheib's comments, if the board were to look into revenue adequacy in this situation it is premature. The board should be looking at that issue holistically, not piecemeal and it has proceeding as you well know, set up to do that in July. There really is nothing you can see from this record or the testimony that would somehow require grain to be treated differently in that context if the board were to undertake that examination. There was a legal point to make that Mr. Clements just made and that is that the board's jurisdiction is confined to transportation in the United States. What does that mean really when it comes down to it? It means that if you were to order apparent Canadian company to provide reports on its Canadian revenues and cost for its Canadian operations, we respectfully submit that that would exceed the board's jurisdiction.

But I think the important point here and it may be equally important with the jurisdictional point is not whether you can do that but whether you should do that. And there the board has looked at that matter before in the ex parte 3634 proceedings some years back when it ordered commonly controlled US railroads to file consolidated reporting. And the issue was raised there, whether Canadian information should be included in that report and the board found that it would distort results. There really has been nothing since then to my knowledge or anything presented today that should change that result.

We'd also suggest that it's really important for reasons of regulatory economy as well that it would be imposing different and overlaying reporting requirements on carrier operations regulated in Canada would be an inappropriate intrusion into Canadian rail regulation. It would wrongly impose regulatory requirements from cost on entities properly subject to Canada's rail regulatory regime it could create new regulatory coordination issues as Canadian regulators must take into account relief granted by US authorities based on conditions in Canada and it would in the end, I think be generally viewed as an attack on the control of Canadian authorities over entities delivering rail service within Canada. And as a matter of regulatory economy we would respectfully submit the board should avoid this court.

Lastly, Mr. Crowley's presentation this morning on making the request to include Canadian information had a chart comparing revenue adequacy determinations in the US and other information gathered suggested that revenue inadequacy carriers in the US, CN, CP. He had posed would be found revenue adequacy if in the fact the Canadian information was included. I would just point out that in 2013 CN and its US operations under GTC Corporation was found revenue adequacy. Before some of my rail colleagues tried to lasso me out of here I would be remised to say that one year's finding of revenue adequacy is not, in our judgment a determination that a carrier is revenue adequacy over the long haul which I think is the way that the board should be looking at that. And I would certainly predict in advance that CN and other shipper interest are likely to disagree of revenue adequacy in looking at the reasonableness of individual rail rates. But I point that out that there's really nothing that has been pointed out about the board's calculation today, the way it calculates revenue adequacy today. The inputs that go into that calculation that were in error so that the determination of CN was revenue adequacy in 2013, was an error.

When you contrast that to the risks and the cost I think that are involved in trying to add additional information that's post both jurisdictional and other elements, that is another reason why the board should not consider that information or require that kind of information in its consideration. I'll be happy to try to address any questions you may have.

CHAIR MILLER: Thank you all very much. So I want to follow up on a couple of the questions related to the Canadian issue and, sir, I appreciate that. We have our hands full trying to be the regulator on the American side of the boarder. We certainly don't want to slip over and try to regulate on the Canadian side. But when this issue of revenue adequacy and the companies come up I'm not asking this question to imply any determination having been made up in my mind, it's just a curiosity in some ways as I think about it. As I understand it, your companies, I mean you operate holistically, is that correct? I mean, you don't' have an American operation with personnel and bookkeeping and administration and all of that in the Canadian, it is one company. Is that a correct understanding?

MR. CLEMENTS: Yes, for the most part that would be correct.

MR. KALICK: And it's true for CN as well. Legally we are organized differently.

CHAIR MILLER: So broadly if you're looking at whether or not the company is operating at a revenue adequacy level it feels like, you know, one has to holistically look at the company?

MR. CLEMENTS: Well, that's why I made the comments about there are standards in both in Canada and the US about allocation of common costs if you want to call them that.

CHAIR MILLER: And how you allocate from the US to versus Canada.

MR. CLEMENTS: With financial statements and the R1.

CHAIR MILLER: Uh-huh.

MR. CLEMENTS: Everything that is consisted with the appropriate guidance on transfer pricing and cost that we can allocate to the different entities. As I said, we have policies internally, we've been audited by the tax authorities and we follow a number of standards. So we do report through the results in the US that are related to the operations in the US through Soo Line Corporation. That has all of our US operations incorporated into it and reflects some of those head office costs.

The point I'd also make is that by operating as a common entity and then having these cross boarder allocations for tax purposes and regulatory reporting we can be much more efficient than if we had to have two accounting departments.

CHAIR MILLER: Oh sure.

MR. CLEMENTS: Two engineering departments and everything else. So those benefits, because we can create those cost efficiencies and then allocate a portion of that through the US gives you a better result than you would otherwise with duplication.

CHAIR MILLER: I'm wondering after we had the presentation this morning from Dr. Schmalensee on the TRB proposal and one of the things they focused on was the issue of arbitration and final offer arbitration I think is what he called it and referenced the Canadian approach. If you all have any comment about that.

MR. CLEMENTS: You are probably talking about one of the few people in the room that's participated in a Canadian final offer arbitration. The biggest thing or the first thing I'd say is that it's a very contentious process, in some ways if you look at the design it's baseball style arbitration so there's offer

A and offer B. The arbitrator in the Canadian process does not have the ability to say these elements are good from this offer and you can't pick and choose and they can't actually find a middle ground.

CHAIR MILLER: Yes, that's the way I understood from our discussion with TRB, that was their proposal as well.

MR. CLEMENTS: Yes. What that does is creates a lot of tension, a lot of animosity where really you should be looking at trying to create a solution between you and the customer in a more, I'd say standard arbitration process where the arbitrator is trying to help the two parties come together or find a solution to the problem at hand. We've said this in the Canadian regulatory proceedings, there's no test about competition and market dominate so you can end up in final offer arbitration when there's alternate modes, competing railroads and a number of factors. I think, without having some kind of test, you can create unneeded final offer arbitration and then end up in a very aggressive situation with a customer. So it's not ideal, if you want to say that.

MR. KALICK: I would concur with Mr. Clements so I don't have firsthand experience with participating in an FOA, I certainly know from my colleagues the difficulties with processing. The only thing that I would add is that at the end of the day there really no standards attached. You essentially get a one line answer as to what the rate is and so there's no explanation, so there's consistency, it's not really rooted in any kind of sound economic policy. One case may weigh some evidence one way but there's no kind of coherent whole into how to fairly evaluate what the right rate should be.

MR. HITCHCOCK: If I could elaborate on that from an invest perspective. I listened carefully to Dr. Schmalensee this morning. I understood him and the TRB to be indicating that anything that would require arbitration of rates would be require legislation and I have to agree with that and I believe it took legislation in Canada to get to that result. So the parties today who have been suggesting that the board should pursue mandatory arbitration really are kind of in the forum respectfully. And then I would like to echo what --

CHAIR MILLER: I'm sorry, would you say that again?

MR. HITCHCOCK: It is in the wrong forum, they should be up on Capitol Hill if that's their goal and not asking the board to do something that would require legislation. I'd like to echo something that Ted Kalick just said and that is we heard a lot of arbitration today. We heard nothing about standards except from the gentleman from Burlington Northern Santa Fey. Every arbitration I've ever been in and I've been in a lot of commercial arbitrations in 30 plus years, has applied some legal standards, tort case, was the defendant negligent, a contract case, was there a meeting of the minds, another contract case, what is the measure of damages as contract law provides. An arbitration that takes place without a standard, it's a small claims court or worse television court. I mean, you have to have a standard if you're going to have any kind of a justified result.

Lastly, that standard needs to be economically based. If a standard for rates is not economically based than it's simply a matter of somebody's judgment about what's fairer to one party and fairer to another party. And how one would ever define that concept is beyond me.

CHAIR MILLER: Well, I guess in some ways whether we're using arbitration or not isn't that what the board's asked to do in many cases is to determine an economically based rate.

MR. HITCHCOCK: Absolutely. The board is a governmental authority, it's invested with the power to transfer from funds from one private entity, a railroad to another private entity, the shipper in the event that it finds that a rate is not reasonable. So yes, the board does make that determination but they're not a private arbitrator, they're an official of the government, they're taking a government action subject to review and above all it is subject to a standard which is today the gold standard for what is an economically appropriately rate in the event of market dominance and that's standing one cost.

MR. CLEMENTS: And I'll just add in the Canadian side and final offer arbitration, Mr. Hitchcock is exactly right, there is no mandate that there is an economic basis or any theory. It is the determination of an arbitrary of what is the most fair of the two offers with no other guidance or no other input. Clearly parties will make arguments around economics and other factors is to their proposal, but that is not a specific mandate of the arbitrator and in fact one of the other flaws is the arbiters often don't come from the rail industry, don't have any understanding and so you can have somebody making on a very arbitrary basis a decision in economic and regulatory type decision with no expertise or understanding of the industry and it can create considerable inconsistency in the decisions that come forth because you get in somewhat what arbitrator you end up with and what do they think and what are their individual personal philosophies.

CHAIR MILLER: It's been interesting today though how often arbitrations come up and how many different witnesses have mentioned it in one way or another. So I wonder if arbitration would be a feasible decision making approach if one did fully define the standards to be used and address some of the issues that you found to be lacking in the Canada system.

MR. CLEMENTS: I'd say that is reasonable if it's defined, well defined and with a clear process around it. I think it creates an opportunity for more efficiency and lower cost in the process.

CHAIR MILLER: One last thing, I mean I guess not really a question but one of the things I found interesting in Dr. Schmalensee's presentation this morning was his point that arbitration was an informal way to discuss the issues and these more complicated issue can more easily and quickly be dealt in an arbitration kind of setting, not a legal pleading setting and I probably have a room full of attorneys who might all have strong feelings on that, but.

MR. CLEMENTS: Actually, one comment I had while into the Canadian piece and maybe at danger of saying too much. Final offer arbitration has been around for a little while in the Canadian regulatory environment. They have actually added an informal mediation and arbitration process subsequent to creation of the regulation and legislation around FOA. Which wasn't mandated through legislation and because of some of the concerns I think around FOA and other proceedings, and that has been used a number of times as well and it's a process supported by the agency in Canada.

Dispute resolution in the context of a commercial disagreement between the seller and a buyer occurs only after there is a failure of the parties to come to an agreement. Now, the parties may fail to come to an agreement for many different reasons but one reason the parties can sometimes fail to come to an agreement unfortunately is that one party may see dispute resolution as a better alternative to a negotiated settlement and therefore looks to the dispute resolution process as a better result.

VICE CHAIR BEGEMAN: I have a few questions. You asked what I was really interested in with respect to the Canadian system. So how does the arbitrator get picked?

MR. CLEMENTS: In the final offer arbitration or the other one?

VICE CHAIR BEGEMAN: Yes.

MR. CLEMENTS: There is submission of proposal, and I may not get this exactly right, proposed arbitrators by both parties. There is a common recommendation on arbitrators than there is usually the agency will pick that or appoint that person. If there's a failure to have some commonality there's a bit of a negotiation between the agency and the two parties to try and determine who is going to be the arbitrator for the process.

VICE CHAIR BEGEMAN: How long has the process been in effect for Canada?

MR. CLEMENTS: I can't remember exactly iteration of Canadian --

VICE CHAIR BEGEMAN: It's been awhile?

MR. CLEMENTS: I think it was since '87 but let me confirm that back to you.

VICE CHAIR BEGEMAN: Okay. Between the two carriers, has it been used against one of you more than the other?

MR. CLEMENTS: The process of final offer arbitration is supposed to be completely confidential, even the specific cases.

VICE CHAIR BEGEMAN: Oh.

MR. CLEMENTS: Yes, so we don't really know specifically what has happened with a Canadian National Case and they don't know specifically what's happened with us.

VICE CHAIR BEGEMAN: I understand.

MR. CLEMENTS: So I can't comment.

VICE CHAIR BEGEMAN: There's not a way to find out how much it's utilized?

MR. CLEMENTS: No, unless the agency would share it with yourselves on a confidential basis.

VICE CHAIR BEGEMAN: Oh, that's interesting. I'll stay with you, Mr. Clements, because of some the discussions that kicked off about URCS and subjective cost allocations, et cetera, when you talked about the cost allocations between your operations in the US and Canada, I assume that they are robustly and accurately accounted for?

MR. CLEMENTS: There's tax law in particular that prescribes what you can and can't do and you have a logical and sort of methodological approach that they agree with on the allocation of those costs. And like I said there is audits and we've been subject to tax audits. So yes, I would say it's a little more robust.

MR. HITCHCOCK: If I could comment on the URCS discussion. URCS got a pretty bad rap this morning.

VICE CHAIR BEGEMAN: It did.

MR. HITCHCOCK: Let me first say that I'm an economic regulation lawyer but not an economist but it seemed to me that Dr. Schmalensee and Dr. Gray were not that far apart. Now, it sounded very much like it but what I understood Dr. Schmalensee to be saying that there is no economic construct that you can apply to a costing system that will support the decisions that have to be made in coming to a costing system. Now, any costing system takes a set of total expenses of an enterprise or an organization and attempts to break those down attributing some portion of those cost to certain activities and that's a very effective way for management to make evaluations of what decisions it should be making internally, should they be producing this product, increasing its production of another produce, all kinds of industries use cost accounting for managerial purposes.

So there is, from an economist standpoint at Dr. Schmalensee was looking at it, there is an arbitrariness to anytime that you take the railroads R1 expenses and start trying to decide how should they be allocated here or here or here, what part of them should be consider capital, what should be considered maintenance, what parts should be considered just the very barest of incremental cost, what should be sort of a marginal cost in a longer term basis. They are judgmental but they're not wholly arbitrary. They might not have an economic foundation which is Dr. Schmalensee's point. But as Dr. Gray said there is value in them. They are, if not perfect they are directionally helpful in making management decisions including making regulatory decisions. Can any costing system when it involves decisions about how to allocate cost be made better, absolutely, no question about that.

But and you heard the experts including Mr. Crowley agree with that I think. You know, it could be made better but I don't think that the two of them were in such violent disagreement as it might have appeared because they were looking at URCS from two different standpoints.

CHAIR MILLER: So I might be addressing this question to sort of the wrong group, maybe this is more of a shipper group, but I've appreciated Vice Chairman Begeman's point that she's made several times today that really our purpose here shouldn't be to try to understand our grain rates too high but rather is the process available to grain shippers. And I'm wondering how you all would address that from your various perspectives and your railroads experience?

MR. SCHEIB: I'd be happy to take a crack at it.

VICE CHAIR BEGEMAN: Surprise us, John.

MR. SCHEIB: I'll be happy to take a crack at it but, you know, Pat and I were having a side bar about Mr. McNulty's presentation because, you know, similar to CSX we serve those chickens with those same operations. And we're not sure we can leave a better imprint on you other than maybe standing up and doing the chicken dance. With that said --

CHAIR MILLER: I'd like to see it.

MR. SCHEIB: That said, I think there's a simple reason why you're not seeing grain rate cases. If you look at our highly confidential filing you will see what our average R/VC ration is and you will see the substance percentage of our traffic that moves below 180 percent. Add into that fact that the remainder of our traffic a very high percentage, which we would be happy to provide to you highly confidentially, a high percentage of our traffic moves under confidential contracts. There's just not a lot of traffic that would even meet the jurisdictional threshold for you have to rate case from us.

Add into that fact all the indirect competition that Pat's talked about that's surprising those rates and I just don't think you're going to see one, you know, regarding Norfolk Southern.

MR. HITCHCOCK: There was a consider amount of criticism of the three benchmark test and certainly CSX has plenty of criticisms of the outcomes of those test and the size of the awards that are available, but the law is the law, we accept that. I would just like to point out that by my count seven traffic lanes have been challenged so far since the board adopted its three benchmark test. Six of those involve CSX going from memory, one involved Union Pacific. CSX was successful in defending one of those lanes that was challenged because the vast preponderance of the business had already been moving for some time by barge. Direct head to head competition and were successful in having that dismissed of no market dominance.

We lost the remainder of those lanes; Union Pacific lost its lane so by my count looking at lane by lane challenges by shippers using the three benchmark test the score is shippers seven, railroads one. Now, if I've miscounted I stand to be corrected but I'm not far off I don't believe.

MR. CLEMENTS: In terms of the system I first would look at the CP system and say competition is alive and well. You've had a number of people testify that grain gets a truck before it arrives in an elevator and if you look at the regions of the states that we service there's competing elevator on another system or ethanol plants and other processing that overlays the entire production territory that we serve in the US. So I think you've got a strong market base system that is setting the rates across our network. We haven't put in evidence on the R/VC and we haven't done a recent analysis but, you know, there's a very strong competitive environment.

If there is any opportunity for improvement, I've heard the comment of the very small shipper and, you know, I'd echo those that, you know, their perception is their reality and so there's always opportunity to improve. And I think the efficiency and the access and the cost to expeditiously deal with the complaints of the small shipper. The large shippers are sophisticated multinationals, they have as many resources as any of the railroads and I think have the capability if there's a concern that they have with their rates to bring forward complaints.

CHAIR MILLER: Anything to add?

MR. KALICK: No, I think I would just go with some of Mr. Scheib's points. There are forces out there whether the board considers them or not on rate matters. They keep rates at competitive at levels, I think that may be a reason, you know, why you don't see as many rates cases as you do. In terms of process, you know, I think like the rest of the railroads I think we're all interested in making a process that works for you, in essence to serve your objectives. I think at least a discussion with regard to final offer arbitration as discussed this morning by the professor and I don't want to mangle his name, but, you know, I think leaves a lot to be desired. It's something to look into as certainly based on the Canadian for a way. It's not in good process for the reasons we've discussed. If there's something in between that can, let's say, improve the current system and make it more accessible I think the industry is open to considering that.

I think we have to be careful of arbitration. I know in terms like informal arbitration as compared to regular arbitration leads a lot, you know, to be defined. I think I can speak for myself, my own involvement at commercial arbitration with CN, arbitration can approach full blown litigation, whether we're at the board or in court. It really depends on the process and the rights that are involved in arbitration, including the right to discovery. You can have an arbitration proceeding that lasts a long time and there are fairness reasons to do that. At least with regard to moving through arbitration, I think it needs to be studies pretty carefully.

VICE CHAIR BEGEMAN: Well, one of the benefits that all of you have on that side of the dais is that, starting with BNF's conversations with the National Grain and Feed Association and the idea of getting other carriers to participate, et cetera, and then everyone discusses the development of an agreed upon process and what the criteria for both sides would be and how it would be judged. You have the ability to more freely have those conversations than we can. We would love to just sit down and talk with you all together about what would work. Unfortunately, that's not reality at this point for us. But to any extent dialogue and efforts in the private sector can bear fruit, and then you can bring it our way, we're certainly interested. Again, we're just trying to help the small shipper. You said it best, the perceived problem is that he feels he has a problem, that he or she has nowhere to go.

MR. SIMONIC: Vice Chairman Begeman, you know, we've listened to your inquiries this morning about are there things that we can do and, you know, if you look at the record one of the things there seems to agreement on is some sort of nonbinding mediation. We talk to our customers all the time so I don't know how fruit nonbinding mediation will be because it seems to me to be just kind of a replay of what we do every day with our customers but certainly there's an agreement in the record that that might be something to look.

There are other things in the record that there's an agreement to look at discarding the limit price test. Universally, every party that's filed has said we should get rid of that.

VICE CHAIR BEGEMAN: I think you know my position on that one.

MR. SIMONIC: I think we've read it yes. Reconsidering moving specific adjustment is another one has agreement across the filings. The same is true with sort of reaffirming what the statute already tells us in 49 USC 17701B about who can bring Complaint. So there are areas, if you look at those pleading where there does seem to be some agreement on issues to move forward.

VICE CHAIR BEGEMAN: Thank you for kind of consolidating that.

CHAIR MILLER: Thank you for reading the record. Any more questions, Ann? Thank you all very much.

VICE CHAIR BEGEMAN: Appreciate it. And Tim, thanks for great testimony, you kept us going.

CHAIR MILLER: I want to meet that chicken. Okay. Panel number VII if you could forward, it's the alliance for rail competition, Terry Whiteside, Mr. Fauth and John Cutler. I don't see Terry Whiteside, oh. Okay. Welcome, I think we'll get started. So Mr. Cutler, can I assume by the way you're lined up there, you're our leadoff. Oh, going the other way. Oh, we're mixing it up. That's good. We're late in the day, let's change it around. Mr. Whiteside, we'll start with you.

MR. WHITESIDE: Thank you. Chairman Miller and Chairman Begeman; thank you for inviting us and also for lasting all day. I wore a bright shirt so that you would --

CHAIR MILLER: And we appreciate it.

MR. WHITESIDE: -- and my baseball tie just to make darn sure that, anything about being this late is number seven is one before number eight and that's the end of the day, so. We want to thank you for holding the hearing. I was reading a book last night called Railroads and the Granger Laws from 1830 through, he gave it to me, he wanted me to do something for the evening. It's all about the act to regulate commerce back in 1887; and it was the Grangers that brought about such actions. Here we are, a long time from there and we're here for the same reason.

Why is it so important for grain to be singled out? That's been asked all day. Let me share one with you. The grain producers bear the cost but they don't pay it; and that's what makes them unique.

CHAIR MILLER: Say that again? They bear the cost?

MR. WHITESIDE: They bear the cost of the transportation, but they don't pay it. It's paid by the elevators or the merchandisers and that's what makes this whole proceeding unique because that's what elevates this to the point where they need some help. The Board in the hearing process you're going to be holding on 7/22 and also 7/11, competitive access, this has encouraged captive shippers and producers who are earners of the freight and practices, but not the payers to look positively towards future regulatory remedies. My name's Terry Whiteside, I'm the principal of Whiteside and Associates in Billings, Montana. I have previously submitted opening and reply verify comments in this proceeding.

I also serve as the Chairman for the Alliance of Rail Competition and represent and appear on behalf, and I'm going to list the names because they want to hear their names on your video broadcast. Montana Wheat and Barley, the Alliance for Rail Competition, Colorado Wheat Administrative Committee, Idaho Barley, Idaho Grain and Idaho Wheat Commission, Minnesota Corn Growers and Minnesota Farmer's Union. Montana Farmer's Union, Nebraska Corn Growers, Nebraska Wheat Board, North Dakota Corn and North Dakota Farmer's Union, Oklahoma Wheat Commission, Oregon Wheat Commission, South Dakota Wheat Growers and South Dakota Farmer's Union. South Dakota Wheat Commission, Texas Wheat Board, Washington Grain and Wisconsin Farmer's Union along with the Wyoming Wheat and Marketing Committee.

For years, the farm producer's been faced with a situation of being price takers, coupled with no real negotiating power due to lack of movement competition and little regulatory recourse. John Cutler will talk more about this in a few minutes and then the Board opening in this proceeding in December of 2013 said, to consider what regulatory changes could be implemented to insure that the Board's rate case procedures are fully accessible to grain shippers and provide effective relief from excessive rail rates.

We have tried at ARC in ARC's pleading in the Montana Wheat and Barley, to give you an alternative; and that was the point in this proceeding. The participants provided opening and reply statements. I'm accompanied by John and I've also got Gerald Fauth here, and the team will address the seven major bullet points that you asked for in your hearing. Both Mr. Cutler and Mr. Fauth will explore with the Board answers to these inquiries and also I was happy this morning you make sure that Michael Hara got introduced to the Board, because he's going to have the transportation portfolio at the Montana

Wheat and Barley Committee; and as you know they have been very active over the years.

So I'll not take a lot of time today. I just wanted the team to concentrate in the areas of expertise. I'm struck, though, by a couple of the things, the railroad's responses. Railroads argue that government intervention is necessary to insure they earn adequate revenues. But at the same time, they argue that no government intervention is necessary to limit their monopoly power. Now, they're doing it in this proceeding; the railroads state there's no need to go forward with change, anything regulatory, anything with regulation in respect to grain. They state that no shipper complaints means no shippers and farm producers are concerned. Really? Shippers are concerned, that's clear from the opening reply statements in the proceeding. The last major rate case on grain was McCarty Farms. I know I don't look that old, but I was part of that. I filed the Section 229 case at the ICC that brought that case on.

Eighteen years later, 3.2 million dollars later, the farm producer received adjudication both against and for the farmers in that case. In our opening reply statements, we made it clear why the three benchmark adjudication procedures is not appropriate. Gerald Fauth will discuss this further and John Cutler will testify in a few minutes and talk about the grain price. It's interesting, the grain price is figured on the basis which determines the price given to the farm producer. And we saw in Fargo last year, when the service kind of went in the tank, the basis got all screwed up and the farm producer lost money. Things such as poor service effects secondary markets.

It isn't a matter of the rate cases or the rate levels; it can be service, it can be almost anything that the railroads are doing. Railroads state that any change by this regulatory body will transfer into greater burden on railroads and price and railroads and shippers. They express that the grain rates are market-based. It's always humorous to me that the words market-based rates are utilized to describe how monopolies or oligopolies price rates in markets they control. They imply that today's rail rates on grain are not based upon captivity or lack of effective competition. Really? Well, if they truly were based upon the market as the railroads claim, then when the price of grain falls, shouldn't the rail-based market rates fall?

