

UNITED STATES OF AMERICA  
SURFACE TRANSPORTATION BOARD

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PUBLIC HEARING

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IN THE MATTER OF: : Docket No.  
: EP 722  
RAILROAD REVENUE ADEQUACY & : &  
PETITION OF THE WESTERN COAL : EP 664  
LEAGUE TO INSTITUTE A RULEMAKING : (Sub-No.2)  
PROCEEDING TO ABOLISH THE USE OF :  
MULTI-STAGE DISCOUNTED CASH FLOW :  
MODEL IN DETERMINING THE RAILROAD:  
INDUSTRY'S COST OF EQUITY CAPITAL:  
:  
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Wednesday,  
July 22, 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 9:30 a.m.

BEFORE:

DANIEL R. ELLIOTT, III	Chairman
ANN D. BEGEMAN	Vice Chairman
DEB MILLER	Commissioner

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

(9:11 a.m.)

MR. ELLIOTT: Good morning and welcome. Today we begin a two-day public hearing to consider issues related to railroad revenue adequacy and issues regarding how the board calculates the railroad industry's cost of equity capital. When I started this proceeding it was in recognition of a change in the railroad industry. As recently as the 1970's, the industry was in dire financial straits, plagued by bankruptcy and deteriorating physical assets. In the intervening decades, however, the railroad industry has rebounded tremendously - due in significant part to regulatory changes designed to foster a return to revenue adequacy. Today we are on the midst of a rail renaissance. The rail industry carries a vast range of commodities, from agricultural products and energy products to manufacturing inputs and retail goods - traffic that amounts to more than 1.7 billion tons of freight a year. Now that the industry is both

1 financially healthier and restructured with far  
2 fewer large railroads, I believe the Board should  
3 continue the process I began of examining its  
4 core policies to insure that they fit today's  
5 modern rail industry and meet the goals that  
6 Congress laid out for the agency.

7           The Board's re-examination of its rail  
8 economic regulatory policies does not necessarily  
9 mean that significant changes to these policies  
10 are in order. Assessing the effects of any  
11 proposed regulatory action in this proceeding is  
12 a consideration of the utmost importance.

13 Recognizing that, my goal is to make sure the  
14 Board's policies reflect thoughtful, balanced  
15 decision-making that takes into account a  
16 modernized rail industry and sound economic  
17 principles. I would like to thank my fellow  
18 Board members, Vice Chairman Ann Begeman and  
19 Commissioner Deb Miller, for supporting me in  
20 carrying out this important evaluation. I would  
21 also like to thank the parties for their  
22 thoughtful comments and for the extensive

1 economic analysis many of them provided. The  
2 Board's decision-making benefits greatly when  
3 stakeholders contribute their views in a  
4 proceeding like this one.

5 Before we begin, let me just take a  
6 few minutes to review a few procedural points  
7 about today's hearing. We want to hear today and  
8 tomorrow from every party that has filed a notice  
9 of intent. To allow that to happen we will have  
10 to ask the parties to stick as closely as  
11 possible to the time that has been allotted. We  
12 recognize that that is not always going to allow  
13 you to say everything you want to, but we want to  
14 make sure that there is an opportunity for  
15 everyone to speak. We will keep the record open  
16 for fourteen days after the conclusion of this  
17 hearing to allow for the filing of additional  
18 written comments. You will have a light before  
19 you at the front of the room. One minute before  
20 your allotted time has expired a yellow light  
21 will appear. When you see the red light, your  
22 time has expired. Please conclude your thoughts



1 at that point. If you are scheduled to speak,  
2 please make sure that you check in with the clerk  
3 at the front of the room. I have also been asked  
4 to remind speakers to please speak clearly into  
5 the microphone. In addition, the public should  
6 be aware that a video archive of the entire  
7 hearing will be placed on the STB website within  
8 a few days of the close of the hearing. In the  
9 unlikely event that we have a fire alarm or other  
10 event requiring evacuation, please proceed in an  
11 orderly fashion out of the double doors at the  
12 back of the hearing room, and out of the building  
13 through the front entrance. Specific  
14 instructions have been posted at the back of the  
15 hearing room for assembly and notification of  
16 return, if any, to the hearing room following any  
17 evacuation.