If the demand for grain falls, shouldn't the market-based freight rates fall if they were built on market rates? When corn doesn't move due to low prices in the marketplace, do the rail rates fall? The railroads even state they are there to open up markets for the grain producers, yet time and again we have observed in various states that the railroads close off the markets they don't want to a particular group of farm producers? Why?

To fit the operational models the railroads want.

For example, in Colorado, they'll force the railroads down to, oh you got that chair. I usually get that chair. They force them to go down to the Gulf coast because they don't want to take the transit times in the Pacific Northwest. John Cutler will talk the practice of how the railroads love to ration prices in high demand or service meltdowns to fulfill operational and financial goals. Railroads state that they're just like every other US industry. They are? Fact, the railroads were given a Federal franchise to operate and they were protected from competition. As many courts have stated over the years, the railroads are quote "greatly affected with the public interest." And the Federal government has seen fit when it granted these protected Federal franchise to operate and operate in the public interest and that regulatory oversight was appropriate. That's why we're here.

And thus establish the ICC and the STB

especially captive shippers, for the protection of market domination. We've talked about, you heard earlier today about barley producers, the inability to move shuttles, but the railroads are trying to force them into shuttles. Pea and lentil people, the rotational crops don't lend themselves to shuttles and quick loading and yet the railroads are giving them equipment that is bad ordered. There continues to be rate and service issues on grain in 2015, which our team will discuss.

So when I watch all of this, I think to myself, we're still here working on the same problem, that's why we came up with the 2B Rules, to see if we can morph this into a process where we can get the farm producers and the ones that are actually bearing the freight to have some access. I was impressed with Mr. Miller starting to think about arbitration, but arbitration isn't the total answer. We've got to still have something that we need to arbitrate because there is a regulatory process. So I thank you, thank the Board for initiating this and holding the hearing and I want the team to testify so I'm going to have Gerald Fauth talk a little bit about the 2B process.

MR. FAUTH: Good afternoon. My name is Gerald Fauth, I'm President of G. W. Fauth and Associates, based in Alexandria, Virginia. I have previously testified in both the opening and reply comments and submitted confidential and public versions of those. The Board, as Terry mentioned, specifically invited comments on several issues and I'll try to go through those one by one and I'll try to be brief and to the point.

The first one was concerning movement-specific adjustments to URCS and whether the Board should revisit this prohibition on movement-specific adjustments, which was adopted in 2007. I believe there's some form of URCS cost adjustments to grain movements is justified. Many grain shippers and grain product shippers were hurt by the STB's adoption of unadjusted

URCS jurisdictional costing in 2007, under which movement-specific adjustments, which more accurately reflect the railroad's variable costs are not allowed.

Since URCS, as some of the railroad witnesses that made the point, since URCS reflect the system average cost, movement-specific cost adjustments can work both ways. Actual variable costs can be higher or lower than system average, which makes sense. In other words, there are winners and losers and most grain and grain producers would be in the loser group. Many grain and grain products move in efficient shuttle trains and larger than average grain trainloads which represent some of the most efficient and least costly movements for the railroads.

In my opening comments, I indicated the cast majority of corn and soybeans move in trainloads and nearly half of wheat and ethanol are moved in trainloads; which the Board currently considers fifty cars. They have proposed moving that number to eighty, but it's still fifty. Moreover, the multiple car shipments are different and they usually move in larger than average trainloads. You talked about gathering earlier, that's what happens with many of these in Montana, these multiple car shipments of up to twenty-five cars or even up to forty-nine cars, moved together and are joined or married into larger cars and moved, a lot of them to the Pacific Northwest. That's different than a multiple carload shipment of say, plastic pellets, which might go in a general train. So a lot of these are the same commodity, moving the same place, but they are multiple car shipments moving in larger trains.

Now, allowing for movement-specific adjustments would certainly help resolve the problem; however, developing such adjustments in rate cases can be time consuming, costly and contentious and you had to hire bad consultant like me, huh, Mrs. Rinn? We'd like to know. Without guidelines from the parties would likely disagree on the development of such adjustments, which would increase the litigation costs. The issue could be dealt with by the Board's adoption of simplified procedures or defined procedures for the development of such movement-specific adjustments which takes some of the contentiousness out of it.

For example, one of the big economies and certainly in shuttle trains is car costs. These cars move in shuttle trains and they're switched quickly, less than fifteen hours, moved back. But in URCS costing, unadjusted costing, you can reflect that. And car cost is pretty simple, a pretty simple movement-specific cost adjustment to make. You can take the car value, the car aids, the car cycle time and develop the actual car costs, car maintenance costs. And the Board could look at, for example, a specific formula on how you could develop movement-specific car costs to remove some of the contentiousness and time and cost out of the process.

Now in order to account for the problems and issues associated with URCS, I propose that the Board develop and adopt grain cost adjustment factors; which are different than movement-specific adjustments. Such grain cost adjustment factors would be similar to the so-called ex parte 270 adjustments that you currently use and costing multiple car and trainloads. Those adjustments were developed in the 1970's in the Eastern coal case and they are still used today. They certainly are not applicable to grain movements. Such adjustments could more accurately reflect the fact that grain movements generally have lower than system average switching, crew costs, locomotive costs and other costs.

They could also make an adjustment to the fact that many single car movements on the waybill sample are actually moved in unit trains or trainloads. I don't think they're really any true single car shipments anymore. If you look, it might show up as a single car in the waybill sample, but that car could be one of a hundred and ten cars. Yet on the waybill sample, it's treated as single car move and allocated more cost. You'd be hard pressed to find a movement, I think, in Montana, where a BN comes out and switches a single car from a facility. It just doesn't happen. But you'll find if you look at the waybill sample, there are many number of single car movements.

If properly developed and applied, such grain cost adjustments would likely increase the amount of grain and grain products traffic that would be subject, potentially subject to STB jurisdiction. So that's how the grain shippers are hurt; they can't even get in the door because of the way URCS currently allocates costs; the shippers without such adjustments are barred from this place. As I said, it wouldn't, if you adopted such adjustments, it wouldn't require the STB to reverse its position concerning no movement-specific adjustments. If they'd be done by commodity and by railroad and thus would not be movement-specific, but for example, you could do a study of BN and wheat and apply grain adjustments to BN by railroad and to Union Pacific. So it might vary greatly by railroad and by commodity, but they wouldn't be quote "movement-specific" per se.

The railroads maintain that URCS understates the cost for hazardous commodities and continues to support the Board's effort to utilize URCS to more accurately cost specific railroad movements as appropriate. However, the railroads are strongly against piecemeal adjustments or favoring grain shippers over shippers of other commodities. In other words, the railroads maintain that it's okay to increase URCS costs for hazardous traffic, but not to decrease URCS cost for gain or other low cost traffic. This could be called wanting to have your cake and eat it too.

But I want to address one point that Dr. Gray brought up. I didn't listen to all the testimony today, but I did listen to part of his testimony and it talked about how hazardous shipments are a little different, that these are phantom costs that aren't in URCS. Well, all costs are supposed to be in URCS. I don't know exactly what type of phantom cost he's talking about, but if it costs more to route a train of hazardous shipments, that routing cost or clerical cost would be included in URCS. Maybe a loss and damage cost is included in URCS. Maybe there's some insurance cost that's not, but it certainly could be and URCS takes whatever they report and allocates it, so I'm not really sure what he's talking about, about phantom costs.

I would also say that URCS, like I used the plastic pellets example, that grain, multiple car shipments of grain does not, may not cost the same as a multi-car shipment of even plastic pellets, which could cost more. Because they're putting a general trainload whereas these gathering of multi-car shipments of grain are usually put in heavier trains and solid grain trains. The Board has asked whether to have an expansive definition of grain; I believe an expansive definition of grain is appropriate. I believe, as I pointed out, if you've really restricted it to just grain, you'd be looking at just one commodity under grain as a STCC code 01013, which would exclude soybeans. Soybeans are technically not a grain, but I think everybody would agree soybeans should be included in it and it is in most studies of grain movements. But those other products, such as should be included too, I mean, wheat flour, corn syrup, soybean meal, even ethanol should be included under grain, since these are simply processed forms of grain.

If you look at soybean meal, it's just the soybean comes in, gets crushed and comes out as soybean meal; it's the same soybean, it's just crushed up. It's similar to the old transit movements where it comes, gets processed and moves out the other side, but it's not going to move out the other side unless it moves in the front side first, so.

The Board has asked whether or not it's to allow the use of nondefended traffic with R/VC rates or with traffic with R/VC ratios below 180 in comparison groups for grain shipments and I believe they should be allowed. The R/VC comp test is currently limited to the same or similar traffic, i.e., traffic with R/VC's grade on 180 on the same railroad. For example, under R/VC comp benchmark tests, the reasonable rate for BNSF wheat movements moving a thousand miles would likely be based on other BNSF wheat movements over a hundred and eighty moving similar distances. I'd like to call it the similarly-screwed shippers, because you're comparing other BN traffic which is priced similarly to the same traffic moving the same distance, generally moving to the same place. A lot of this traffic moves from Montana for example, moves to the PNW and so you can't look at other railroads or how they price traffic and/or other traffic on the same railroad moving below 180 and it could be significant.

That restriction makes it really hard to win a three benchmark case, because you're looking at, they say they're looking at market-based rates, but they're looking at the same market-based rates, the same market. So you're comparing, if they do look at market-based rates, that's what they're comparing it to, so. I will note that they said the railroads don't want to look at other railroads, but they want, they talk about the competition and market-based rates and some, and that they do compete with other railroads, but they don't want you to look at those other railroads revenue cost ratios and for example, if you looked at BN's rates or even BN's rates to the Gulf compared to UP's rates to the Gulf. It's the same market, they're going to the same place. But you can't look at UP's rates, just look at BN's rates.

UP doesn't have as much going to the PNW, but certainly going to the export market, so if you want to look at export grain on BN, you can't look at export grain on UP under the current standards. The Board asked whether or not to adopt a new rate reasonableness procedure such as a two benchmark approach, which we suggested, or the AG commodity maximum rate methodology that National Grain and Feed suggested. The Board could make changes to URCS and a waybill sample and a three benchmark test which would make it more accessible to grain shippers and help provide effective relief from excessive freight rates, which is the goal of this proceeding. Since the Board asked for ideas, we suggested that a two benchmark approach may be appropriate for grain shippers and this would be, the railroads say that this would cause great harm and would not be fair, but it would be very limited application. We suggested it be restricted to only revenue adequate railroads, first of all. You're only taking about a limited amount of traffic that's jurisdictional, so the application would be very limited. Currently it wouldn't apply to CSX since they are not revenue adequate, it would apply to BN.

I'm sure Mr. Crowley, I didn't listen to all his testimony, but I'm sure he talked about their approach and I won't dwell on that. But I think that talking about the three benchmark, it does have some economic basis, it was developed by the Board, it would be simple to administer and the Board develops those numbers based on an economic and rational approach. If you're looking for simplicity and an easy test to administer, I think that would be a good one to use.

I also note that the Board commissioned a study last year to look at alternatives to reduce the time, complexity and expenses associated with the stand alone cost methodology and maybe they'll have some ideas on that on how to improve those tests. Whether the Board decides to make improvements to URCS and the three benchmark test or adopt a new test, no test is going to be perfect. I will say over the years I've been involved in many different tests, starting with the fully allocated cost test and the seven percent solution and the ton and ton mile and the

R/VC comp test, so I've been around for a few tests. These tests take time and those tests that I mentioned were all proposed by the Board, formula replacement costs, and they were subsequently rejected, so. If the Board does decide to come up with a completely new test, I would suggest that the Board keep the modified three benchmark test in place until this test is fully studied and developed, if it adopts a test. I don't have much to say on the Canadian proposal as I'm sure National Grain and Feed fully went into that. The only thing I would say is that it appears logical and sound and such a policy should result in more accurate ROI calculations and preclude CN and CP from playing financial games by shifting revenues and expenses in investments between US and Canadian carriers. It seems like a logical approach.

Number six, whether the Board shall allow multiple agricultural farmers and other agricultural shippers to aggregate their distinct rate claims against the same carrier into a single proceeding. I think Terry addressed that, that the farmers and the producers are actually the one, they don't actually pay the freight, but they incur the cost. It's a logical approach to do, it's to allow parties to aggregate disputes. Farmers are economically impacted by higher rates, but they may not be, it's not settled law whether or not they're considered a shipper. If the Board could clarify that it would be helpful, I think.

Other ideas such as whether there are ways in which the Board could create greater transparency for grain shippers regarding how rates are set. In my younger days starting as a teenager, I hung out at the ICC tariff room, I spent many hundreds of hours --

CHAIR MILLER: You are a wild one.

MR. FAUTH: In the ICC's tariff room and the ICC's reference room, working for my dad as a teenager even, Christmas and summers. I was able to go in the IC tariff room and look at any tariff I wanted to and pull out and study and analyze the tariffs and I did. And until recently I was able to go to BNSF website and look at their public, their quote "public available rates." I'm no longer able to do that. After forty years of looking at public rates, I'm not allowed to look at public rates anymore. You've talked about it and the railroads have sort of had said well that, they're there and we'll walk you through the process, but I went through the process, I registered on the Board's, the BNSF website, I'm a registered user and I have a password, but I still am locked out of looking at the rates. And if you go on the website, they have a little lock on those tariffs and it's there for a reason; it's only available to who they want to let look at the rates and I'm not one of those people.

So I urge the Board to have transparency and make publicly available rates publicly available. I'm not able to see them anymore, so. Anyway, that concludes my remarks; I think John will have a little more.

MR. CUTLER: Thank you Terry. Let me begin with some preliminary thoughts about this morning's TRF presentation. First, I thought it was great to hear some of the economists talk about fairness; I rarely hear economists recognize that of any interest what so ever in a regulatory context. And the TRF guys did, it was very refreshing. The second thing I noticed is I didn't hear any support from TRF for differential pricing of captive traffic. Now, ARC has argued for a long time that with revenue adequacy achieved or imminent, there's no longer any justification for captive shippers and producers paying more than non-captive shippers and producers; thereby experiencing a competitive disadvantage in their markets. TRF of course, ignores revenue adequacy completely but that's because they have the luxury of ignoring the statute and the rest of us have to try to figure out some legal way of getting from where we are today to a brighter future.

For us, the achievement of revenue adequacy, particularly in the context of co-rate guidelines constrained market pricing and the ICC's promise in 1985 that once revenue adequacy was achieved, that's as much money as a regulated entity should be able to recover from captive traffic through differential pricing. Now, for us, the attainment of differential, of revenue adequacy is a hinge point, a huge hinge point in regulation of railroads, because for decades now our feeling has been that as to service issues, as to revenue adequacy definitions, as to mergers, as to paper barriers, and certainly as to rates. Over and over the benefit of the doubt has gone to the railroads for understandable reasons, because Penn Central bankruptcy, late seventies, concerns about the fragility of the entire industry, the importance of the industry, the feeling understandably enough even though we kept losing case after case was, okay, benefit of the doubt goes to the railroads because they need more money.

If shippers have to be gouged a little bit, presumably the railroads aren't going to overreach, they're not going to drive their customers out of business, but there needs to be a new look at this whole approach to railroad regulation. Because we've reached the point at which after thirty years of funding, along the competitive shippers, the revival of the railroad industry into an industry that's now has a huge and extremely bright future, making a lot of money, five railroads revenue adequate in the last analysis. Particularly, the major grain hauling railroads seem to be doing the best of all. We've felt for a long time that the time, the Board in this proceeding and in ex parte 722 and as the years go by, because let's face it, we don't have an NPR on our hands, we have an inquiry.

Nothing has been proposed for action by you or for comment by us other than sort of, what do you think about grain rate regulation today and what do you think revenue adequacy means? We're talking about a span of two, three, four years during which these issues are grappled with; and our guess is that as those years go by, not only we'll be looking at railroads achieving revenue adequacy, we'll be looking at railroads exceeding revenue adequacy by greater and greater amounts. During which time captive shippers continue to be subject to a really inadequate selection of remedies, two of which are just prohibitively expensive, SAC and simplified SAC. Three benchmark, we've talked about before. One more point about the TRF.

It sounded like they might agree with us that the R/VC comp benchmark should include all rail traffic, not just captive rail traffic. Why? Because they don't see any reason for higher prices on captive traffic than on non-captive traffic. Well, if the ideal is for captive rates to match competitive rates, they why in the world would you want to restrict the R/VC comp benchmark to captive traffic? In fact, and also why would you want to restrict it to a single railroad? In fact, if you compare one set of rates controlled by a monopoly railroad with another set of rates controlled by that same monopoly railroad, isn't that pretty much of a stacked deck? Can't the railroad control the answer to the question?

Also, to anticipate the possible question from the Board, bear in mind that the R/VC comp choice made by the shipper is going to be counterbalanced by the R/VC group developed by the railroad and you are the ultimate deciders of which one is preferable. Now right now, it seems to us that we are limited in our ability to look at the universe of possible competitors and offer those as our R/VC comp for you to say yea or nay. I mean, a lot of freight can't even be on the table, whereas if you allowed us to offer rates below 180 percent or rates of a competitor and the shipper went too far, tried to suggest that totally dissimilar commodities or totally dissimilar circumstances or totally dissimilar rate levels ought to dominate the rate comparison; you would be in the position to say well, this is ridiculous, we're not going to treat those rates as comparable.

But suppose the shipper is in a position to say, look, BNSF and UP have a very similar cost structures for the rates in question. Or we're suggesting that because UP's rates are a little bit lower than BNSF's, not wildly lower, but a little bit lower; but the BNSF shipper or producer that I represent is losing business because of that disparity. You would be in a position to say well, in this circumstance, maybe a broader definition of the R/VC comp component of the three benchmark test ought to be broadened a little bit. So I guess that would be, that's part of my thinking based on TRF and let me hedge that by saying that like everybody else in this room, I haven't read the report. Very curious about what it says, very curious about what the rationale is. And to say that this is how it should work if we had a clean slate to work on; but it has to be fixed by Congress, well all of us who live in Washington know how likely it is that Congress is going to fix this real soon. You can't even get as highway built through Congress these days; some of the most basic functions of government are not being covered. But the other question that crosses my mind and I'm running out of time so I'll try to speed through this. You've heard railroad after railroad say we don't, we set our rates in order to enable captive shippers to remain viable competitors for non-captive shippers. Well, if that's the case, why all the resistance to a more relaxed approach to rate regulation for grain? Grain is subject to all these forces that the smallest shippers, the most isolated shippers need some help with. The railroads say, we tried to give them some help; but what they're really saying is, we want to dictate how much help they get, we don't want the shipper to have regulatory recourse if there's a dispute.

I mean, they say the door's always open, we appreciate that, and we appreciate the service that the railroad industry provides; but there needs to be, as you have said a couple of times, Vice Chairman Begeman and as you reiterated, Chairman Miller, the issue here is not are rail rates too high. The issue is on those occasions, no matter how rare they may be, on those occasions where a grain shipper, particularly a small grain shipper or an isolated grain shipper has a serious dispute with the railroad, is there a regulatory remedy? Not talking to the marketing department of BNSF, is there regulatory recourse?

Now, this doesn't mean a lot of rail rates, freight rates, rail rates are going to be challenged; but what the big difference is that in negotiations, the captive shipper has leverage. Maybe not a lot, but at least it has more than none. The captive shipper will be in position to say, look I'd like to work this out with you; if we can't do that I think I have a remedy under the three benchmark test as expanded in ex parte 665 Sub 1, and I'm going to pursue that remedy. Maybe we should talk a little bit further, maybe you should give a little bit more. Today, that shipper doesn't have that remedy and that's really what we're asking for in this proceeding. Thank you.

CHAIR MILLER: Thank you very much. Ann, you want to start?

VICE CHAIR BEGEMAN: Whoever wants to may answer this question. About the 3B process that the Board has for the smallest cases, the most simplified process that we have. We talked about it a bit more this afternoon than we did this morning. It's been used -- I thought it was around five times, seven times apparently based on what the last panel mentioned, but, why does 3B not work for frian shippers? I mean, why doesn't it work for grain if it works for a chemical shipper? It seems like there --

MR. CUTLER: I think part of the problem is the restrictions on the comp group; but the other is even if --

VICE CHAIR BEGEMAN: As they apply to the other commodity as well?

MR. CUTLER: No, I'm saying, for the smallest shippers, there's a resource problem, they don't have a lot of money. It's difficult and you have to hire lawyers and experts to try and figure this out. This is one of the reasons that we proposed eliminating the R/VC comp test entirely once the railroad becomes revenue-adequate. There are two ways of looking at the R/VC and the three benchmark test. One would be to find and fix the outlier rate. There are lots of shippers paying lots of rates and most of them are here and one of them is here. That person could use the R/VC comp test to attack his individual rate but we're talking about rate structures for grain. So an entire state or entire region may be paying essentially the same rate. Now, I think in that kind of situation, the R/VC comp benchmark tends really to be the way for the railroads to look at our RSM level, look at the R/VC 180 level and layer on top of that as much differential pricing as they think they can get away with. As I said before, once the railroads attain revenue adequacy, it becomes a question of whether any further differential pricing should be allowed. This may be more of an ex parte 722 issue than for here. But for grain, it's particularly important because grain shippers are in this category of having an entire structure work against them. Where if --

VICE CHAIR BEGEMAN: How is their structure different than a chemical shipper?

MR. CUTLER: It tends not to be an outlier situation. It tends to be, the railroad doesn't just raise my rate, the railroad tends to raise Montana grain rates across the state. And if the only potential members of the comp group are other Montana wheat --

VICE CHAIR BEGEMAN: I understand that part.

MR. CUTLER: Okay. Terry, you want to?

MR. FAUTH: I'd only like to add that despite the railroads saying they only look at the market and weather in Canada, I heard one railroad attorney say that that was one of the market-based things they look at. They play, in captive situations like Montana, they paid very close attention to the URCS cost and they know exactly how high they can push those rates. And I think that is proven by a case that Montana brought, it's a forty-eight carload case. I don't know if you're familiar with it. But where the railroads were setting rates to get below the fifty car trainload threshold, so they, the market based rates that they have certainly in captive situations, they paid close attention to URCS and they know exactly how high they can push those rate levels before they would get into a three benchmark situation, so. That's one of the reasons why there aren't any three benchmark cases. They're very careful to go just below that level to avoid those cases.

MR. WHITESIDE: And the R comps basically rise all boats; so you can't look around in the immediate area and come up with lower rates at all; they'll all be in the --

VICE CHAIR BEGEMAN: No, I understand that, but I would think that applies to other commodities as well. I mean, they can't go below 180, they have to be a captive shipper. I'm still lost on how grain is unique with respect to 3B, how 3B can work for others.

MR. WHITESIDE: Well, I'm back to the basic premise.

MR. CUTLER: It hasn't worked for very many people.

MT WHITESIDE: Yes. Back to the basic premise. They don't pay freight rate, they bear it. The first thing that the railroads went after in McCarty Farms was objecting to farmer standing in the rate case. We have the same issues that are going on now that they're the bearers of the freight, they don't pay it. So therefore, when you start looking at R comps, they're not paying those. They're bearing them, but they're not paying them. That's what makes the farm producer unique.

MR. CUTLER: Maybe the explanation is

that it's a bunch of things. So Terry --

VICE CHAIR BEGEMAN: So the elevator could do a 3B case, but the producer, the farmer, couldn't, is that what you're saying?

MR. CUTLER: Well, that's part of it, but I think maybe the way to answer your question, Vice Chairman Begeman, is it's not one thing. It's a bunch of things. You have the issue of standing, you have the farmer versus elevator issue. For the elevator, it may be an issue of if I challenge the rate at elevator A, I'm just shooting myself in the foot because the railroad will simply raise the rate at my elevator in the next county and I won't get anywhere that way. There's the concern about the rate structure problem.

There's the fact that in the US Magnesium case, the Board's decision granted relief, but the relief prevented the railroad from raising their rates above 350 percent of variable costs. Now if you say to someone who's paying 280 percent of variable cost, that the last time anyone won one of these, that was the point at which relief was provided. He's going to say, oh my God, this is hopeless. That means the railroad can raise my rate seventy points; I don't want to call attention to myself in that kind of situation. And you have market dominance, well in Montana you probably don't have market dominance concerns, but some shippers do. The Montana Department of Agriculture speaker this morning posed the possibility of a test case being brought, for example by the State of Montana on behalf of a group or a small or a large group of grain shippers.

That's the kind of thing that might get past some of these obstacles, create the perception among farmers that there's the possibility of this working. But you add it all up, not to mention McCarty Farms, and you have this perception that it's such a long shot, it's going to cost a lot of money, it's going to take a lot of time, market conditions may have changed by the time the decision is reached, and I think you add it all up and it's understandable frankly, that no one wants to go first, stick his head up and tackle this. There's always next year's harvest to get hauled by the railroad.

MR. WHITESIDE: We keep talking about Montana, but it's North Dakota, it's South Dakota, it's the whole northern plains. They're all in the same boat together and the, I think, the thing that we keep coming back to is, there is a process. If they had a process that would work, then they're in much better shape to arbitrate or negotiate. But right now, it's pretty tough for the small farm producer to be able to arise; you know we were talking the other day that this is all about profit on the farm. How much can they take? Every time they come up with an innovation and they're having it right now with the pulse crops. The rail rates come in, take more and more and more of it every year; and the reason for that is because they can. So they have no way of being able to isolate that crop and take that profit for themselves, which is what they produced.

VICE CHAIR BEGEMAN: Mr. Fauth, I think it was when you were talking about the Grain Cost Adjustments Factor or maybe it was stemming from the, what's it called?

CHAIR MILLER: The market?

VICE CHAIR BEGEMAN: The other cost adjustment factor that you were asked about, you mentioned that folks are barred from getting in the door here from bringing a case. To what extent?

MR. FAUTH: Well, if you look at --

VICE CHAIR BEGEMAN: You need to be market dominant but --

MR. FAUTH: Well, the single car --

VICE CHAIR BEGEMAN: -- would the adjustment be -- I would assume it's a small percentage.

MR. FAUTH: If you look at single car traffic of wheat for example, most of it will be under the jurisdictional threshold, because of the costing problems, so simply they, the traffic is quite profitable but according to your costing approach, they're losing, you know, they can't go over 180.

VICE CHAIR BEGEMAN: But how much of a swing?

MR. FAUTH: Well, I don't know; it depends on the --

VICE CHAIR BEGEMAN: But what I'm trying to understand is, are you saying that someone, at least from your perspective --

MR. FAUTH: How much traffic --

VICE CHAIR BEGEMAN: Is it really at 190 so they should get in, or are they at 500 over variable cost? How extreme?

MR. FAUTH: Well, the most important thing is they're below 180 and they can't get in, so if you can't get in under 180 and there's a --

VICE CHAIR BEGEMAN: Well, you must be assuming that otherwise they could get in but for the fact that they're not able to make the adjustment?

CHAIR MILLER: Could I ask a question,

because maybe I'm not understanding correctly either. I thought what you were saying, I thought part of the point that you were making is that a lot of the grain rates are showing up under 180 but you would argue that in fact, they're more costly than that and it's just that URCS isn't fully costing the grain?

MR. FAUTH: They're less costly than that.

CHAIR MILLER: Oh, they're less costly, excuse me.

MR. FAUTH: Because the R/VC ratios, they're more efficient than is reflected in the Board's costing approach.

VICE CHAIR BEGEMAN: So "how off is the costing approach" is, I guess, what we're trying to understand.

MR. FAUTH: I think the railroad put up a graph comparing the trainload rates and the multiple car rates and said there was like thousand car per car difference, but in reality, the shuttle trains are very efficient and much lower costs and the multiple car and the single car movements are lower than to a certain degree, but I mean, a lot of these traffic, a lot of this traffic moves in efficient trainloads and it's not like a multiple car of plastic pellets or hazardous materials or anything else.

It's very efficient and it's not treated, that efficiency is not reflected in the URCS adjustment, so the only adjustments that you make are the 25 percent. You take 25 percent of switching for trainload movements and 50 percent for multiple car movements, then you add that back, the 50 percent back in the make-whole adjustment, so. The multiple car shippers really what's taken away is added back with the make-whole adjustments. Now the trainload shippers, they often have no switching at all, but they still get 25 percent of the switching costs allocated to them, whereas these trains are shuttle trains with the same locomotives and a lot of times the shuttle facility will do any switching that's required. So there are a lot of economies and car costs that are reflected. I don't know, I haven't done a study on how much traffic should be jurisdictional, but I --

VICE CHAIR BEGEMAN: Maybe I can ask it in a different way or we could just move on, but at what point do you envision an R/VC ratio would need to be to prompt a case?

MR. FAUTH: Well, it certainly probably has to be over 180 but I don't know how far off --

VICE CHAIR BEGEMAN: I think I knew that.

MR. FAUTH: I don't know how high is up on that. I can't tell you a number. But you know, in the 300 range maybe that you would consider a case, 250, I don't know.

MR. WHITESIDE: Let me try something. Let me, simple view for me. You take a twenty-six car unit and they put them together, which has make-whole adjustment applied on it, which means that the R/VC's are low. And they put it together with three other 26's and they move it as a 98 car movement, which is what happens. The economics are really shuttle train economics once it's been put together in Montana or in North Dakota or in South Dakota. So what's happening is that there is no way that you'll see those with the make-whole adjustments that you'll be able to see and not being able to adjust some of the URCS costing.

It's almost like a single car, it would be like having a locomotive and a single car going all the way to the coast. That's what it cost as, but that's not really reality. And so if you have two 48's, they put them together, away they go. And somewhere in the state they get put together, from then on, they act like a unit train. That's one of the issues with trying to get, and that's one of the reasons why we wanted to talk about the possibility of putting together adjustments, because we know that's what's going on. They don't take 26's all the way to the coast, never seen one. Go ahead.

MR. FAUTH: I was just going to say,

lots of multiple car shipments or even single car shipments, go to the same destination; so they all may be going to Rivergate. It's unlike plastic pellets or anything else that could go to multiple different destinations on the train. So when these things go over the mountains, go down the Columbia River Gorge, they're all on the same train going to the same place.

MR. WHITESIDE: But the URCS ones just don't show that. What they show is it's as if this 26 goes all the way to the coast with a locomotive; it's not how it works.

CHAIR MILLER: The costing in URCS makes that assumption, basically?

MR. WHITESIDE: Right. It is late in the day and I think you guys have done wonderful. I want to compliment the staff, they've done wonderfully today, too.

CHAIR MILLER: They stayed awake.

VICE CHAIR BEGEMAN: All the folks out here are helping keep this going.

CHAIR MILLER: Can I go back? I'm

sorry, maybe it is just because it's late in the day because I'm sure yesterday when we were talking about this stuff, I knew the answer, but in your proposal when you're talking about 2B, what makes it the 2B over 3B as it's the R/VC comp test that you're removing? Is that correct?

MR. FAUTH: Right.

CHAIR MILLER: And --

MR. FAUTH: Just for revenue-adequate railroads on the long term.

CHAIR MILLER: Is this correct, part of your argument is that for grain shippers, that doesn't help them very much because the rates are being set on a statewide or a region wide basis, so everybody is at the same rate?

MR. FAUTH: Your R/VC comp test doesn't help then.

MS MILLER: It doesn't shed any light or show a different sort of rate.

MR. CUTLER: But without the R/VC comp bench mark you're dealing with two numbers that the Board produces every year. It couldn't be easier.

CHAIR MILLER: Yes, so you're saying it also simplifies it --

MR. CUTLER: Yes.

CHAIR MILLER: -- and takes any argument out.

MR. CUTLER: Yes

CHAIR MILLER: It is objective.

MR. CUTLER: Once again the Railroads, this is where the Railroads argue that we're simply trying to drive all the Rail rates down to whatever RSM is, but the fact of the matter is as you said at the outset, Vice Chairman Begeman, farmers don't want to hire lawyers and litigate. After they complain a little bit, they want to figure something out in a reasonable way and that means some give and take but if they are looking only at the SAM number and the R/VC 180 number that the Board gives them every year for each railroad and they think their rate is way out of line with those two numbers out of their two benchmark tests, then they have some bargaining leverage to sit down with the railroad and say, look we know you guys have to make money too, we appreciate the service you're giving us but how do you justify this disparity.

VICE CHAIR BEGEMAN: I appreciate the chance, that you have prompted me to correct any misimpression if I left it, I really was kind of teasing --

MR. CUTLER: Yes, we understand.

VICE CHAIR BEGEMAN: -- but it is true.

MR. CUTLER: We brought a farmer here.

VICE CHAIR BEGEMAN: Well folks, their first choice is not to hire a lawyer--

MR.CUTLER: Yes.

VICE CHAIR BEGEMAN: -- that's probably their last choice, beyond their last choice even.

MR. CUTLER: Pretty much their last resort.

VICE CHAIR BEGEMAN: They have a farm to run.

MR: CUTLER: Yes.

MR. FAUTH: Can I make one more point about the two benchmark and the RSM for revenue adequate railroad eventually if they're long term revenue adequate would be necessarily below 180. For example, BN's most current RSM would be I think 177 because you're allocating the surplus to the traffic over 180 group but in reality the rates could never go below 180. So or you could set the rates to 177 and the end could increase them to 180. So there's a surplus there a benefit there built in too under the three benchmark that although their RSM might be below 180 the rates could never set below 180.

VICE CHAIR BEGEMAN: Mr. Whiteside, if I could just ask you this question because you're from Montana. I was really surprised to hear the extent to which the Montana BNSF arbitration program covers 90 percent of all of shipments there. I'm curious if you know -- they mention a case maybe in 2009 -- and perhaps you're not personally familiar with it, but whether or not some of your folks you hang around with are or?

MR. WHITESIDE: Look, I don't want to get in political trouble --

VICE CHAIR BEGEMAN: That's a good idea.

MR. WHITESIDE: So, but I think the thing is what's interesting to me about that process is the fact that the Burlington Northern sat down with the growers and made it work. It has a standard that starts well above 180, you can't even challenge them either it's 220 or 225 under that system, but I was impressed with Mr. Miller today in talking to NGFA about their process. I think we're going to end up with an arbitration process for grain over time and I think that's important but I think what's important from our standpoint is that two benchmark would at least them a regulatory backstop. So I think the process, the railroads have spent a lot of time trying to work out this process in Montana and for that you just got to pat them on the back because they've done well.

The two organizations, I don't think represent 90 percent of all the farm producers but what you were saying was 90 percent of the traffic ---

VICE CHAIR BEGEMAN: Yes.

MR. WHITESIDE: --- and all of those farm producers can go ask and become involved. And I think that's accurate, so it's unique it's a start ---

CHAIR MILLER: Uh-huh.

MR. WHITESIDE: You know I mean and we'd love to see it down here at the Board. One of the things the Board can do is provide guidance in that process over at with BN moving at NGFA, they can provide guidance to an arbitration process that would be encouraged here. I do think that voluntary arbitration proposed up in congress coming down here is just ridiculous. Voluntary arbitrations won't work they got to have some kind of binding process to them at some point. But mediation arbitration who knows if we can get it working over at NGFA then yes, we might be able to get something done over there. So that was kind of the bright light today when NGFA suggested, wouldn't tell us who and then BN volunteered that it was them. So I think that's a good start and it's going down the path.

MR. CUTLER: It's been a long time since I looked into the BNSF Montana arbitration program in detail, I do think they have been some questions raised about the specifics of that particular arbitration program and we have some time, I'll see if I can find any further information for you on that.

VICE CHAIR BEGEMAN: I'm not looking for trouble ---

MR. CUTLER: But it's very interesting to hear that ---

VICE CHAIR BEGEMAN: --- looking for good things.

MR. CUTLER: The NGFA arbitration program has been a big success dealing with everything other than rates.

ACTING CHAIR MILLER: Uh-huh.

MR. CUTLER: The possibility of its being expanding to cover rates was some of the suggestions that you've heard today for tweaking is very appealing and we're all I think interested in seeing where that might lead. But one more thing about arbitration I think it was Mr. Hitchcock who said you can't really talk about arbitration without talking about the standard that the arbitrator's going to be using to try to decide the case. Now if arbitration was to be based on SAC it would mean no progress whatever ---

VICE CHAIR BEGEMAN: Uh-huh.

MR. CUTLER: -- because we would have to back up truckloads of data for our poor arbitrator to try to figure out and then hire your staff to help him understand ---

VICE CHAIR BEGEMAN: They're not available.

MR. CUTLER: Yes, so with that caveat, I think the idea of expansion of a well-established popular successful NGFA arbitration program covering grain rate issues has a lot of natural appeal.

VICE CHAIR BEGEMAN: Thank you, great.

CHAIR MILLER: Thank you, thank you all.

MR. WHITESIDE: Thank you guys, appreciate it.

CHAIR MILLER: We need our last panel to come up and I think we probably need to take just a few minutes break so our poor court reporter can take just a little bit of a break and make a phone call. So the panel come on up and we'll wait until our Court Reporter's in place and ready to start.

(Whereupon, the above-entitled matter went off the record at 5:38 p.m. and resumed at 5:46 p.m.)

CHAIR MILLER: Okay, we are on our eighth panel.

MR. MACDOUGALL: Let him go first otherwise, if I go first, I won't want to listen to him.

CHAIR MILLER: We're enforcing discipline on you.

MR. MACDOUGALL: I spent a whole day down there learning things.

CHAIR MILLER: Yes, if you spent the whole day you might well as just keep going right? Alright, so we have Mr. Kaufman from the TTMS group who's going to lead us off.

MR. KAUFMAN: Thank you, Madam Chairman. My name is Kevin Kaufman I am the Managing Director of TTMS group which is a DBA which is Texas Trade and Transportation Services from South Lake, Texas, it's a little consulting group I formed after I left BNSF in February. I have kind of a unique background actually, Commissioner Begeman and I have known each other for a long time, back in 1995, there's the ICC Termination Act and we were involved with that.

CHAIR MILLER:: You weren't buddies at that point, at that time.

MR. KAUFMAN: No, I wasn't a buddy I worked for a shipper, I worked for a large shipper Dreyfus Corporation, I worked for them for 25 years and we were involved, just in the transition that was going on because it was important.

VICE CHAIR BEGEMAN: Nobody was my buddy during that time, I think that's what he's saying.

MR. KAUFMAN: From that you know they formed the Rail Shipper Transportation Advisory Committee and I was a charter member of that and served there for six years so I had experience with that which was great and then after that about 12 years ago I went to work for BNSF. So I'm sitting here before you with kind of a unique set of credentials I've been an ag shipper, a large ag shipper for a multinational. Worked for a large Class I railroad is the head of agricultural products, the V.P. of agricultural products and then now I'm representing producers as one of the people our group work with and my fellow partners are Loch E. and Dan Kidd from Montana and we got to know each other about ten years ago when we started working on these problems in Montana. We were very much involved with this arbitration process in Montana, so I'm going to speak about that a little bit later.

I'm representing US producers and they really have the largest economic interest in this hearing. I don't agree with Terry Whiteside very often but the fact in the matter is ag producers, for most of the history in the grain industry that I've been part of for 35 years, have been price takers which means that in the business of agriculture and agriculture economics as price takers, they basically pay the cost because in a supply push market, basically the international world of agriculture sets prices and then the logistical supply chain works backwards and all the costs get passed onto the producers. So the producer pays for it and so when he brought up the point that shippers pay the freight but the producers bear the cost, that's absolutely true because in the world of agriculture and it is a bit of a conflict of interest when the ag shippers stand up here and talk about rates, the reality is they are all pass throughs for them and their pass throughs to the producers. In a hypothetical situation, for instance, if an ag shipper brought a rate case and it's no coincidence that an ag shipper hasn't brought a rate case and McCarty farms was producer based not ag shipper based, an ag shipper wouldn't necessarily if he won a rate case, pass the winnings, as we want to call them, back to the ag producer he'd probably pocket them and that's just the way the grain industry works, right?

The fact of the matter is and you have a copy of it in your files. North Dakota State University did a study of it about five years ago that proved that actually margins of the elevator charged by the ag shippers was actually grew much faster pace than rates from the railroads. You have a situation where rail rates have increased over a period of time and actually less than you would expect because of productivity but at the same time, elevator margins in some cases have trebled in that same period and most of the reason is because we're dealing with a duopoly in the ag shipping group.

In fact, if you take the HH index that the Justice Department uses which is the Herfindahl-Hirschman Index you'll find that ag shippers actually exceed that index in some regions of the United States and so it's always interesting to me that they were testifying about rail rates when the reality is that they probably have more price taking power from the producer, than the railroads have had in the past or will have in the future. So I find it interesting that they're advocating on the basis, talking about railroads and advocating changes in your process where the fact is they don't actually need the process because it's a pass through for them. I find that interesting.

Shippers and producers are pretty smart and they are less interested in rail rates and more interested in service because in the case of, for instance, last year the cost that producers bore because of poor railroad service far exceeded anything that had to do with rates. Then on top of that, when you sit there and talk about well, let's talk about rates in the same context of service to me it's a little bit bass ackwards because in reality increase in rates will never increase railroad service, it's just economically not viable. So in reality when we talk about rates, yes producers have a real interest in transparency because they really do want to understand their costs and what they're paying for and what they're bearing but for them, it's about having reasonable rates that they could understand but more importantly they want to have service they can rely on because if they lose markets, they are absolutely in a bad way.

Now in the case of Montana for instance last year, last year when we had all these service matrix with the Northern Plains and you guys went out to Fargo for instance, in June and held a hearing, the interesting fact is because Montana was kind of west of where the real bottlenecks were in the BNSF shipping patterns. The Montana producers in almost no case where the shippers had any problems with service during that period and in spite of being grain piles being alleged to be caused by poor service those actually were the result of poor Canadian rail services so the Canadian farmers sent their grain to Montana and it sat in piles in Montana. That's another subject about taking markets away for the Montana producers because of poor rail service but it had nothing to do with BNSF' poor rail service in Montana.

When we talk about these things there's a lot interconnecting facts and realities that are going on between shippers, producers, the entire logistic supply chains, back it all the way up from the People's Republic of China, wherever the destination is. It influences what these costs are and it's one of the reason why as an expert, I guess in the grain industry and generally global transportation, I just wonder about how and what your job really is in the STB as far as to oversee agriculture rates because it's really complicated. The railroads talk about market pricing but the reality is, and if you look at the USDA study I think that they put out in February where they were talking about looking for a relationship between rail rates and commodity prices, there's very little correlation it's very hard to find these correlations. If it was easy, the grain industry would have done away with hundreds of traders that they pay billions of dollars to, to trade this stuff to make money and instead they sit there and come up with an algorithm and push a computer every day to decide how are they correct trade cash grain against cash futures and how they are going to involve their transportation costs and apply it across the whole spectrum to make money. They don't, they use people. So it's really hard to come up with the idea that we're going to somehow pull something out of the sky that's going to allow us to somehow simply, and I hate this word simply, analyze rates, put them in some sort of context based on a formulary one size fits all process and somehow do no harm.

So let's talk about the Montana arbitration. I'm a big advocate of arbitration and you know that because when we started with the restack one of the first things we put out from restack is a recommendation in fact the base of the arbitration provision within the STB today came from myself and Andy Goldstein who wrote them coming from restack. Now they've been bifurcated and changed and they don't look at all what we originally proposed, but we started with that process with arbitration for ag because it's so complicated.

So in the case of the BNSF in Montana, why arbitration? Well for one thing Montana really is unique, it is really probably the only place where economically you can make the argument that it really is a captive shipping area. Most other places you can say they're single serve, the UP put up that lovely slide of Iowa but in reality there's all this market competition because people forget if there's a ethanol plant, if there's a crush plant, if there's a whatever, all a farmer has to do is put their grain on a truck and truck it to the best market and farmers are really smart, they truck it to the best market. In Montana, it's a little bit different because God put Montana where it is in the United States, there aren't a lot of markets. There's no crushing facilities that I know of, there's no ethanol plants that I know of, it's mainly a wheat producing state. There are some mills, there's one in Great Falls but there's not a lot of milling demand so most of them go for export. If you want to use that economic definition, they are kind of captive.

When we thought about this, we thought, who legitimately should worry about how there could be market dominance by the railroad and control their pricing. It was Montana so we negotiated with them, which is when I worked with BNSF to create an arbitration process that really works. How do you know it works? There's never been one arbitration in this process in Montana, there's been three or four mediations but there's never been an arbitration because it was mandatory mediation and it's really, really simple. How does it work? Producers think that he's getting a bad deal from his local elevator. He can't figure it out why but he thinks it's because of rail costs, he can go to farmers, to Farm Bureau or Montana Grain Growers and say, I think I've got a bad deal here.

Now the beauty of this is, both Grain Growers and Farm Bureau have a stake in the game and seen that it works and it's legitimate. They don't want somebody just saying, hey I don't like the railroads, let's go ahead and file a rate case. Farmer comes in, proves his case, they say fine, they call up BNSF and they say we have a legitimate case here we want to mediate this and that's exactly what happened in the case of Shelby. For whatever reason, we, I worked for the railroad at that time had screwed up with the rate mod in Shelby. The rate in Shelby was out of alignment with all the other rates in highline. They're all related, all of the rates are related because of the markets they compete with. I don't want to get into grain 101 but the drawing arcs for all these elevators compete for truck grain from these farmers so there's always an economic relationship with all of them.

So you can't change one rate and not change a bunch of rates and that's what makes rate cases so tricky because if you change the rate for XYZ elevator, you've suddenly put the elevator down the road at a competitive disadvantage. What does he have to do now? He's got to file a rate case too, otherwise you've ensured that he's got a competitive disadvantage for whatever the length of time that the prescription lasts.

In the case of Shelby, it was legitimate, it was out of alignment and so we sat down we recognized it was out of alignment and we immediately changed it. We've had other mediation issues or BNSF has in Montana where these things are resolved but in most cases people when they're put into a situation where they could have a reasonable dialog and there's a structure and you can read this arbitration, it's ten pages long, it's not super complicated. I listen to some of the other railroad attorneys talking about you need to have standards and all this kind of stuff, you know what, you do need to have certain rules and you do need to have some sort of parameters but it doesn't have to be overly technical. When we're talking about ag, we're talking about relationships between your elevators, we're talking about relationships between transportation, we're talking about relationships among commodities you can't just tweak one and not affect the whole thing and so you really do need an expert or somebody reasonable sitting at the table that understands agriculture so they can sit there and say, you're right it doesn't fit, oh but if we change that it's probably going to affect those markets.

What happens many cases when you get

together on these things, you don't just change one rate you have to change 5, 10, 15 rates all the rates that are related you have to do it across the board. So it's not simple it's very, very complicated.

Now, who's done this really well, National Grain and Feed has done it for a hundred years, has done it really well. I have always asked myself, why won't the rest of the railroads agree to arbitration under an existing formula that exists with National Grain and Feed, they have rail shipper arbitration. The existing arbitration is about what the rules says not about the rule. In other words, if they all agree that the rule is X you can arbitrate the rule but if the rule is stupid like for instance if you have rules tariff at the railroad and it's really not very good, let's take for example the case, reciprocal switching cost with the eastern railroads. Let's just pick a number that says $550.00 a car, you can't arbitrate that. If you could, you would let out the gas out of a lot of tires because suddenly people would feel like there was some sort of judicial review and the process already works.

They've got expert arbitrators within the whole organization, so they sit there and today in National Grain and Feed, of course, it's all voluntary and so you've got peer arbitration. Well, if you include railroad arbitration, you are going to go through in the railroaders too, on top of that, you are going to have peer review. Now, you and I can play the games of how you pick the arbitrator, pick one from this list one from that, if you don't agree, you get to pick a third one, whatever. Have five arbitrators, have three arbitrators that's not a big deal the hard thing is to have arbitrators that actually know the business they're arbitrating and so that's what producers, when we think about this, are really worried about.

Maybe your rate is too high, but remember the United States is the envy of the world for shipping agricultural products within this country by rail. We have a 45 to 60 dollar a metric ton advantage over Brazil. I get it that there are some problems. I get it that there needs to be judicial review so that people understand the process and I absolutely agree with you, that there needs to be some sort of transparent process so people don't feel like they're getting a bad deal. Remember, we've got something that already works.

So to me, the issue is, how do we do this without making something worse? Okay, URCS is screwed up, great at least we know what it is. I hear sometimes Montana complaining my gosh, 180 percent we got single car shippers and why don't you bring a rate case because they're at less than 180 percent. Oh, well somebody's been following the rules is that a bad thing or a good thing? You can change the rules but you have to be careful that when you change the rules, you don't make it worse. I guess what my point is and I think I've almost used up my time, I'm timing myself so that thing doesn't have to go beep in front of me.

My point is producers really care more than anything else about getting a square deal through the entire logistical supply chain. They do want some additional transparency, so they know what it is. But he biggest concern they have is not getting reliable service, because if they wake up one day and, especially Montana, if they lose that export market because the railroad, in the case of last year, didn't work for them but for instance North Dakotans, they suddenly couldn't move their grain to the west coast. It couldn't get there. That's a problem because when that happens, the price backs all the way back to the farmer, the basis goes from, make up a number, 25 under to 100 under because now what happens is the function of the market is to incent the farmer to store that grain and to hold it until the rail transportation is fixed, it's really costly.

So, for farmers, what we're interested in is reliable service. If we're going to mess with the rate structure and make it more transparent, yay, we do need judicial review but let's be careful about thinking about how we do that because we don't want to affect service when we do that and on top of that, we keep asking ourselves, why do we want to make a new thing when something that is successful already exists. In fact, the STB currently has arbitration provision, maybe we ought to examine some tweaks we didn't need to make to it, to make it a little more viable. Originally, when we proposed it to the STB, way back in I don't know must have been '98 or something like that, we thought it would work, ALJ's don't work as soon as they decided that they were going to make the arbitrators ALJ's, end of story.

If you have an arbitration, both parties have to believe in the arbitrators because whoever loses has to still say it was a fair decision that was rendered. An ag arbitration doesn't work with baseball style arbitration because it's too complicated. You need an expert who can actually render a decision that is economically reasonable. Baseball arbitration, sometimes you just get so desperate, you just want to get out of there and end it and it doesn't necessarily end with a good deal. So, that's kind of the end of my story about where we are, I hope I can answer some questions for you. I've been around this place for a long, long time. I think I sat at this chair four or five times, shocking, but I've heard pretty much some of the same things for 10 or 15 years. Thanks.

CHAIR MILLER: Thank you very much Mr. MacDougall.

MR. MACDOUGALL: I will be very brief, last time I was the last speaker at one of things the fire drill came so we shut down and I got a very short shift, which is good. I'm here on behalf of SMART Transportation Division the general committee of adjustment, the General Chairman is J.L. Schoemeyer and that represents the BNSF lines on the present northern lines. The case started back in the involvement of that time of year, to you, in this case, was when the chairman of the STB was in Great Falls, Montana on the Columbus Day weekend and that was a big thing for Great Falls chairman of the STB. They were bitching about the grain rates and Mr. Fitzgerald, at that time, was the general chairman of the UTU for the northern lines. He said well, you're all bitching about the freight rates, so the chairman said we're going to have a hearing. I'm going to open a hearing the next day that was the beginning of ex parte 665, that was October 11, 2006.

We want the system to work better. We haven't taken sides for what should be done about the grain rates. We do have some ideas and we filed four separate pleadings in this case since 2006. The most recent one, which I just summarized is we think you ought to have the rates before you. I question, and I've been in many rate cases myself whether you know freight rates you deal with ton mile earnings, you deal with R/VC's to make your decisions. We don't deal with freight rates and we suggest that you have an investigation into the grain rate structure. There's been two of them before, one of course after 1925 docket 17,000 cases and the second one in the early '70's under commissioner, I forgot his name, but the staff person was Leonard Goodman.

We need to understand what the rates are because what you deal with is a rate from point to point but as the last speaker just said it's the structure and you don't know the structure, you make decisions but still, you don't you know it and anybody that's been in rate cases for a long period of time realizes it. So you have very little credibility among the railroad people but you don't know it because you deal in 180. They question whether you know the rate structure and I would read Volume 345, 245, I think, 345 the ICC reports which is the last rate structure case and all the rates of the United States at that time, all the basic rate structure but if you just do the green one you'll find out more and the 180 meaning something a little different then ton mile earnings you'll realize that your report 10 years wasn't worth much. They use ton mile earnings and not the way freight weights are made, they taper, therefore they have grain rates falling when actually they had them rising for those years.

That's all I have to say and I said the thing was filed August 25th of last year, our recommendation is bring a grain rate structure investigation, so that you'll learn what's all about and not just dealing in figures that are manipulated. The average person in Montana, and I've only been there a few times, is interested in the rate. They're not interested in talking about 180, what are you talking about, ton mile earnings and you make your decisions and you don't discuss rates. You discuss 180's and all that and so I think it's time to review the rate structure and it shouldn't take too long, it has been done twice before this week you have some background to it and if you restrict it just to grain, it will be a lot easier because the last investigation was of all of the rate structures and it took several years.

CHAIR MILLER: Thank you very much, Mr. MacDougall and thank you for graciously being our last testifier today. So Mr. Kaufman, I am curious, clearly as your background shows and as your testimony indicated, you have a lot of experience in this area. I think what I could take from your testimony is that any changes we make we should be very careful and cautious and perhaps am I going too far if I say that you don't see the need for wholesale changes?

MR. KAUFMAN: I don't know, the fact stays and BNSF even testified to that, there is a need for judicial review, if nothing else, to let the air out of the tires to stop people from saying, my gosh, our rates are unreasonable and nobody cares. There does needs to be a judicial review process, I just think that agriculture by nature is so complicated that it's going to be really difficult to come up with a one size fits all structure, in order to evaluate it. I'm suggesting it's going to be really hard to come up with something. As much as we disparage the current system that exists, at least we know what it is and we know the harm it causes. That's always the problem when we dabble into new things. We think we are going to make it better.

It's kind of like back in my day when the USDA came up with the PICK program. I mean you have no idea what that is but they had no idea, it looked like a great idea to subsidize as an export, it has the subsidy but when it ended up doing is creating a marvelous new trading environment for train companies to make millions of dollars. It was just an unintended consequence. When you start messing with something like this, you just worry that it's going to make things worse.

The ag producers look at trucking. They're regulating trucking more and more and more and it's getting worse and worse and worse and more and more expensive. So the bias is always that if we fuss with something, it's probably not going to be cheaper, it's going to be more expensive.

Again, I really worry about the inverse relationship between rates and service. What I'm talking about is, you regulate rates, the railroads don't have to the serve agriculture, and in fact you have to understand agriculture is really volatile. One year, we got 7,000 cars that cost you know 75 or 85 thousand dollars apiece in storage. The next year hallelujah we got an export market. This year, we have a horrible export market and when you don't have an export market, it means we have all these stranded resources and stranded capitol because of it.

How is URCS going to take into account the volatility of ag? I remember too many anecdotes for you guys I know, but I remember sitting in a Minnesota hearing. This is when Roger was the chairman and each one of the railroads, except for the BNSF raised their hands and said we don't make any money shipping ag. You don't know but 30 years ago, the BN seriously thought about divesting all its ag businesses because they didn't think they could make any money at it. So when you look at agriculture and its volatility and its costs and how it works, you have to careful about fussing with it too much because somebody might say, it's not worth it anymore or we're going to change the game.

One of the reasons why US agriculture can ship the millions of tons it does by rail and if you don't pay attention to this you wouldn't know this, but the ag changes in ag shuttles to make it more efficient was led by the farmer because the farmer started to having to take because of yields increasing off the field they were filling up their trailer in the field every 15 minutes. They needed to be able to get it somewhere so it could be moved quickly. The whole development of ag shuttles is sufficient movement of grain out of Iowa and all across the board, has allowed the US to become extremely efficient exporter, not just by barge but by rail. You simply make it so that it's not in somebody's interest to efficiently move that stuff by transportation, remember each shuttle train is carrying 12,000 tons of grain. It only takes four trains to fill up a ship or five trains. You mess with that and change the economics so that it is no longer in their interest; you've created a lot of harm.

CHAIR MILLER: So is it reasonable to conclude that for the proposals that have been brought to us in this procedure where part of what the parties who prepared them are trying to do is to create something that was formulary that was predictable that had simplicity built in, again I don't want to put words into your mouth but I'm good at doing it so that's what I'm going to try to do. Would you say that just does not fit the complexity of the agricultural market and it's sort of a fool's errand to try?

MR. KAUFMAN: Give you an example, when they talk about trying to bundle rates, so we're going to compare like markets and competitive areas or something like that and we're going to compare CSX rates with BNSF rates to come up with a bundle, it's comparing apples and rutabagas. By doing that, you'll have a wonderful revenue transfer to the ag shipper because you're going to plummet rates. You're suddenly going to make the maximum threshold for a railroad, for instance to ship, you're going to cut it down to a point where maybe they're not making any money or enough money that it's even worth them to devote the resources to handling it.

CHAIR MILLER: Why do you say that's apples to rutabagas?

MR. KAUFMAN: So if you take the United States and you divide it at the Mississippi River, there's very little interaction market wise. It goes on between agriculture west of the Mississippi and east of the Mississippi--

CHAIR MILLER: Uh-huh.

MR. KAUFMAN: -- for instance, look there's no question that some Iowa corn moves east in the chicken markets but that's only in drought times or whatever. Where it doesn't work, most of the times stuff east of the Mississippi goes to --

CHAIR MILLER: Uh-huh.

MR. KAUFMAN: -- eastern markets or it goes down the river, now look I'm not including the fact that you know along the river there's a very strong drawing arc down the river for each side of the river but for the most part agricultural products don't cross the Mississippi River; look wheat goes from hard wheat from Kansas to eastern mill markets and stuff like that but just as a rule the bulk of the commodities don't. So rate structures in the eastern railroad is like the NS and CSX they're mainly receiver contracts or they're lottery receiver contracts, they don't have as one testified they don't nearly as many tariff based rates, it's a completely different market.

CHAIR MILLER: But what about BNSF and UP, is that a Gala to a Fuji?

MR. KAUFMAN: Yes, you could compare those rates but you know the situation you have if you look at the math, in most cases except maybe in Montana and parts of North Dakota the UP and the BNSF are within 200 miles from each other so if they get out of whack with their rates, farmers just puts in a truck and moves it to the other elevator, which is exactly what happened when the railroad BNSF was broken down on service last year. The UP you noticed their market share went up to the roof because they were handling much more grain. So the system flexes. When I look at these formulas, they're going to say well I'm going to mix all these things together and come up with a legitimate rate. I think one person testified, I think the UP, she did a great job but there's probably enough density of rates in each individual railroad, that if you're going to compare competitive moves, just compare them within railroads. If you have to do that, that may work. But, when you start reaching out, I'm sorry, but I think you begin to find that it's not simple anymore, it makes it complicated.

By the way, you don't think the people involved can game the process? You change the rules, everybody's going to also game the process too, right? So it's not as predictable as everybody thinks. We certainly learned that in the grain trade for the last 35 years, every time the US government changes the rules on the way grain trade is handled. Canada is another negative example. We're reciting, oh what a wonderful job the Canadian regulatory people have done. Well, I hope you take the time to look at what happened in Canada last year. It wasn't just because they had a huge miraculous crop, the railroads couldn't handle it but the regulatory things made it far worse. You want another anecdote, a little example?

CHAIR MILLER: Sure.

MR. KAUFMAN: The Canadian government mandated that they had to move so many tons. You have to move this many tons of grains per month, the railroads then just changed the thing so they moved it in little short distances back and forth, back and forth, back and forth, back and forth. Then what happened, they also said, oh my gosh, I have these cars back because I have to have this stuff moving so we're not going to let any of our grain go over Chicago anymore, remember?

CHAIR MILLER: Uh-huh.

MR. KAUFMAN: All the complaints, not going to go over Chicago anymore. So suddenly everybody wanted to use the BNSF to go over Chicago where the service was melting down. What did the BNSF do, they raised the rates over Chicago $500.00 a car. Everybody said, boo, boo, boo, you raised the rates $500.00 a car but it was because everybody only had one railroad that they wanted to use over Chicago, in order to get the grain to the eastern milling markets. There's always these consequences that nobody thinks about how they're fussing with it, it's and interrelated network business I'm sorry if it's complicated and that's why I'm an advocate of arbitration.

CHAIR MILLER: Can you say a bit more about, you made the point and I think you said sort of an inverse relationship between rates and service?

MR. KAUFMAN: Well it's about rate regulation not rates per se ---

CHAIR MILLER: Uh-huh.

MR. KAUFMAN: If you want to reduce it absurd if the railroad could charge infinity for their rates, their service would be marvelous. The joke, sometimes, is the railroad would operate perfectly without customers, right. There really is a relationship though when you increase regulation, it never increases service. Can you cite an example of where we increase regulation and somehow the cost goes down and service goes up, I don't think you can come up with a very good example. That's the problem I worry about, even well-meaning regulation, because it has the impact of somebody who has a choice choosing to do something else.

A perfect example is Canada again when they put in their regulation on export rates, where do you think the Canadian railroads invested all their money? Intermodal, petroleum, everything that wasn't regulated on the grain side. I know you guys haven't paid attention to this but there's a problem in Canada with the rail cars. When was the last time a Canadian railroad spent any money on rail cars? Most of the rail cars in Canada are almost 40 years old reaching their interchange life. That's a problem that still haven't been solved. Why? Because if you're getting incentive serving everybody else and you getting regulated to serve a particular thing, where do you put your investments? You put your investments where the best return is, so that's the unintended consequence.

Whereas, BNSF and I can't speak for them but I worked for them long enough to know the billions of dollars they're putting into their network is real. You're going to see there's going to be a long tail to this money from a ag service standpoint. They really were shocked by the poor service they had or the problems they had, which was at the very end of my tenure as leaving all of -- -

CHAIR MILLER: So you were responsible then?

MR. KAUFMAN: I absolutely was.

CHAIR MILLER: We can point our fingers at you, now we know.

MR. KAUFMAN: After I left they spent all this money to fix it, but you know it does work. At the same time, I'm not sitting here saying you don't need some sort of judicial review process because just like Terry Whiteside and the Montana guys were talking about, there are shippers that feel left out. As long as there are shippers that feel left out or farmers that feel left out, you're going to get complaints and so there is a legitimate reason to have some sort of process where people at least feel like they're getting a fair deal.

CHAIR MILLER: So let me ask this question then, we do have a process and apparently they still feel left out so what is it that needs to be tweaked in that process so that it feels more inclusive and available?

VICE CHAIR BEGEMAN: Can I interrupt just a second?

CHAIR MILLER: Sure.

VICE CHAIR BEGEMAN: I think it's more than just a feeling of being left out, I think that it's a reality.

CHAIR MILLER: Their reality.

MR. KAUFMAN: They are left out, I don't disagree, yes.

VICE CHAIR BEGEMAN: Oh, I was curious to know if you disagreed with that.

MR. KAUFMAN: No, I don't.

VICE CHAIR BEGEMAN: Okay.

MR. KAUFMAN: When I worked for the BNSF, why did we attack, I mean attack in a positive way, Montana so hard because it was clear that they had a legitimate beef. I don't mean to talk about the economics of captivity but they really are, in my opinion, the only state except maybe western North Dakota, that is economically technically captive from a transportation standpoint, they had a legitimate beef so we tried to fix that.

Again I can tell you another anecdote. Shortly after I worked for the BNSF, I went to Helena and met with these people. I was ripped a new one and I came away and I said, oh, there's something I don't know. One of the things I didn't recognize, the great epiphany was that it wasn't about the shippers, it was about the farmers. The farmers were the ones that felt like they were getting a raw deal, the shippers you know were treating the farmers like mushrooms like they usually do. So they didn't know really what was going on.

Then I discovered what they perceived the railroad was doing to them, was really negative and so we tried to attack it so it's real. I'm not saying it's a feeling but the biggest problem with ag is density. We talk about filing a rate case but even the most dense ag origins probably ship no more than 10,000 or 12,000 cars a year. So when you sit there and raise your hand and have some sort of case or judicial review, it's going to cost a million dollars. Forget that, let's pretend it's going to cost $100,000.00 and I might earn a million dollars. It's not worth it. Think about it, even if you ship 12,000 cars, what do I get I get a prescription for three years of my rate; what my rates going to be cut $100.00 per car, do the math.

VICE CHAIR BEGEMAN: Oh.

MR. KAUFMAN: That's part of the problem is the one size fits all doesn't fit very well for the way agriculture really exists. We talk about single serve places but there's a reason why they're single serve, there's just no density. The other side of it is again; a dirty little secret, do shippers really care about rates? No, what they care about is relative rates. They care about what their competitive elevator down the road is being charged. They don't care about absolute rates because it's a pass through. Unless rates are so egregious that it stops the farmer from planting a crop, they don't pay it. They're interested much more in relative rates and how the United States fits in the total global paradigm of agriculture. When you add those things up, it's really hard to come up with something that's going to be cheap enough to regulate rates in a way that's going to make it simple enough that somebody can get judicial review that works.

That's why I like arbitration because NGFA works with these same guys, these same elevators, big or small. Their cases cost less than $10,000.00 to prosecute and get a decision in six months. The process works. I truly believe if railroads were incorporated in some of that, you wouldn't have very much arbitration.

You wouldn't have issues that come up like reciprocal switch costs that go up in the east suddenly. You get a phone call that says, my gosh I'm being charged $550.00, $650.00 because somebody would say ooh I can't do that because somebody's going to arbitrate it NGFA. That's why I go that direction. As much as I love you, I just don't know if you can put together something that works. Even though, like you said, that's responsibility.

MR. MACDOUGALL: Well let me just say one thing, I think it wasn't mentioned but the shippers used to have a forum and it wasn't here, it was the rate bureaus. I'm serious, it was the rate bureaus and every week I used come down there in ICC it was published all the rate dockets. When there was going to be a hearing and a lot of things, the other railroads were there. So you had a railroad able to talk to other railroads that were serving other regions of the shippers, so this thing worked out. This existed from way back in 1880's. It didn't end until about the time of Staggers. It was rate bureau thing and those of us they had schools in Chicago, if you wanted to go into transportation, you learned the rate bureau procedure. It was a manual.

How you make out your proposal? They have one in New York as well Arthur Arshom ran that one there. They had one there. The decline of the evolution of the rate bureaus put greater burden on the ICC and on this agency because that initial review process was no longer legal. You could only go to your individual railroad. They can't put it on the docket and you can't go to a hearing. That used to be an important process. I recall when Volkswagen put up a plant in Pennsylvania, we had to go to the rate bureau in New York, DEA. That is where it was resolved to get the freight rate not to the ICC.

CHAIR MILLER: So Mr. MacDougall sounds like you're saying that we need to have more hearings.

MR. MACDOUGALL: Hearing?

CHAIR MILLER: We need to have more hearings so the railroads and shippers can ---

MR. MACDOUGALL: But you see there were discussing not just the point to point rate what you get with your percentages. They look at how that was going to affect, in other words, you could want a reduced rate on lumber from Coos Bay to Chicago but got to affect the rate from Hattiesburg to Chicago.

CHAIR MILLER: Uh-huh.

MR. MACDOUGALL: They all from different railroads but you're not getting that in your rate cases you're getting point to point with a formula and you're not seeing the structure and if you had a hearing, you might hear more other people might come in. But the evolution of the rate bureaus is what precipitated problems for small shippers because it didn't have a forum. Then they formed a forum, which didn't have to pay any money. They just go themselves and talk.

VICE-CHAIR BEGEMAN: I think that's one

of the things that prompted this hearing and the proceeding. We know the frustration out there for folks, --

MR. MACDOUGALL: I'm just giving you some background of these changes and it wasn't the Staggers Act, we had a hearing on the Staggers Act ex parte 653 or 658 and pointed out that all these things didn't come about it was the Staggers Act. The Staggers Act's only major thing was contract rates. All of that stuff was done before our act and the professors have written a book on that. So in the Staggers Act, in fact when I heard you were going to have this thing, I brought down the filings I made in the proceedings on the Staggers Act, which is instituted really by the late board member, Mulvey, he's the one that got the funding for the TRB and told him at the time, I said --

VICE CHAIR BEGEMAN: Former, not dead.

MR. MACDOUGALL: Former.

VICE CHAIR BEGEMAN: Former, not late.

MR. MACDOUGALL: Yes, it wasn't the

Staggers Act that was a propaganda stunt. They called it the Staggers because he was a labor guy and they wanted to blame the labor people for it. The Staggers Act didn't do these things, it was a minor little tinkering in the Staggers Act on market dominance and some other things but the Staggers Act after 35 years of using it after 25 years is a fake, for all this rate regulations. In fact, the ICC gave the railroads the contract rates but they wouldn't use it so the chairman of the ICC went down to Arizona, to the practitioner and said why you railroads are not using it, we gave you the authority. Well the real reason is what happened in the steamship industry. The Federal Maritime Board, at the time, said come on in here and prove your dual rates. The Supreme Court, Judge Black was there and he was on the Merchant Marine committee, or whatever was the Senate committee and knew all that he knew when steamships come to the FMC to be regulated with proof contracts rates, it was wrong it was an Anti-trust violation.

CHAIR MILLER: Well, Mr. MacDougall --

MR. MACDOUGALL: The railroad here said we're not going to use the contract rates until it had congressional approval because they weren't going to be like the steamship industry. The staff person they could study of contract rates in the United States, the had the sewer line and pipe rates in contract, New York Central had the Amsterdam New York thing but it took legislation and anything that was different than what the proposal was, it's secret the railroads had never wanted secret tariffs, it was their shippers that wanted it big shippers. They wanted to know what their competitors were doing so if the contract rates would pass it made it secret.

CHAIR MILLER: So Mr. MacDougall it sounds like --

MR. MACDOUGALL: Just some background, that's all.

CHAIR MILLER: Yes, I was going to say maybe we can follow up sometime. It sounds like you have history that I certainly am not familiar with and I'm sure I could learn a lot.

VICE CHAIR BEGEMAN: Well if I could just say, thank you. Really I think the hearing ended as interestingly as it started, thank you. I also thank the folks that have managed to stay here throughout this whole process. You know who you are. We can count you on about two hands but --

CHAIR MILLER: Blue ribbons will be handed out later.

VICE CHAIR BEGEMAN: Thank you all for sticking with us for the whole day and really thank you for sharing with us your perspectives. Kevin will keep figuring out a way to get the right answer.

MR. MACDOUGALL: Make sure to repeat on the record that that there are 14 days for their comments.

CHAIR MILLER: Yes the record is open for 14 days.

MR. MACDOUGALL: Because I don't think

the people just on the website will know.

CHAIR MILLER: Thank you all very much and for those of you who stuck with us thank you for hanging in there.

(Whereupon, the above-entitled matter went off the record at 6:35 p.m.)

E

J

S

C E R T I F I C A T E

This is to certify that the foregoing transcript

In the matter of: Rail Transportation of Grain, Rate Regulation Review

Before: US STB

Date: 06-10-2015

Place: Washington, D.C.

was duly recorded and accurately transcribed under my direction; further, that said transcript is a true and accurate record of the proceedings.

Neal R Gross

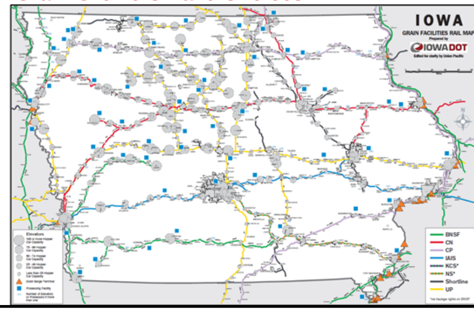
Court Reporter

June 10, 2015

Ex Parte 665(1)
Rail Transportation of Grain, Rate Regulation Review

Louise A. Rinn
Associate General Counsel

Grain Growers Have Choices



"Previous studies have concluded that many agricultural shippers have a range of transportation alternatives, that grain transportation markets are largely competitive, and that different modes of transportation often compete head-to-head to move grain." USDA Reply Comments at p. 3.

URCS Costs Do Reflect Grain Train Efficiencies

Trainload Costs 37% Lower than Carload

2013 West Region URCS Hypothetical Movement

		Trainload per car	Carload per car	Variance per car
1	Gross Ton Mile	$824.24	$824.24	$0.00
2	Locomotive Unit Mile	$378.38	$619.02	($240.64)
3	Carload Orig & Term Clerical	$19.06	$25.34	($6.28)
4	Carload Handled Other	$2.80	$2.80	$0.00
5	Crew Wages	$176.74	$271.16	($94.42)
6	Train Mile Other	$8.76	$13.45	($4.69)
7	Switching	$49.46	$321.51	($272.05)
8	Car Mile Running	$149.41	$149.41	$0.00
9	Car Mile Yard	$1.55	$5.05	($3.50)
10	Car Day Running	$76.32	$76.32	$0.00
11	Car Day Yard	$81.42	$264.61	($183.19)
12	Car Mile Running Accessorial	$3.67	$3.67	$0.00
13	Car Mile Yard Accessorial	$0.04	$0.13	($0.09)
14	Car Day Running Accessorial	$1.12	$1.12	$0.00
15	Car Day Yard Accessorial	$1.20	$3.90	($2.70)
16	Loss & Damage	$2.96	$2.96	$0.00
17	Ex Parte Adjustments - Make Wholes	$0.00	$245.64	($245.64)
18	Variable Cost Per Car @ 2013 Cost Level	$1,777.14	$2,830.33	($1,053.19)

Grain Can Also Cost More

- Longer cycle times for cars to Mexico
- Car storage due to variability and seasonality
- Fuel costs for export trains moving over Blue Mountains

Specified operating parameters: 1000 mile local move; 110 cars in train; railroad-owned covered hoppers; 95 tons per car

NGFA proposes a new maximum rate approach for Ag commodities -- The Ag Commodities Maximum Rate Methodology ("ACMRM")

1. ACMRM uses a comparison group approach similar to the Board's current Three Benchmark Methodology.
2. The comparison group includes rates for shipments above and below the 180% R/VC cost level.
3. The comparison group includes shipments from all railroads, not just shipments from the incumbent carrier.
4. The shipper would select all comparable moves that meet the selection criteria for the movement at issue from Confidential Waybill Samples.

NGFA proposes a new maximum rate approach for Ag commodities -- The Ag Commodities Maximum Rate Methodology (“ACMRM”) -- Continued

5. Comparability to the issue movement will be based on the following factors:
   a. Distance (+/- 20% of issue movement miles);
   b. Commodity;
   c. Railcar Type;
   d. Railcar Ownership; and
   e. Movement Type (originate/terminate, originate/deliver, etc.).
6. Even though the comparison group would include movements with R/VC ratios below 180%, the maximum reasonable rate produced by the analysis would be subject to the statutory 180% floor.
7. NGFA’s ACMRM approach *will not* allow for examination of “other relevant factors.”

NGFA proposes a new maximum rate approach for Ag commodities -- The Ag Commodities Maximum Rate Methodology ("ACMRM") -- Continued

8. The ACMRM also makes commodity specific adjustments to reflect each Class I carrier's revenue adequacy status.

The proposed ACMRM Revenue Adequacy Adjustment Factor ("RAAF")

RAAF = {[(COC – ROI) x RRIB] ÷ (1 – Tax Rate)} x (STCC Rev $_{>180}$ ÷ RR Rev $_{>180}$) ÷ STCC Rev

Where:

RAAF	=	Revenue Adequacy Adjustment Factor
COC	=	Railroad Industry Cost of Capital
ROI	=	Railroad Specific Return on Investment
RRIB	=	Railroad Specific Tax Adjusted Net Investment Base
Tax Rate	=	Railroad Specific Marginal Tax Rate
STCC Rev $_{>180}$	=	Railroad Specific Revenue by STCC from Movements with R/VC Ratios Greater Than 180%
RR Rev $_{>180}$	=	Railroad Specific Revenues from Movements with R/VC Ratios Greater Than 180%
STCC Rev	=	Railroad Specific Revenues by STCC

The RAAF calculation is based on data already calculated by the STB

Example - 2014 Union Pacific RAAF For STCC 01132 - Corn

Item	Source	Statistic 1/
(1)	(2)	(3)
1. Railroad Industry Cost of Capital	STB Ex Parte No. 558	10.65%
2. Return on Investment	STB Ex Parte No. 552	17.35%
3. Investment Base	STB Ex Parte No. 552	$30,455,169
4. Tax Rate	STB Ex Parte No. 682	38.83%
5. UP Total Revenues for STCC 01132	QCS or Waybill Sample 2/	$748,869
6. UP Revenues >180% for STCC 01132	Waybill Sample 2/	$314,525
7. UP Total Revenues >180%	STB Ex Parte 689 2/	$11,213,960
8. Total Railroad Shortfall/(Overage)	[(L.1 - L.2) x L.3] ÷ (1-L.4)	($3,335,780)
9. STCC 01132 Shortfall/(Overage)	(L.6 ÷ L.7) x L.8	($93,561)
10. **UP STCC 01132 RAAF**	**L.9 ÷ L.5**	**-12.5%**

1/ Dollars in thousands.

2/ Figures assumed for this example.

Applying the ACMRM approach provides a straightforward assessment of the reasonableness of an Ag commodity rate

Example of the Ag Commodity Maximum Rate Methodology

Issue Movement Parameters

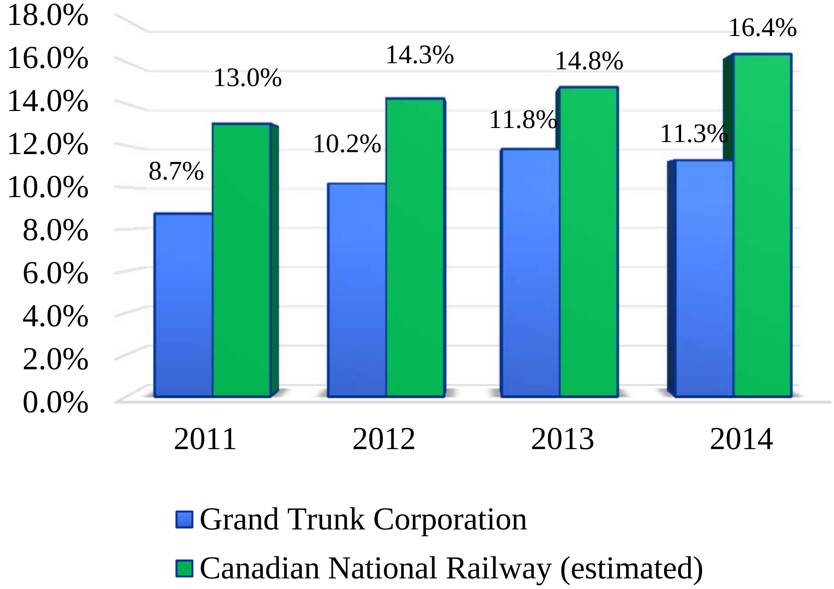
1. 5-Digit STCC	01132 - Corn
2. Distance - Miles	120.0
3. Total Revenue Per Car	$1,800
4. Variable Cost (Per Car)	$400
5. Revenue to Variable Cost ("R/VC") Ratio	450.0%
6. Jurisdictional Threshold (Per Car)	$720

Comp Group Analysis

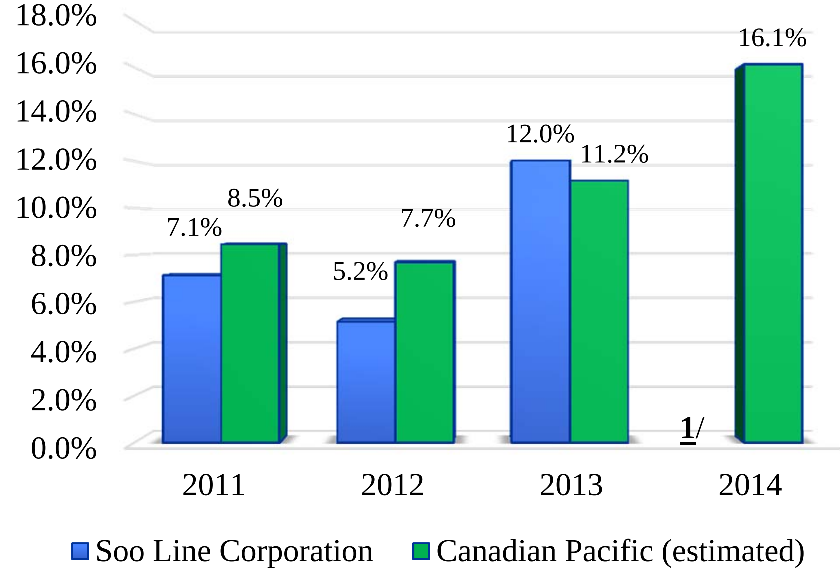
Movement	Railroad	Distance	Revenue	RAAF	Adjusted Revenue	Variable Cost	Adjusted R/VC Ratio
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
a.	UP	115.0	$935	-12.5%	$818	$580	141.0%
b.	UP	112.0	$835	-12.5%	$731	$400	182.8%
c.	UP	112.0	$835	-12.5%	$731	$383	190.9%
d.	UP	115.0	$1,900	-12.5%	$1,663	$432	385.0%
e.	UP	110.0	$1,200	-12.5%	$1,050	$571	183.9%
f.	BNSF	110.0	$440	-4.2%	$422	$330	127.9%
g.	BNSF	96.0	$350	-4.2%	$335	$255	131.4%
h.	CSXT	140.0	$890	2.8%	$915	$384	238.3%
i.	CSXT	96.0	$450	2.8%	$463	$309	149.8%
j.	CSXT	132.0	$450	2.8%	$463	$372	124.5%
7. Simple Average R/VC (Line a. through Line j.)							185.5%
8. Adjusted Issued Traffic Rate (Line 4 x Line 7)							$742
9. Maximum Reasonable Rate (Greater of Line 6 or Line 8)							$742

The choice of including some, but not all, of a railroad's subsidiary companies impacts the railroad's ROI

Grand Trunk Corporation and Canadian National Railway Return On Investment – 2011 to 2014



Soo Line Corporation and Canadian Pacific Return On Investment – 2011 to 2014



1/ Soo Line's 2014 Schedule 250 shows an Adjusted Net Railway Operating Income of negative $12.1 million due to write downs from its sale of the DME.

TRB TRANSPORTATION RESEARCH BOARD
OF THE NATIONAL ACADEMIES

Modernizing Freight Rail Regulation

RAIL TRANSPORTATION OF GRAIN, RATE REGULATION REVIEW
Docket No. EP 665 (Sub-No. 1)

Richard Schmalensee
June 10, 2015

Congressional Study Request

Examine and Make Recommendations on:

- Rate and service trends, post-Staggers
- Regulatory performance in balancing revenue adequacy and reasonable rates
- Future role of STB in regulating rates and service

Funded by USDOT

NAS/TRB Role:

- Congressionally chartered to advise government
- Committee members: no financial conflicts, balance of views and expertise, serve pro bono
- Reports are peer reviewed, fully independent

Committee for a Study of Freight Rail Regulation

- Richard Schmalensee, MIT, *Chair*
- Ken Boyer, Michigan State University
- Jerry Ellig, George Mason University
- Tony Gómez-Ibáñez, Harvard University
- Anne Goodchild, University of Washington
- Wes Wilson, University of Oregon, Eugene
- Frank Wolak, Stanford University

Study Process

Briefings by:

- **Government agencies (STB, FRA, USDA)**
- **Railroad industry (AAR, Short-lines)**
- **Rail Labor**
- **Shipper Groups (coal, grain, chemicals, other)**
- **Briefings on Canadian system**
- **Academic Experts and Consultants**

Review of literature & STB documents

Statistical Analysis **of Carload Waybill Sample**

Closed Deliberations to Develop Report

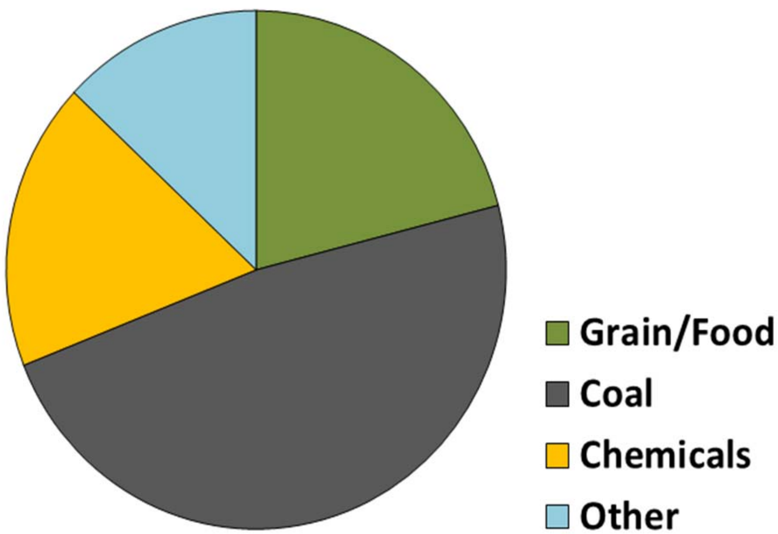
Use of Common Carriage (with Reasonable Rate Obligation)

Share of Total Common Carriage Ton-miles

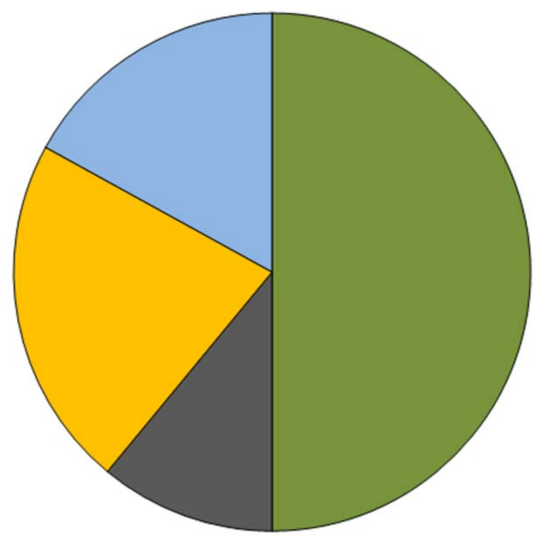
>Coal drops from 48% to 11%
[Use falls from 52% to 5%]

>Grain/Food up from 21% to 50%
[Use remains ~70%]

Year 2000



Year 2012



Current Rate Relief Process: 3 Steps

1. Initial screen: 180% R/VC formula, using URCS VC numbers

2. Market dominance inquiry for rates > 180% R/VC

3. Rate reasonableness ruling: SAC, simplified SAC, or 3-benchmark

Process, level of relief must respect the law's interest in protecting revenue adequacy

Best viewed as a "system"—a permissive and/or unreliable URCS R/VC screen will prompt regulators to rely on steps 2 and 3 to safeguard revenue adequacy.

Finding : Variable Cost Allocations (a la URCS) are Economically Invalid and Unreliable, Better Alternatives Exist

With joint & common costs, there is no economically valid measure of shipment-specific variable cost (in contrast to incremental cost)

- **Omitted costs—costs not recorded in expense records (e.g., risk)**
- **Arbitrary time frame for fixed/variable determinations**
- **Any allocation of common cost is purely arbitrary**
- **So, no reason why rates should reflect URCS numbers**

URCS is unreliable—but its unreliability is not random

- **Some types of traffic have uniformly high R/VCs**
- **Illogical results, 20-30% of traffic R/VCs below 100%**

***URCS cannot be fixed*: Such cost allocation is fundamentally flawed**

A better alternative: *use rates determined under competition for screening*. Not possible when Staggers was enacted, feasible now

<u>Finding: Market Dominance Inquiries Should be Disciplined by Time Limits, not Categorical Limits on Evidence</u>

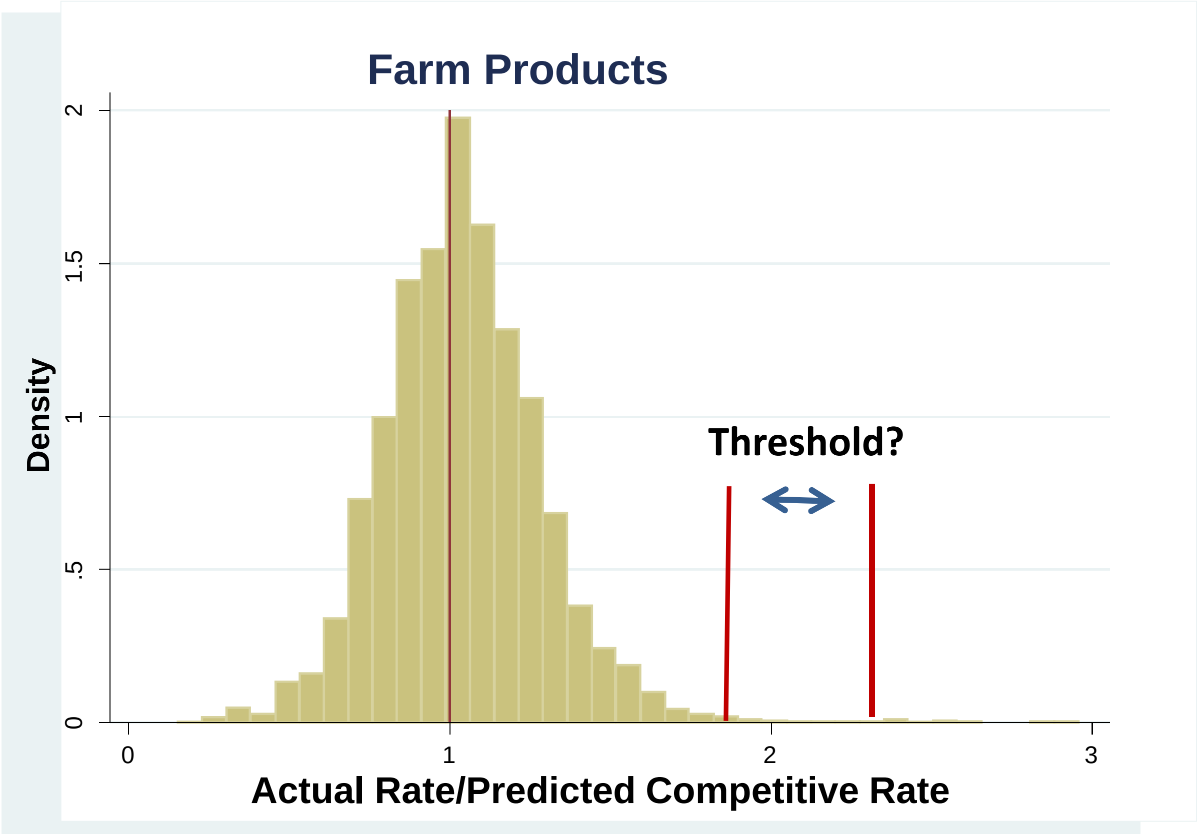
- **Considering all substitution possibilities can slow and deter cases, *but excluding evidence biases outcomes***
- **Antitrust agencies routinely examine complex product and geographic competition – *in informal proceedings***
- **Time limits on all sides compel prioritization of arguments**

<u>Finding: Methods for assessing rate reasonableness lack a sound economic rationale and are unusable by most shippers; sounder and more economical methods needed</u>

- **Railroads & shippers have incentives to move all profitable traffic, so rate relief is about fairness, not efficiency**
- **SAC aimed to prevent uneconomic entry in telecom (not an issue here!), not indicative of actual revenue needs, & too costly & time-consuming to be usable by small shippers**
- **Simplified procedures conceptually flawed, seldom used by shippers, & make more use of URCS – *the wrong direction!***

Recommendation: Prepare (via method development) to Replace R/VC and URCS With Competitive Rate Benchmarking

- **Determines *potentially* unreasonable tariff rates based on comparable rates in competitive markets**
- **The farther a tariff rate is from its predicted level under competition, the more likely lack of competition was a factor**



Competitive Rate Benchmarking (cont.)

- **Benchmarking (like the URCS R/VC test) can only identify plausible candidates for further scrutiny**
- **Regulators would determine the threshold(s), taking revenue adequacy into account.**
- **Threshold determination is likely to be controversial, *but transparent***
- **Report has a "proof of concept"; USDOT should develop, test, and refine competitive rate prediction methods.**
- **Legislation would be required to implement this approach**

Recommendation: Replace STB rate reasonableness hearings (dominance, SAC, etc.) with time-limited final offer arbitration

- **With a sound & unbiased screening tool, burdensome processes no longer needed for safeguarding revenue adequacy**
- **Arbitration is relatively informal, so can be fast, economical, & will not deter cases.**
- **Final offer rule will prompt compromise and settlement.**
- **Canada has shown effectiveness when accompanied by time limits**
- **Arbitrator should assess market dominance; competitive rate benchmark cannot assure dominance was cause of high rate.**
  - **No artificial evidence restrictions, only time limits**
  - **If dominance not demonstrated, case dropped or RR offer selected.**

Other Relevant Recommendations

Allow reciprocal switching to be proposed in arbitration proceedings

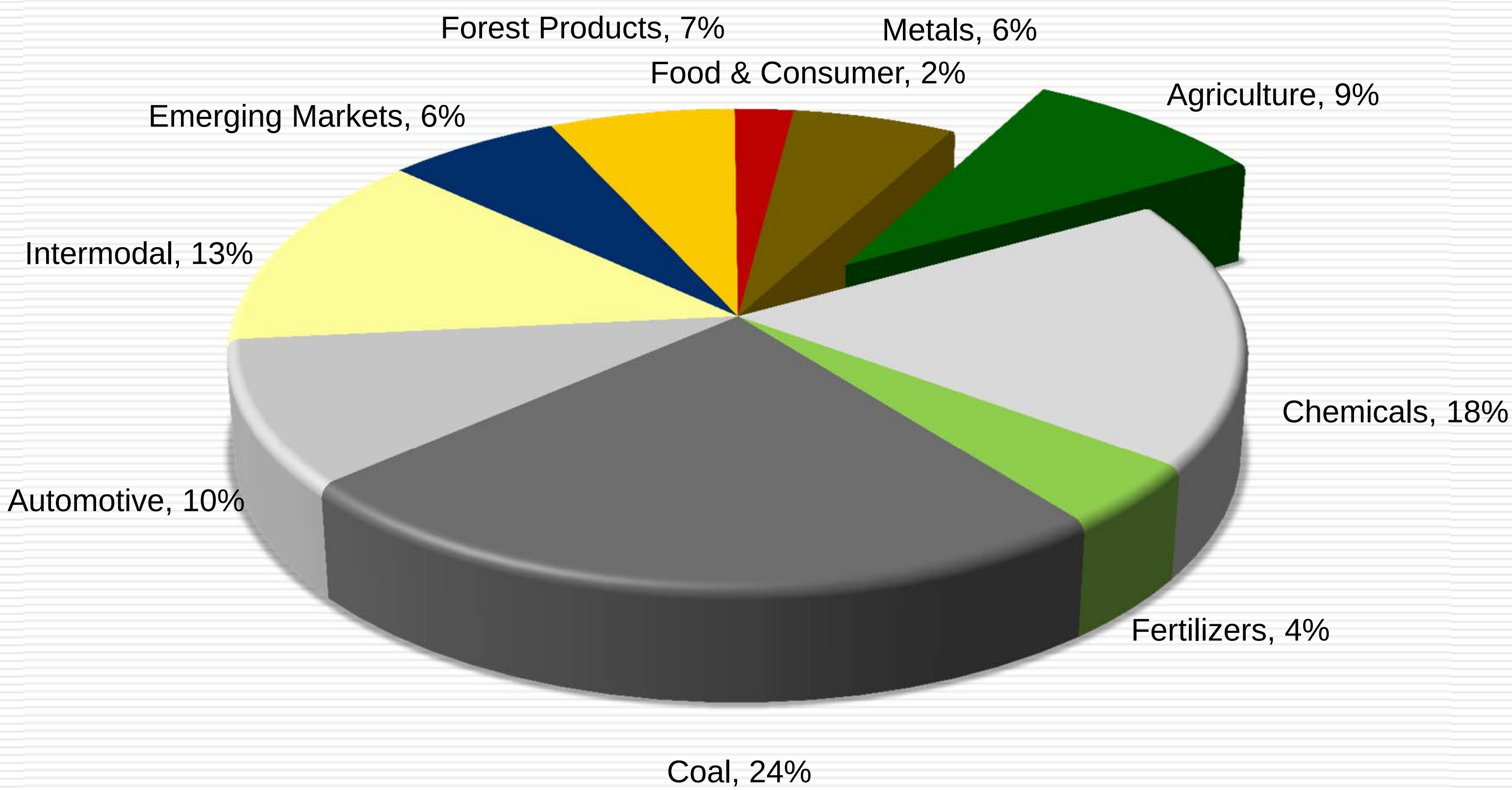
End annual revenue adequacy determinations; require periodic, deeper assessments of industrywide economic and competitive conditions.

CSX
HOW TOMORROW MOVES

CSX Testimony
STB Hearing

June 10, 2015

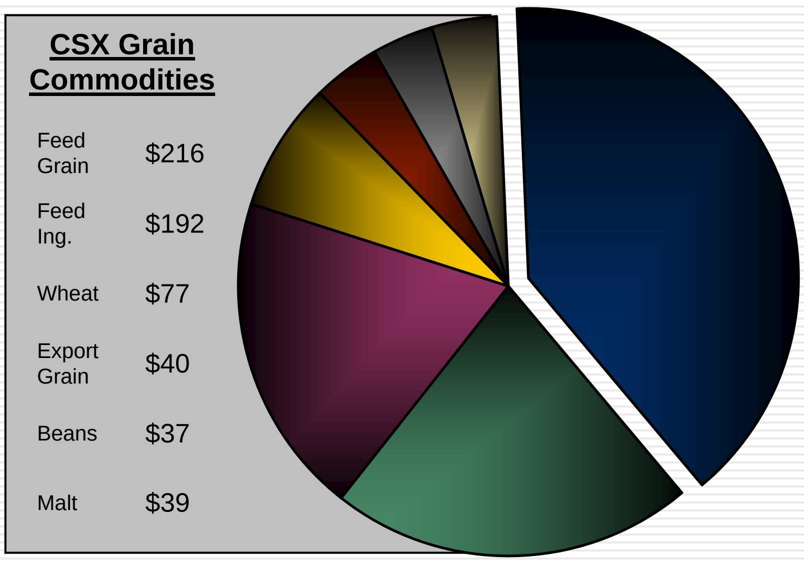
CSX is a $11 billion rail transportation company moving a diverse business portfolio of products



How tomorrow moves

Grain comprises 60% of CSX AG line haul revenues

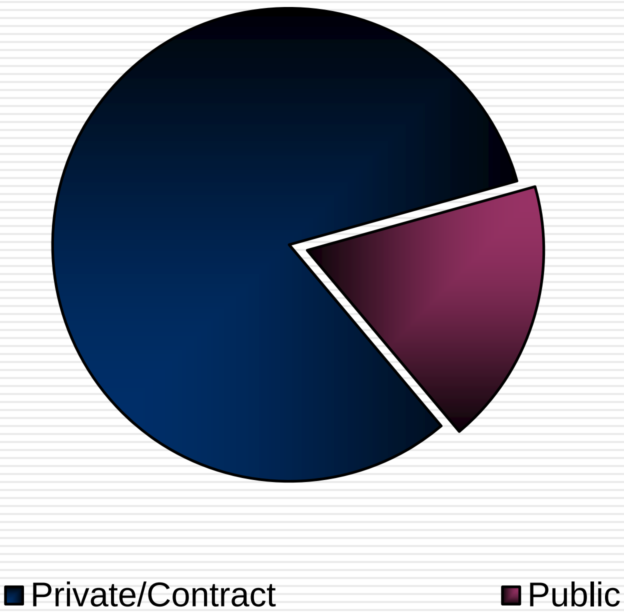
2014 Line Haul Revenue
Agricultural Products



- Feed mill consumption represents 60% of grain revenues
- Grain for processing represents 25% of grain revenues
- Balance is export grain

Majority of CSX grain traffic moves under contract

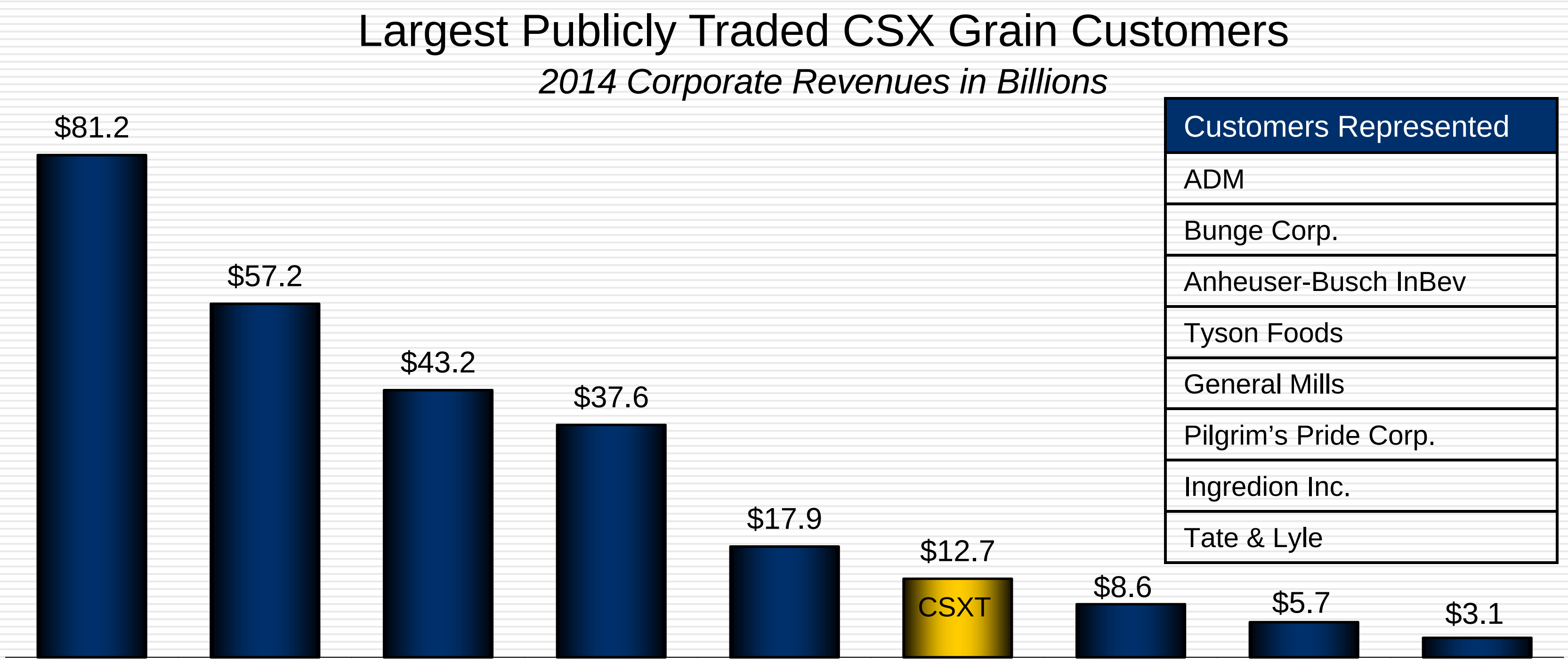
CSX Grain Carloads



2014 CSX Grain Carloads *Carloads in Thousands*	
Private/Contract	214
Public Tariff	48
Total	262

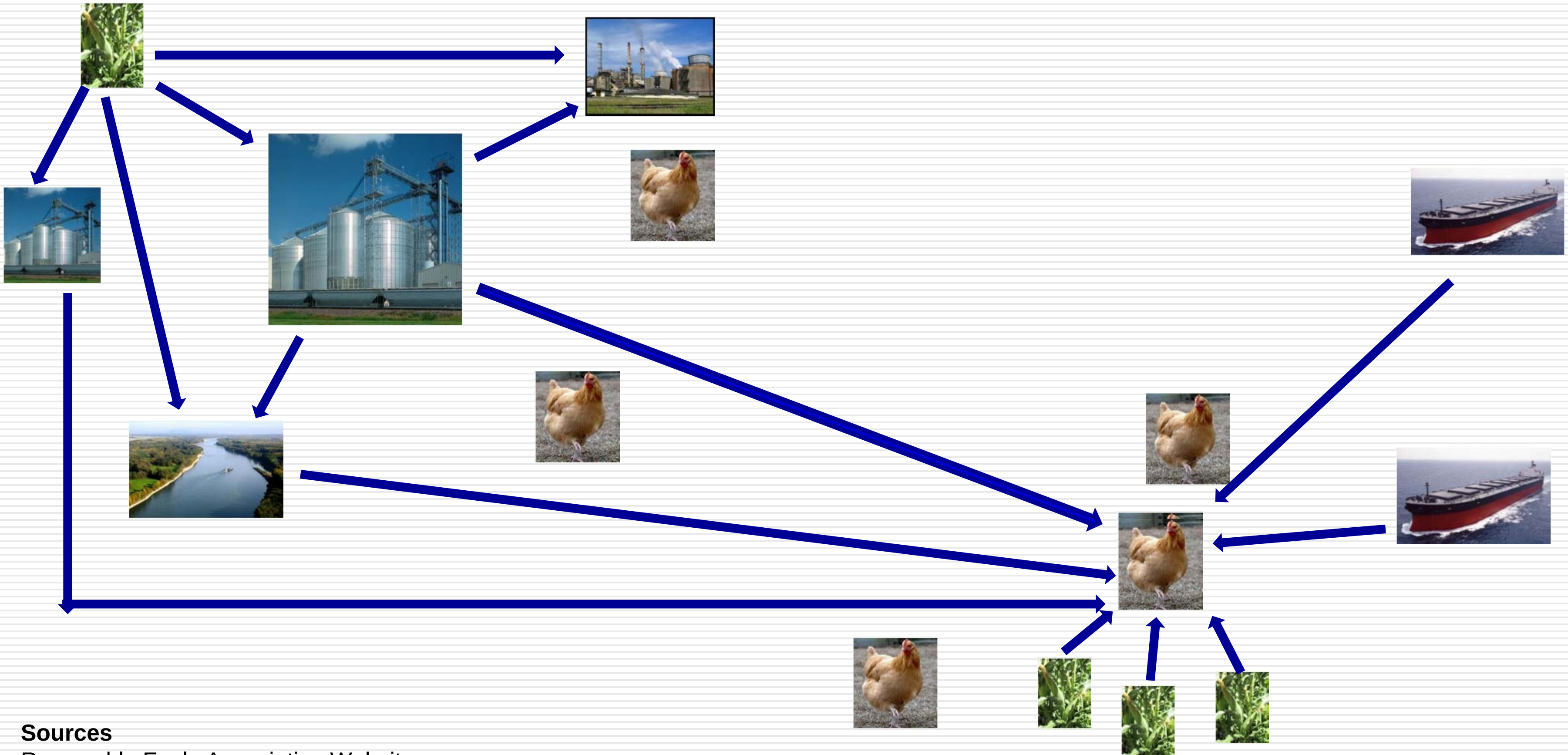
Only 18% of CSX Grain carloads move under public tariff

CSX Agricultural customers are large corporations



Customers Represented
ADM
Bunge Corp.
Anheuser-Busch InBev
Tyson Foods
General Mills
Pilgrim’s Pride Corp.
Ingredion Inc.
Tate & Lyle

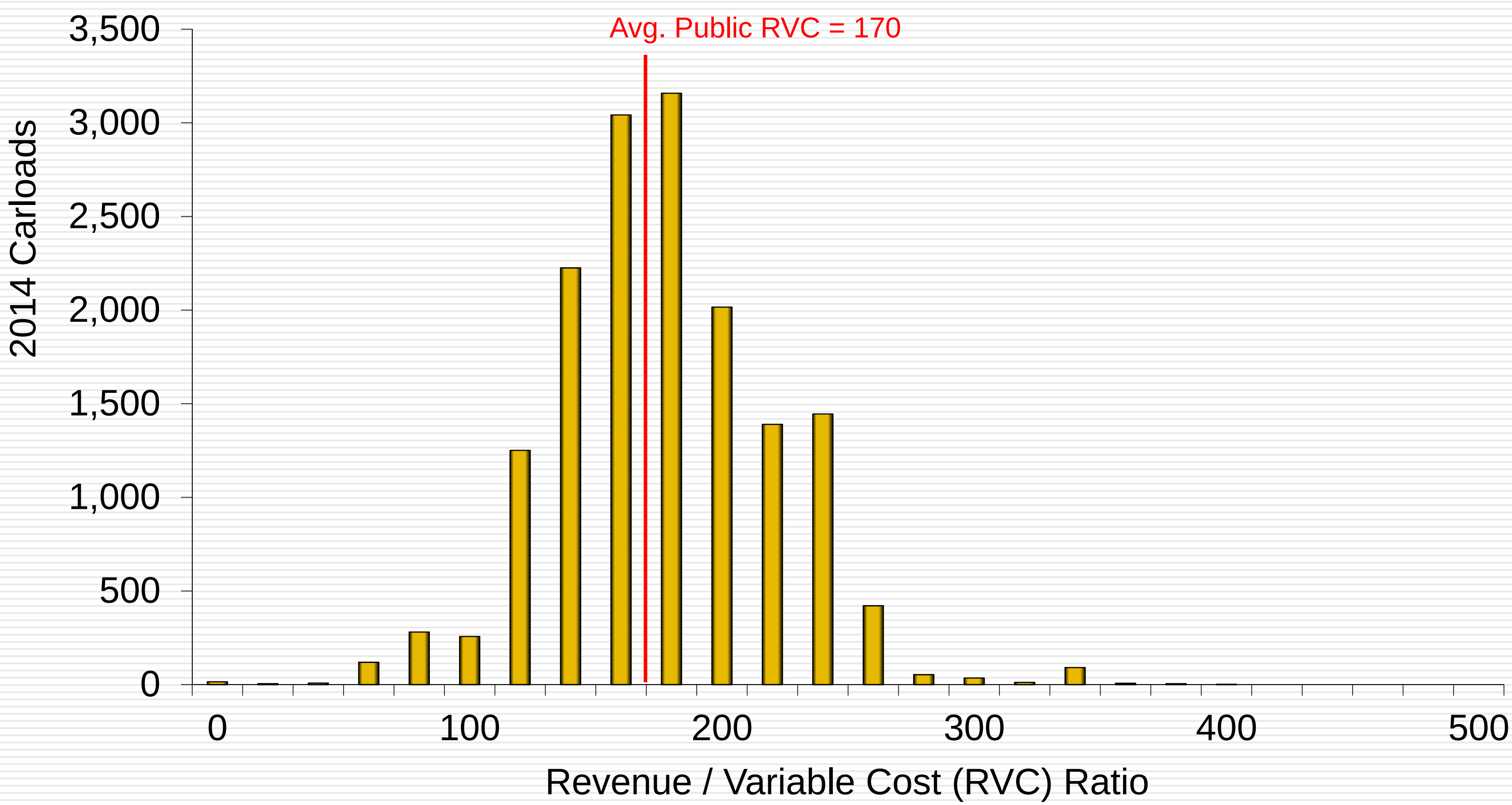
Eastern Industry has varied options



Sources
Renewable Fuels Association Website
National Grain and Feed Association
United States Department of Agriculture
ProExporter

Regulatory Profitability Analysis– Grain 2014 URCS Costs

Public Tariff Traffic



CSX has a vast network of Products & Programs to better serve the AG customer

- **Unit train products**
  - 90 Car Unit Train Product
  - 65 Car Unit Train Product
  - Single Car Product
- **Express Programs**
  - 15 hour Incentive Load/Unload Programs
- **Network Operations => Grain Desk**
  - Direct communication
- **Blend of Railroad and Private Car Incentives**
  - Pre-load inspection
  - BidCSX program

In summary…

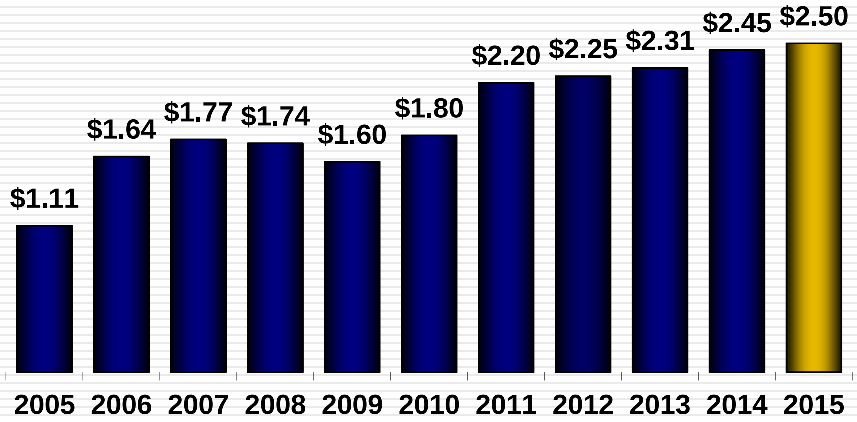
- **Agriculture is an important business to CSX**
- **CSX services align with large Multi-faceted agricultural companies**
  - *Competition on origin and destination grain sourcing is vibrant*
- **CSX is working to improve efficiencies for both CSX and our customers through mutually beneficial programs**
  - *90 Car Product*
  - *Express Programs*
  - *Blend of RR and Private car investment*
- **CSX appreciates the partnerships that we have with our customers**

Appendix

CSX has invested significant capital over the past ten years inclusive of Agriculture investment

- Core investment remains at 16% – 17% of revenue for 2015
  - *Infrastructure spend maintains a safe and reliable network*
  - *Locomotive, car investment driven by commercial demand*
  - *Strategic investments support growth and productivity*

CSX Capital Spend In Billions



New Car Purchases

❑2,155 cars since 2008

✓5201 Cubic Foot

✓286K GWR

Fleet Upgrade Program

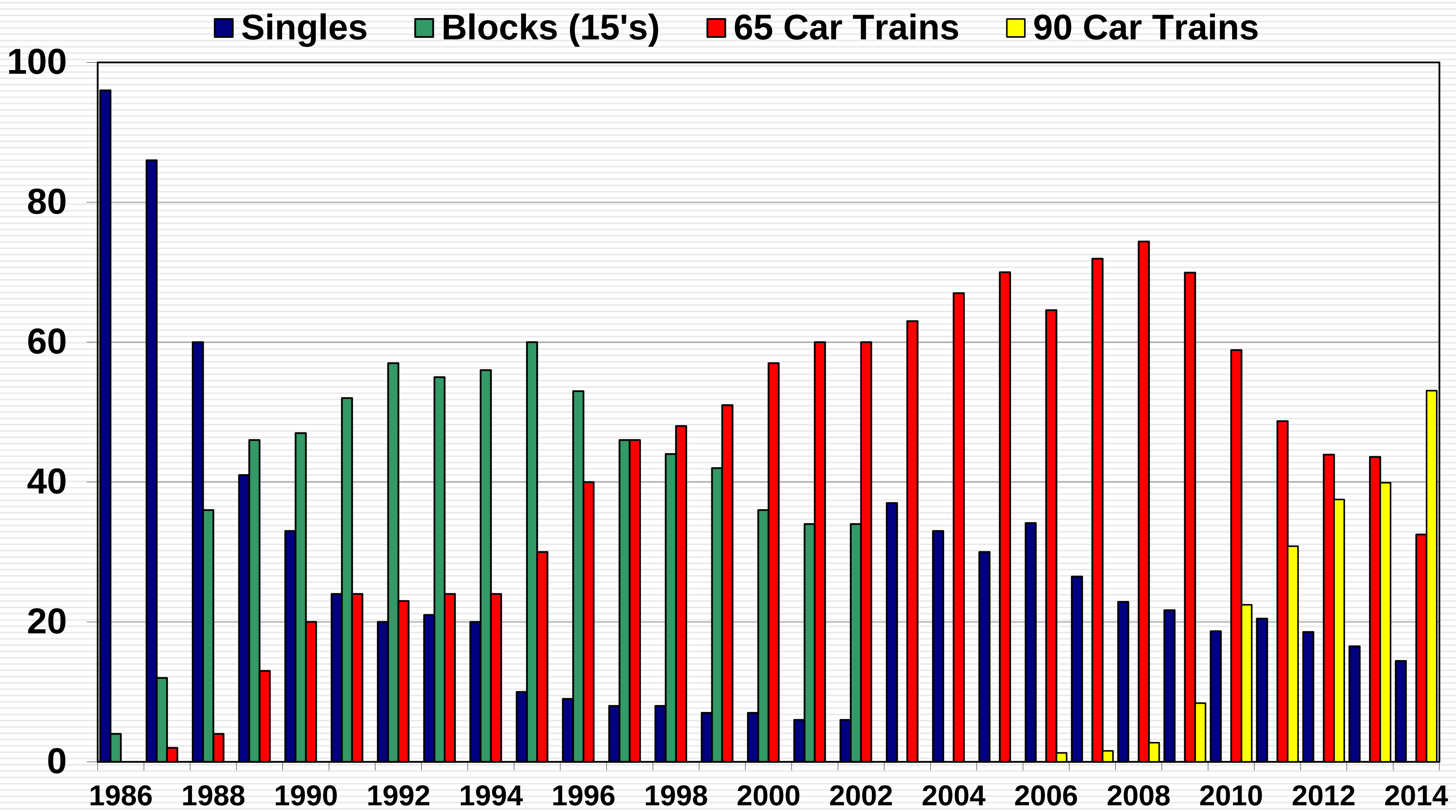
❑New doors, hatch covers and paint

❑200-300 yearly

The Agriculture strategic direction over the past 12 years has focused on Simplicity, Size and Speed

- 1999-00 Simplify CSX pricing structure by forming 80 distinct origin elevator groups.
- 2000-03 Create common origin spread relationships and simplified price documents
- 2003 Development of Ethanol Network
- 2003-04 Elimination of 15 Car Product
- 2004 CSXBid preferred car placement
- 2005 Train Expansions/Refine Express Programs
- 2007-12 TSI: Optimizing the size and speed of our grain network to 90 car trains
- 2012-17 Finish transition to 90's and enhance express programs

History would indicate that larger units will become the standard



Docket No. EP 665 (Sub-No. 1) Rail Transportation of Grain Rate Regulation Review

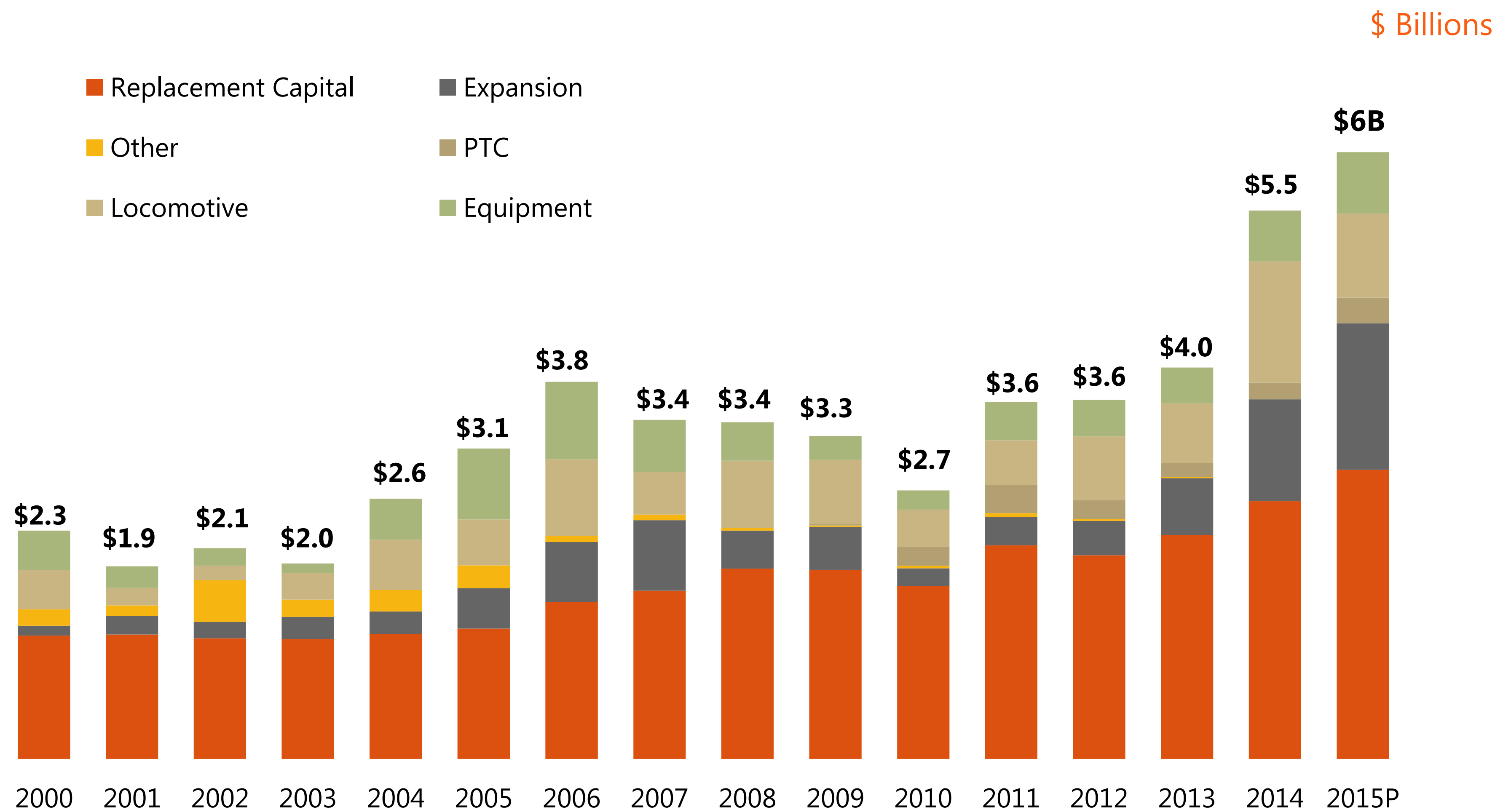
JUNE 10, 2015

BNSF RAILWAY

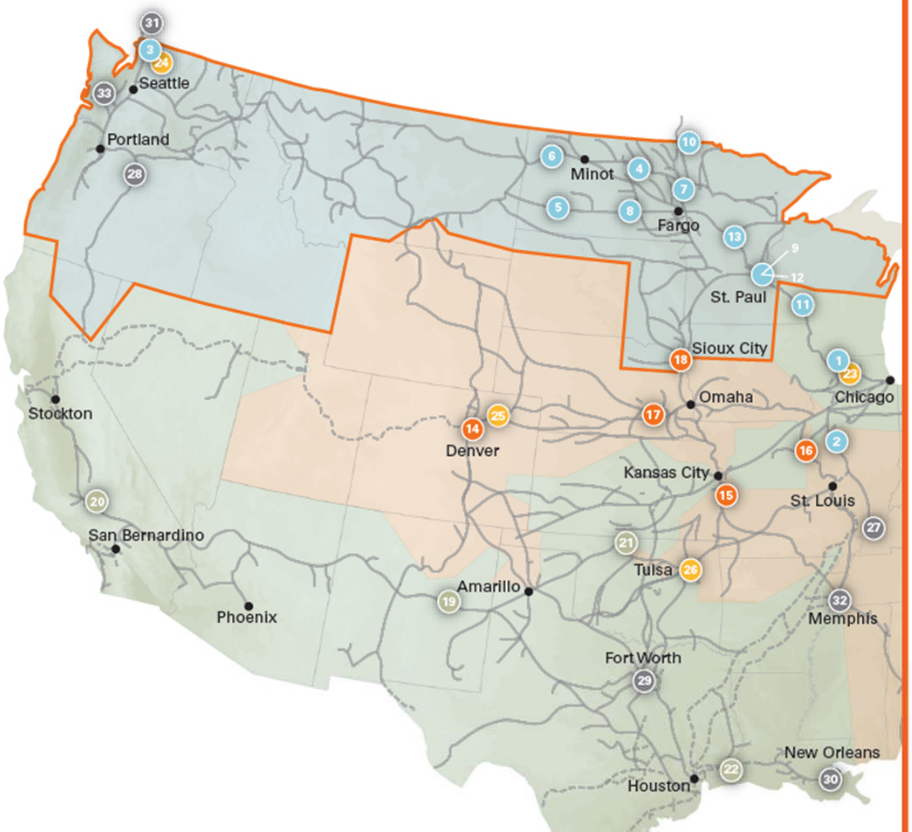
Predominant BNSF Grain Traffic Flows
2010 to 2012

Source: BNSF Internal Data; arrows indicate flows for regional origin-destination groupings

BNSF Investing to Meet Capacity Demands



BNSF's 2015 Capacity Projects



Terminal & Line Capacity Expansion Projects

Major line and terminal projects by region, route and subdivision (sub)

North Region

1 **Aurora sub:** CTC signaling project with crossover plants
2 **Beardstown sub:** five siding extensions plus CTC signaling on the north end of the subdivision
3 **Bellingham sub:** one double-track project
4 **Devils Lake sub:** CTC signaling on subdivision
5 **Dickinson sub:** one siding extension
6 **Glasgow sub:** complete three double-track projects started in 2014
7 **Hillsboro sub:** CTC signaling on subdivision and connection upgrade
8 **Jamestown sub:** completing CTC signaling project started in 2014
9 **Midway sub:** one double-track project, Northtown connection to Canadian Pacific and track upgrades
10 **Noyes sub:** one new siding
11 **St. Croix sub:** CTC signaling project with crossover plants
12 **St. Paul sub:** one triple-track project
13 **Staples sub:** one CTC signaling project and three double-track projects

Central Region

14 **Brush sub:** seven siding extensions
15 **Ft. Scott sub:** one double-track project
16 **Hannibal sub:** complete two siding projects started in 2014
17 **Ravenna sub:** two new double-track projects
18 **Sioux City sub:** new bypass track at Sioux City

South Region

19 **Clovis sub:** one double-track project
20 **Mojave sub:** one double-track and one siding extension project
21 **Panhandle sub:** two new double-track projects
22 **Silsbee sub:** one new siding

Terminals

23 **Aurora sub:** complete double-tracking project through LaCrosse, WI terminal (project started in 2013)
24 **Bellingham sub:** Everett, WA yard expansion
25 **Brush sub:** extend tracks at Denver, CO terminal
26 **Cherokee sub:** add new receiving / departure tracks at Tulsa, OK terminal

Bridges

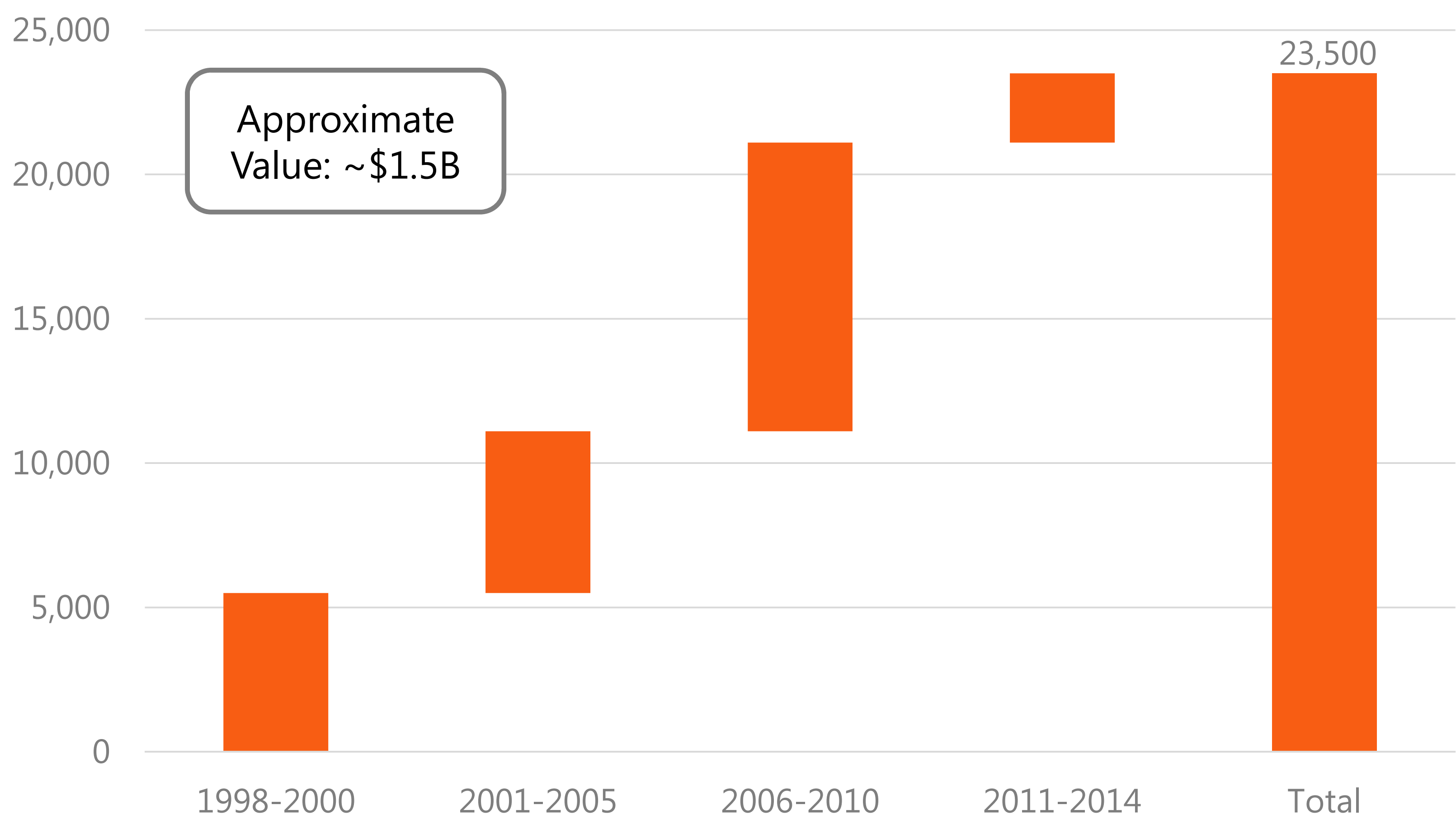
27 **Beardstown sub:** Bridge 212.07 in Metropolis, IL; design, permitting and land access ongoing with construction starting this year
28 **Fallbridge sub:** Bridge 24.8 over Washougal River in Camas, WA; permitting and right-of-way constraints continue with this project. Once project begins the replacement of the river bridge will take more than two years to complete.
29 **Fort Worth sub:** Bridge 348.5 in Fort Worth, TX; reconstruction of the bridge over the Trinity River
30 **Lafayette sub:** Bridge 32.06 in Des Allemands, LA; major work to the moveable bridge that crosses Bayou Des Allemands will start this year
31 **New Westminster sub:** Bridge 129.3 near Vancouver, BC; completing final phase of 3-phase project on bridge over Serpentine River
32 **Thayer South sub:** Bridge 482.1 in Memphis, TN; construction of the Memphis Bridge over the Mississippi River will be done in several phases. The first phase of the project will start this year. Other phases of the project are under design.
33 **Seattle sub:** Bridge 81.4 in Vader, WA; design, access and permitting ongoing with construction starting at the end of 2015

Additional Projects

Intermodal facility expansion: Railcar loading/unloading track, support track and/or parking expansions at the following locations: Alliance (Haslet, TX); LPC (Elwood, IL); LPKC (Edgerton, KS); Lorenzo Rd (IL); Phoenix, AZ; Stockton, CA; Willow Springs, IL

Automotive facility expansion: Railcar loading/unloading track and/or parking expansions at the following locations: Alliance (Haslet, TX); Amarillo, TX; Portland, OR; San Bernardino, CA; LPC (Elwood, IL)

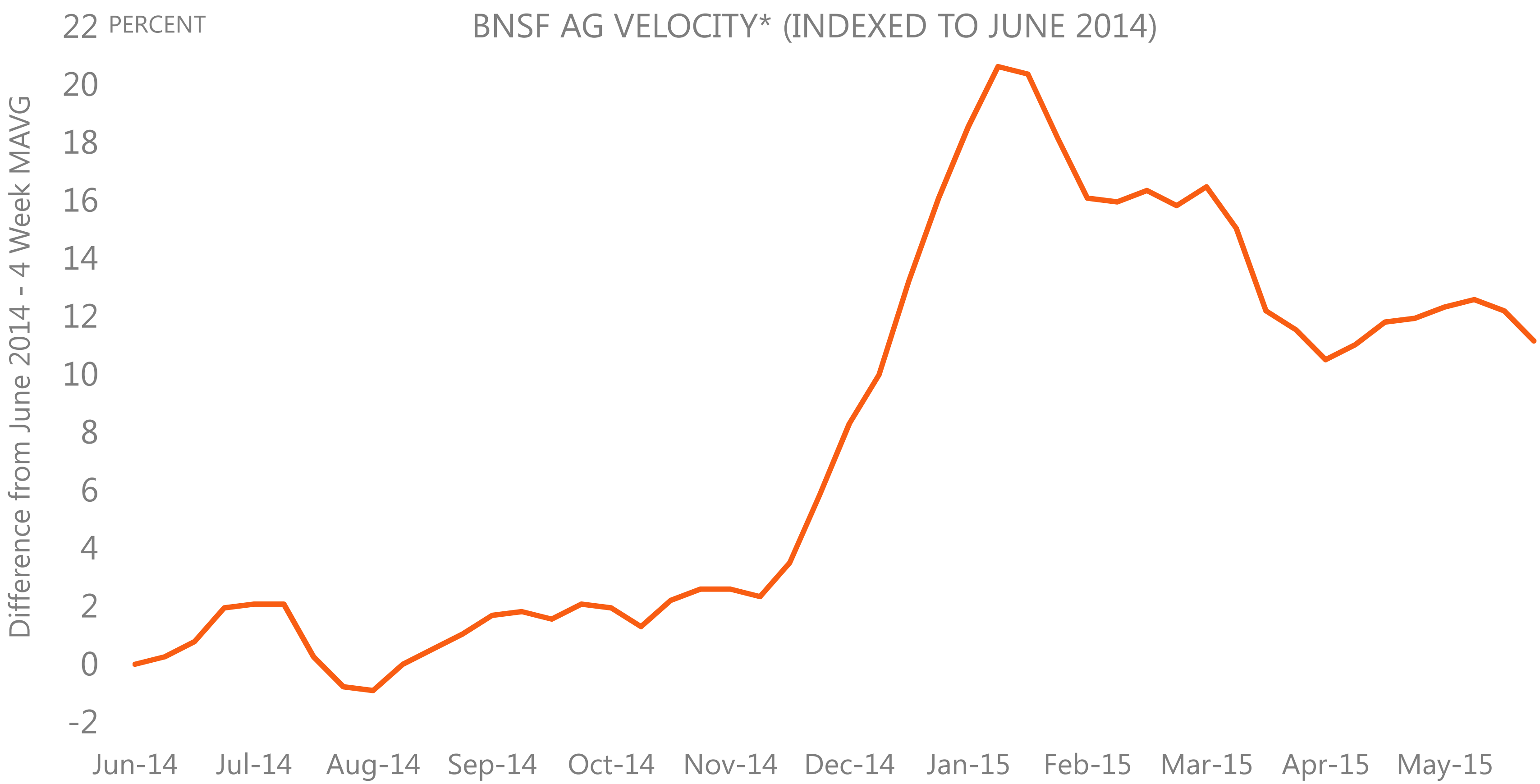
Grain Fleet Car Additions



BNSF RAILWAY

Source: BNSF Equipment Team

With Added Capacity Comes Improved Performance



*Four-week moving average (measured in miles per hour) ending on the dates shown versus the average train speed recorded for the four-week period ending 6/27/14

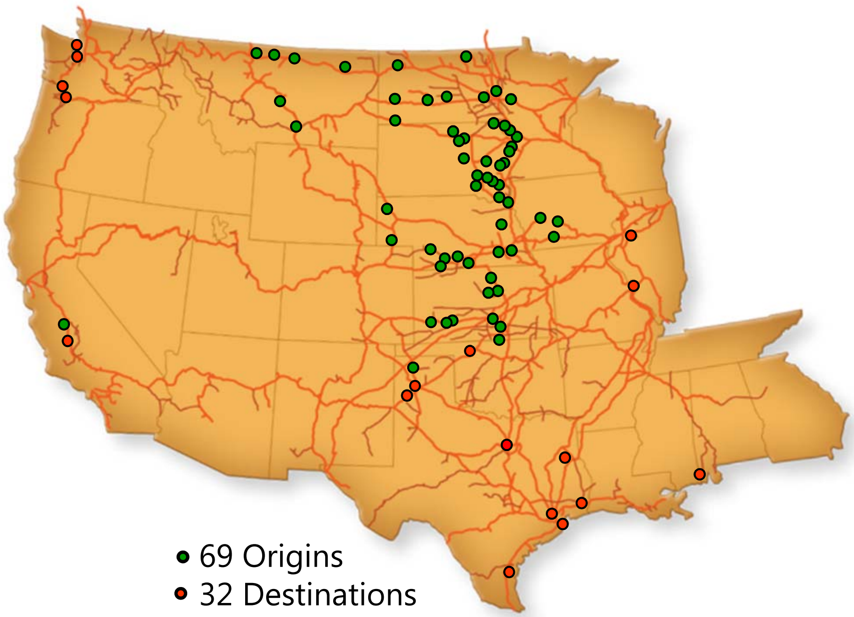
BNSF RAILWAY

Source: AAR through May 22, 2015

BNSF and Our Customers Have Grown Our Business

The number of BNSF shuttle facilities has increased dramatically over the last 15 years

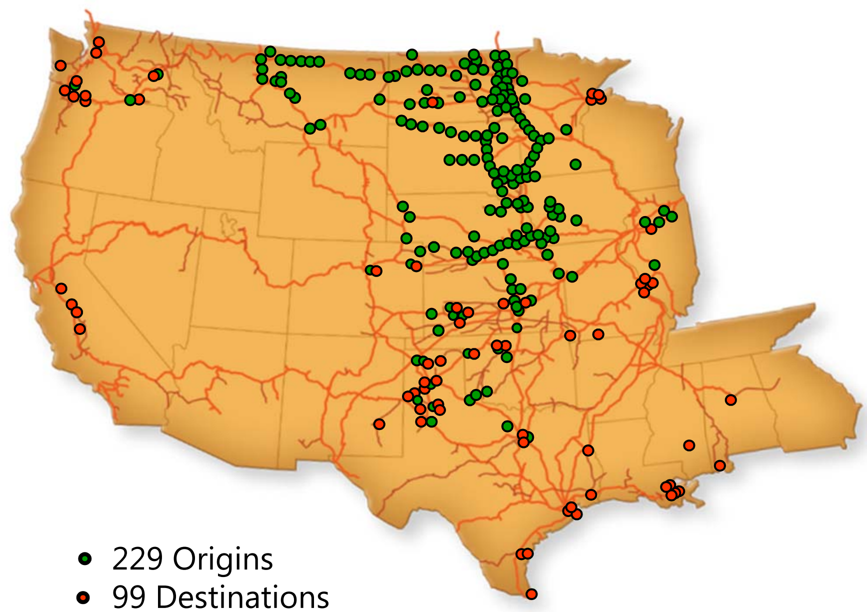
2000



● 69 Origins
● 32 Destinations

13 Mexico Shuttle Destinations

2015



● 229 Origins
● 99 Destinations

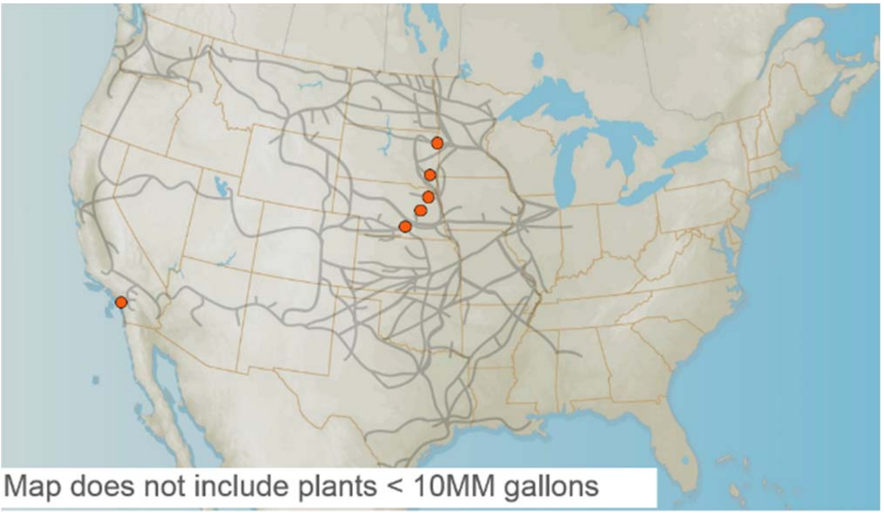
31 Mexico Shuttle Destinations

Estimated Total Customer Investments: $2.2B

BNSF RAILWAY

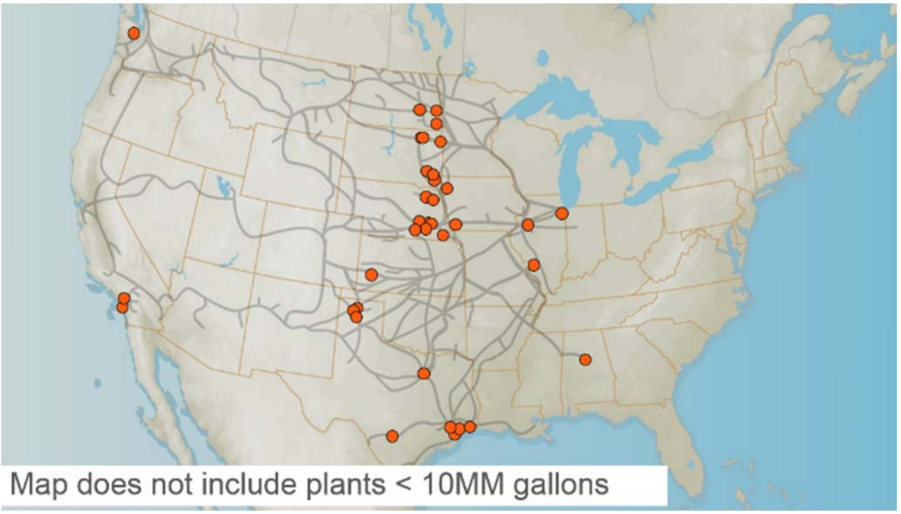
BNSF-Served Unit and Gathered Train Ethanol Network

2003



- 5 Origins
- 1 Destination

2015



- 24 Origins
- 12 Destinations

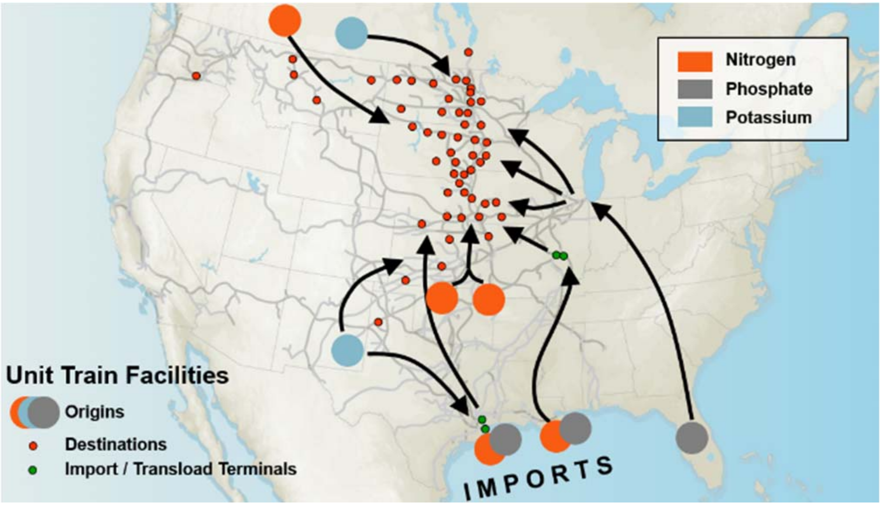
Estimated Customer Investments: $2.1B

BNSF RAILWAY

BNSF-Served Unit Train Fertilizer Network

2002

2015



- 1 Origins
- 5 Destination

- 14 Origins
- 52 Destination

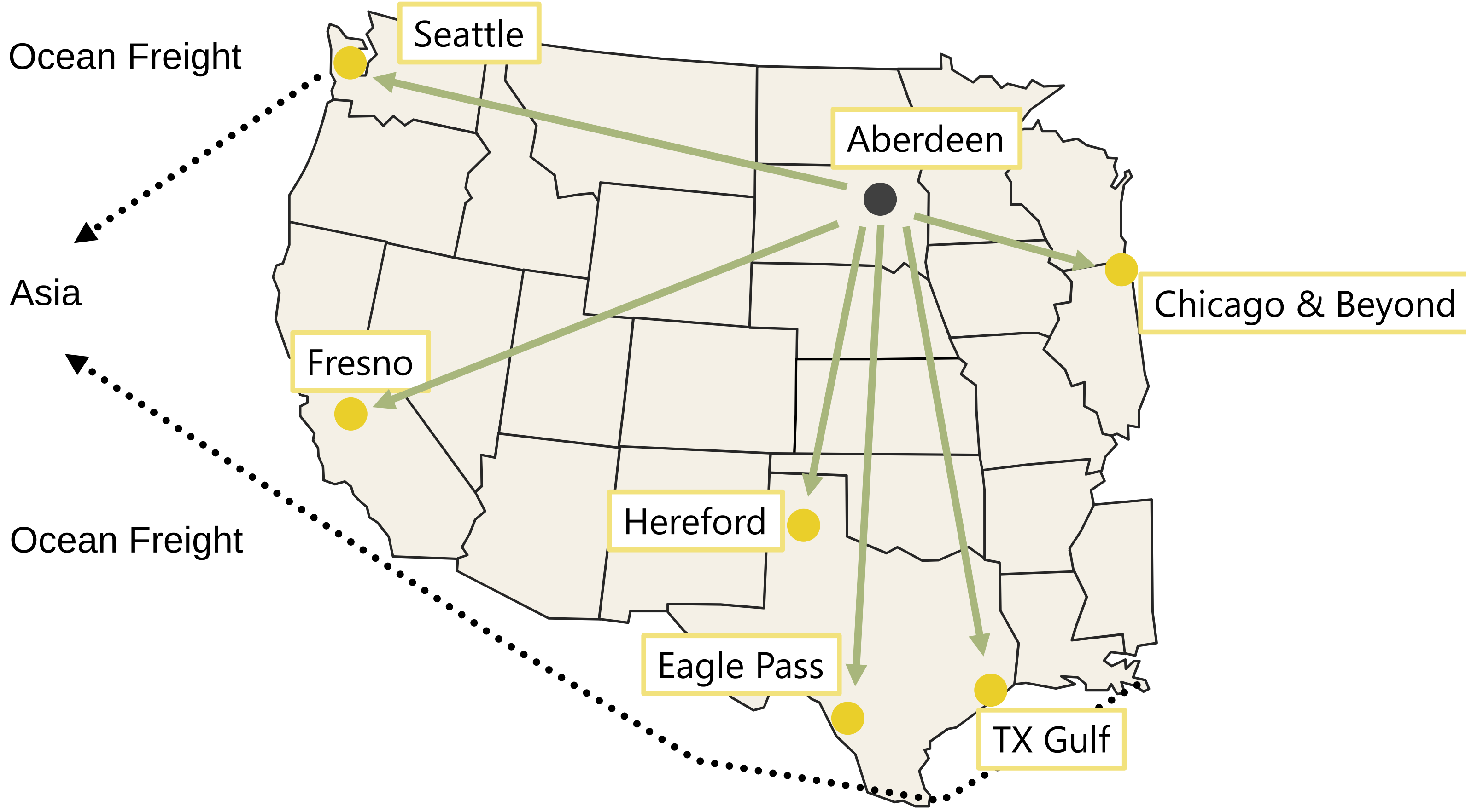
Estimated Customer Investment: $750M

Grain Markets are Highly Competitive

- Market competition in rail rates for grain is everywhere and is persistent.
- Grain shippers have multiple options in many geographic areas.
- Grain shippers' competitive options include other railroads, trucks, barges and extensive geographic competition.

BNSF RAILWAY

Destination Options from Aberdeen, SD



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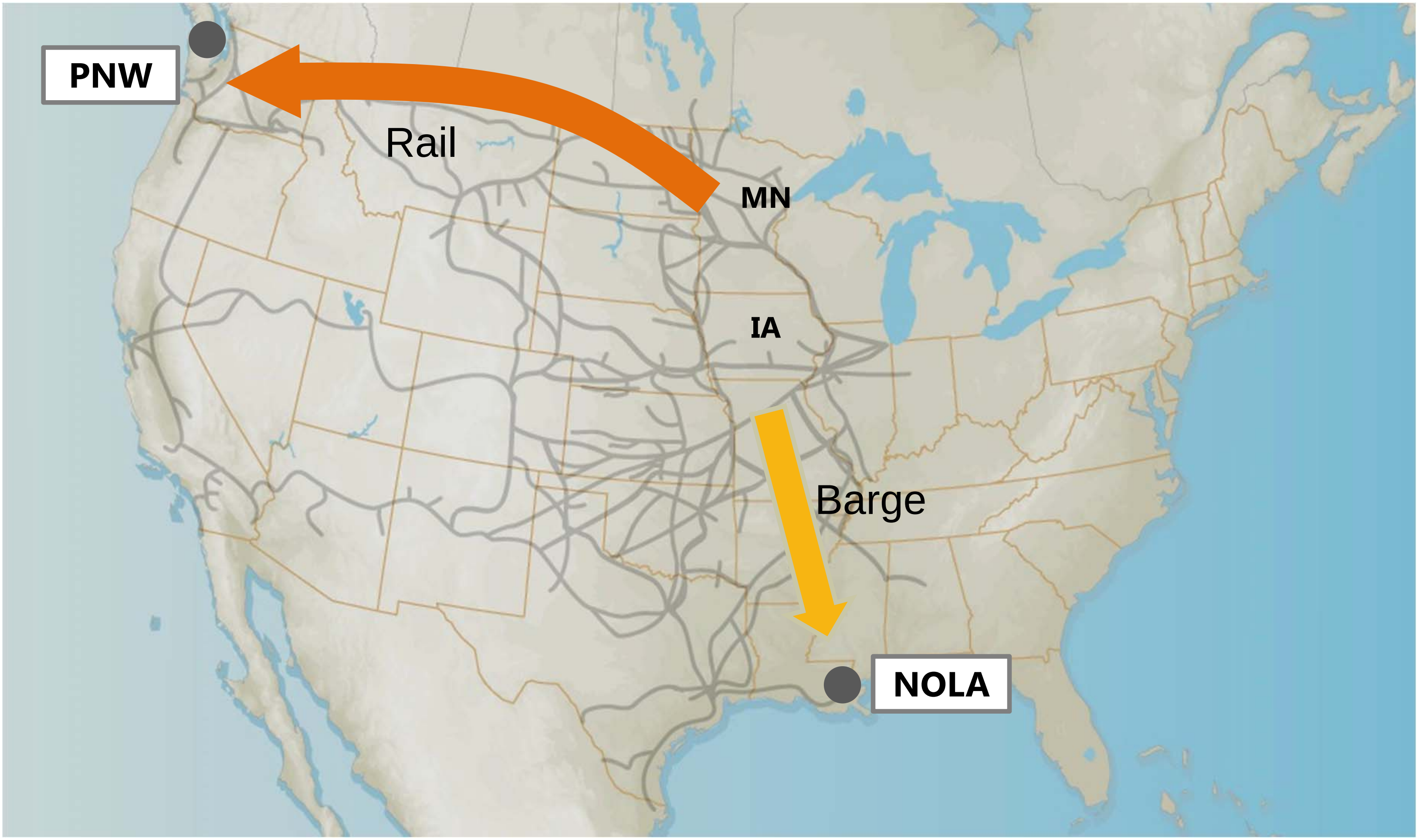
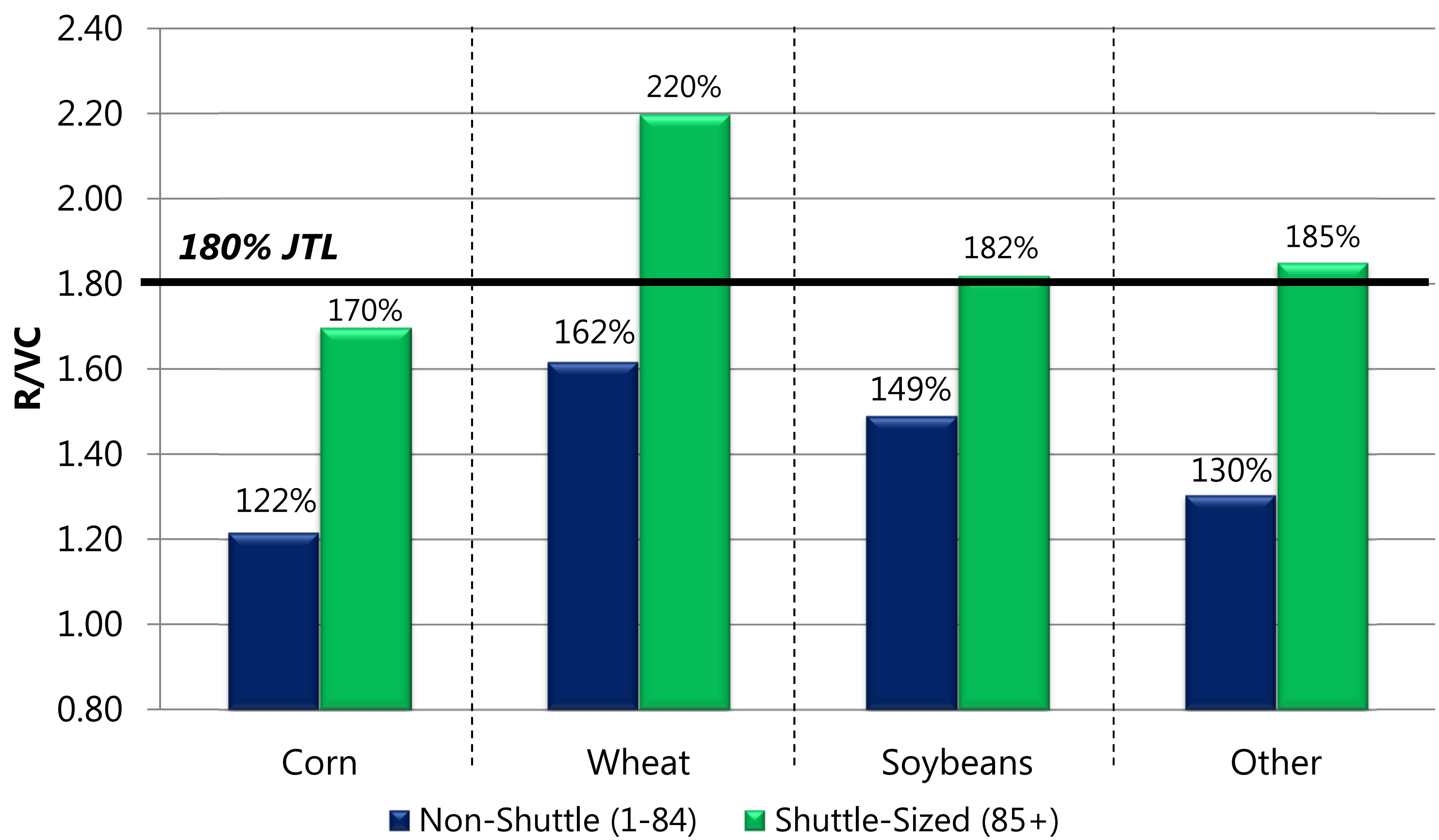
Examples of Corn Export Markets



BNSF R/VCs: Non-Shuttle versus Shuttle Shipments

2010 to 2012 CWS Data (FTI Opening Exhibit 10)



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Agricultural Shipper and Producer Outreach

- Montana Alternative Dispute Resolution
- Ag Rail Business Council
- Regional Ag Coalitions
- Ag Symposiums
- Customer Advisory Board
- Trade and Industry Events
- Producer Organization Events
- Ag Ombudsman Program
- Participation in broad number of shipper-sponsored and producer-sponsored forums every year

- Grassroots, Seminars, Town Halls, Listening Sessions
- Bi-weekly Podcasts and ag-focused service and market communications

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Conclusion

- Virtuous cycle of investments.
- Service has and will continue to improve.
- The competitive market place is working efficiently.
- We have pursued alternative resolution mechanisms.
- Formulaic, outcome-oriented regulations are not productive and would have unintended consequences.


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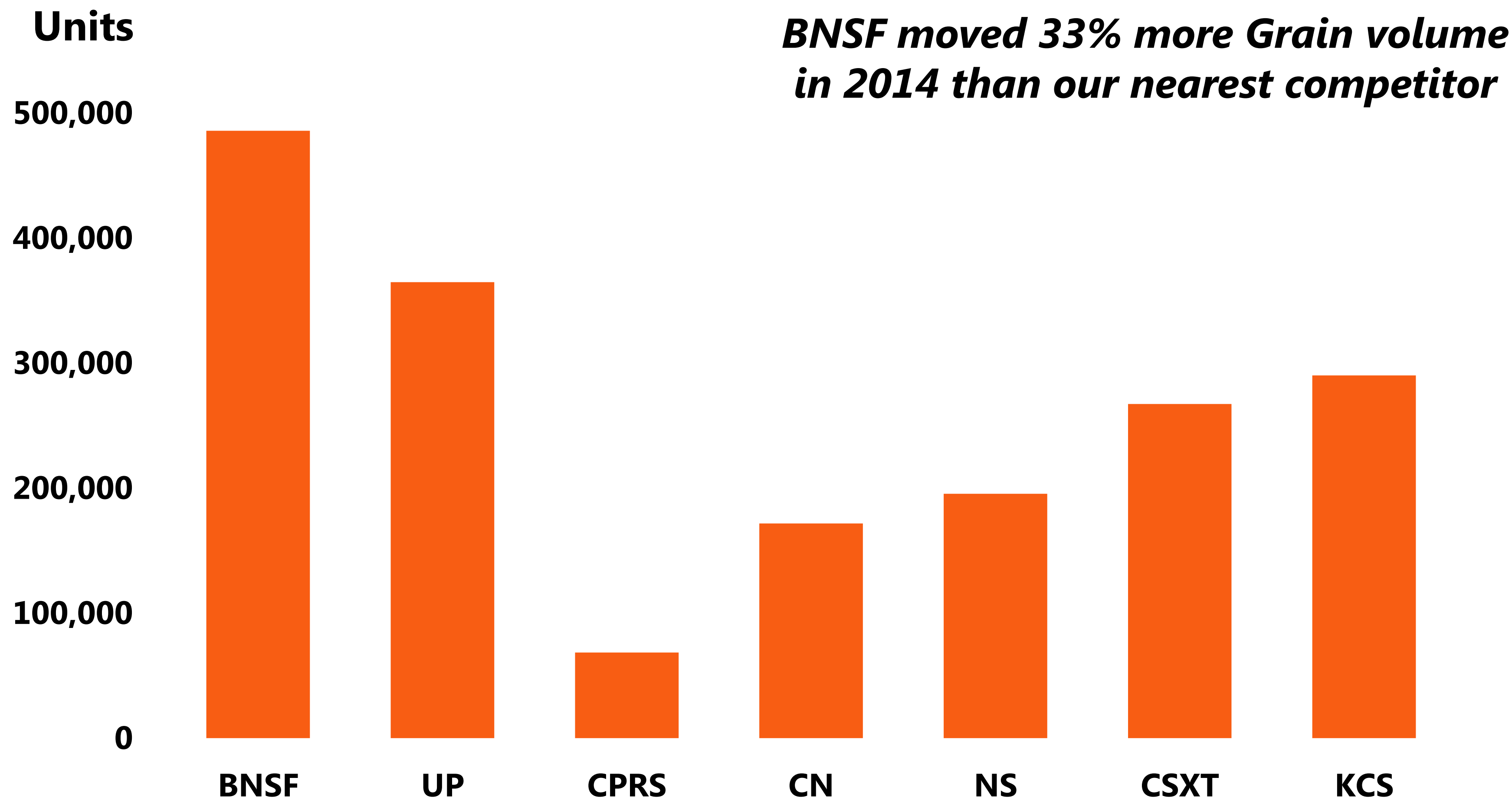
Appendix

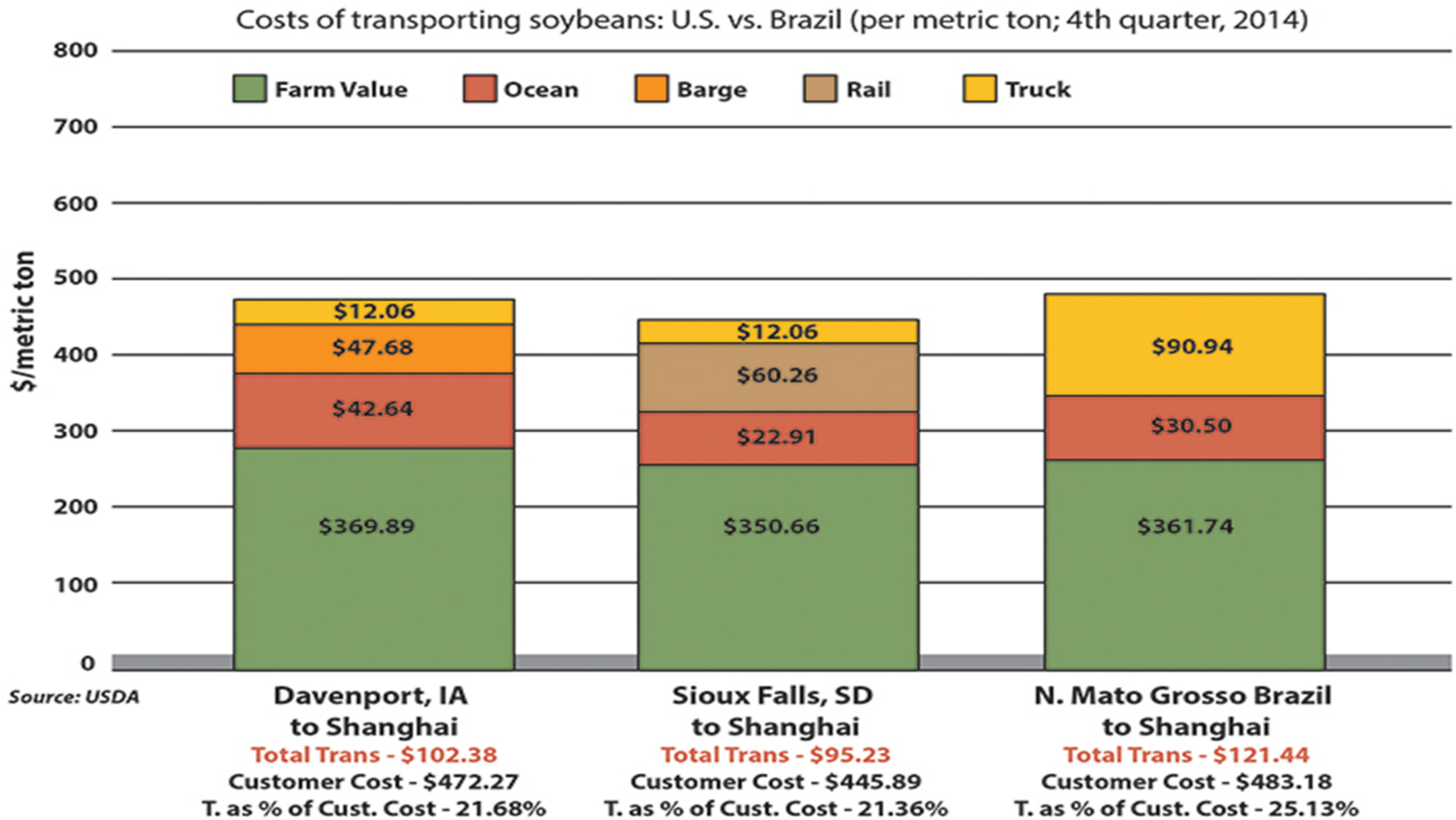
BNSF is the Grain Leader in U.S. Rail Shipments



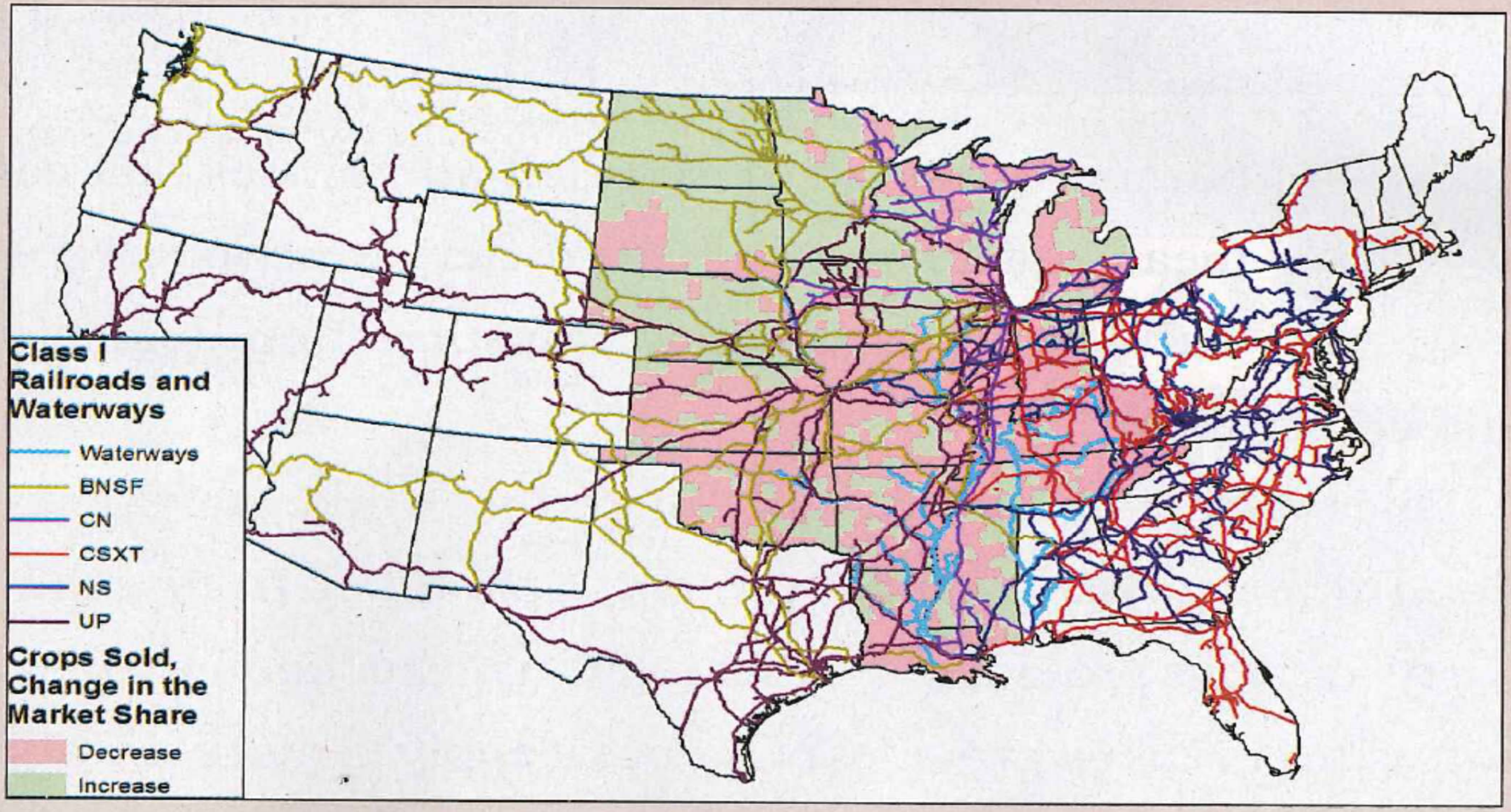
Source: Association of American Railroads (AAR) FY 2014 Weeks 1-52 Units Handled

Why Should Farmers Care About Transportation?

...because our international competitiveness depends on it.



Crops sold, 1997-2012 change in the market share



Source: USDA, National Transportation Atlas, Moffatt & Nichol.

BNSF RAILWAY

Testimony of James E. Byrum
President, Michigan Agri-Business Association
Before the U.S. Surface Transportation Board

STB Docket No. 665 (Sub-No. 1)
Rail Transportation of Grain, Rate Regulation Review

June 10, 2015

Acting Chairman Miller and Commissioner Begeman, I am James Byrum, president of the Michigan Agri-Business Association headquartered in East Lansing, Michigan. Thank you for the opportunity to appear before you today. The Michigan Agri-Business Association (MABA) represents more than 500 grain handlers, agronomy retailers, agricultural input providers, agricultural transporters and food manufacturers. Country elevators are a critical part of Michigan's agricultural supply chain and an important segment of our membership. The commercial grain industry helps drive Michigan's growing agriculture sector. Those in the grain industry are vital partners in rural communities, and their impact has far-reaching effects on other sectors of the agricultural and rural economy overall.

I hope to build on testimony you heard earlier today from the National Grain and Feed Association, and emphasize the atmosphere of tremendous uncertainty in the countryside.

This is due to two facts:

First, pending rail rate increases are beginning to cause market shifts that could fundamentally alter U.S. and international grain markets.

Second, we see little in the way of fair or reasonable avenues of recourse for grain handlers to address this situation. I wish to share our Association's concern that the current rail rate appeal processes through the U.S. Surface Transportation Board (STB) – the Stand Alone Cost, Simplified Stand Alone Cost and Three-Benchmark methods – are too complex, too time consuming and too costly to be relevant to grain shippers, especially country elevators, and they are unlikely to be a useful recourse for our industry in this situation.

The impacts of rate increases are virtually immediate, while the current appeal processes can take months or years, even then. A resolution through this process only happens long after the effects have changed the industry.

We are concerned that the Board's three existing rate-complaint procedures simply are inappropriate and unworkable for agricultural commodities and country elevators. To challenge a rate under any of the authorities provided by the STB is costly both in terms of time and money. Those costs often outweigh the potential recovery of rate overcharges. The evidentiary burden on captive shippers, even under the simplified stand-alone cost rules, is excessive.

Commodity movements are also a "moving target" by the very nature of the business. Origin and destination pairs, freight volumes, and production trends vary, which makes contesting a rate case more difficult. Market demands also shift constantly, making it more difficult to show long-term trends that are crucial to contesting an STB rate case. In addition, commodity shippers often do not generate the tonnage necessary to meet traffic densities needed to bring a rate challenge under the Board's current procedures. This is due in part to the low-density rural areas where our members and customers are located.

Finally, the railroads make the process difficult by virtue of their "bully pulpit" in the commodity transportation markets. Railroads use their market power to impose rates across-the-board for certain commodities or groups of commodities. Because STB rules require proof of a single market actor abusing the market, this industry-wide practice makes contesting a rail rate case more difficult. Under the current three-benchmark rules, only the movements of the defendant railroad may be included in a comparison group.

With regard to the market impacts of this rate increase, MABA and our members have multiple concerns. The pending rate increases are a surprise to our sector given the significant investments many in the grain industry have made in response to requests in the past by Class I railroads. These actions could have a number of significant impacts on the U.S. grain trade. For example:

The changes will arbitrarily determine "winners and losers" in the grain market. I want to emphasize that many, if not most, major rail infrastructure investments by private companies have been predicated on what Class I railroads explicitly requested, or demanded.

Many grain handlers that now are impacted negatively by these new rates have already invested heavily to improve their own rail loading operations to handle larger unit trains and move commodities more efficiently in partnership with the railroads. These investments often have been made with the encouragement or insistence of railroads.

Earlier today, for example, the Committee heard from my past Board Chairman, Bruce Sutherland with Michigan Agricultural Commodities (MAC), that his company invested more than $35 million over the past five years on such improvements. Specifically, MAC increased storage capacity and expanded operations to ship 90-car unit trains. I can highlight other companies with a similar story, such as the Cooperative Elevator Company and Auburn Bean and Grain – now The Andersons – who have invested and are now penalized. These investments were made at the insistence of CSX. These are just a few examples among many others across Michigan, Indiana, Ohio and other states. These stories highlight how pending rate changes would undercut the value of proactive infrastructure investments by the private sector.

Markets will likely fundamentally shift for Michigan-produced commodities, and U.S. producers will be at an economic disadvantage against foreign suppliers.

Proposed rate increases likely will alter and disrupt customary "grain flows," with significant consequences on agribusinesses, farmers and customers. Currently, Michigan-produced grain moves primarily to markets in the Southeastern U.S., and these changes would signal a paradigm shift in that marketing opportunity. As a result, Michigan producers and agribusinesses likely would keep grain closer to home, sending it to local livestock or ethanol production facilities whose needs are different from those of current customers in the Southeast.

In addition, current customers would be forced to look to other markets for grain. This likely would mean an increase in imports from South America for major feeders located near ports, which would hurt Michigan and U.S. companies, producers and others in the long run.

Anecdotally, we are already hearing of some customers making preparations or even carrying out plans to import corn from Brazil and Argentina.

Short line railroads that grain producers depend on would be hurt as well. The cumulative potential of lower grain volumes moving on rail puts additional pressure on the viability of short line railroads, which rely on agricultural shipments for their livelihood. This comes at a difficult time for short line operators, who are looking for opportunities to improve deteriorating infrastructure. Lower volume could mean decreased revenue and ultimately even more deterioration of the infrastructure, if not the abandonment of some lines. This would in turn cause additional harm to grain handlers and farmers.

We are already seeing pending price increases reflected in elevator bids across Michigan, and we believe the long-term economic impact will be in the tens of millions of dollars. Given the percentage of Michigan grain moved by rail, a 10 cent increase per bushel on transportation costs would result in an annual impact on Michigan producer income of nearly $50 million annually. The increase in transportation cost will be passed down to farmers, who will ultimately be hit in the pocketbook.

As the president of a local trade association, I field calls on a daily basis from those concerned about the impact of this action by CSX. As I mentioned at the beginning of my testimony, our members face a very uncertain future.

Perhaps of the greatest concern, there is no clear or timely recourse for Michigan grain handlers under current STB practices.

Ultimately, our grain shippers and other members whose livelihoods are based on grain markets are in a difficult spot. They face the many market uncertainties I outlined for you today, but have little or no reasonable opportunity to seek relief. This is a unique issue, but it has far-reaching consequences – and I hope that together, we can find reasonable ways to work through this issue and maintain the competitiveness of Michigan's agriculture sector.

Mr. Chairman and members of the committee, once again, I appreciate the opportunity to join you today, and thank you and your staff for reviewing this situation. This remains an uncertain time for grain handlers for a wide variety of reasons I outlined for you today, and I hope that we can work together to remedy this issue.