18 Also a note regarding slide  
19 presentations. If you haven't done so, please  
20 send an electronic copy or two hard copies to the  
21 Board's Office of Proceedings within the next two  
22 days. Contact information is available from the

1 clerk. Finally, if you have not done so already,  
2 please turn your cell phones off. Also, we will  
3 be taking a lunch break. We haven't set the  
4 exact time, but it will probably be after the  
5 third panel, but we'll see how the panels go as  
6 we go forward. With that I will turn it over now  
7 to Vice Chairman Begeman.

8 MS. BEGEMAN: Thank you, Dan. I want  
9 to join in many of your comments. I certainly  
10 agree with much of what you said. I strongly  
11 supported initiating this proceeding back in  
12 2013. I've been working on these issues for most  
13 of my career, not specifically railroad revenue  
14 adequacy, but that issue really did come to the  
15 forefront when I was on the Senate Commerce  
16 Committee when we worked on the 2009  
17 reauthorization bill and there was a provision  
18 that talked about the need for the Board to do  
19 what we are doing now. So I think it's long  
20 overdue.

21 This is a very complex, complicated  
22 subject matter, and I really appreciate all of

1 the different filings and the fact that so many  
2 are here today and will be here tomorrow to offer  
3 their views. Mostly I want to hear what you have  
4 to say, and I'm trying to stay somewhat open-  
5 minded, although I do have strong opinions. I'm  
6 not looking to turn the clock back on the  
7 industry. You know, the industry's success is  
8 key to shippers' success, but I'm very interested  
9 in everyone's comments. I thank you, Dan, for  
10 chairing the hearing, and I also thank you, Deb,  
11 for scheduling this hearing when you were acting  
12 Chairman. So thank you both. I think we're all  
13 eager to continue this process.

14 MS. MILLER: Well, good morning. I,  
15 too, want to welcome you here and apologize to  
16 those of you from out of town for bringing you to  
17 D.C. in July. Although I must say, you're lucky  
18 to be here today and not earlier in the week. I  
19 kind of wanted to play hooky today. It was such  
20 a beautiful morning as compared to what we have  
21 had. I also want to say a thank you to staff  
22 and, to note for those of you who have been in

1       this room many times since the last hearing, we  
2       have new television screens which are bigger.  
3       Hopefully that will make it easier for you all to  
4       see. We have a new sound system and we're hoping  
5       that we'll improve the quality of the audio, and  
6       we have Wi-Fi in the room. Hopefully, for many  
7       of you, that will make these hearings easier for  
8       you to keep up with your daytime job and being in  
9       here. Staff had to scramble to get everything  
10      done and hooked up, but I'm, you know, really  
11      pleased to see it all done today.

12               I was thinking this morning, and I  
13      think we could sort of say, you know, today's  
14      hearing brought to you by the Staggers Act.  
15      Thirty-five years ago I don't know that anybody  
16      could have imagined that we would need to worry  
17      about the issue of revenue adequacy. Hard to  
18      imagine that we could have gotten here. So it's  
19      a true testament to the Staggers Act that 35  
20      years later we even have a need for having this  
21      hearing at all. Certainly no one, having read  
22      summaries of everyone's comments, is asking us to

1 turn the clock back or to fully regulate  
2 railroads in any way. And certainly that's not a  
3 goal of anyone on the Board that I'm aware of.  
4 We've made remarkable progress, and we certainly  
5 want to keep that going. And I think it's a good  
6 thing to remind everyone and to remind ourselves  
7 that when we're talking about the regulation the  
8 STB does, we're talking about five percent of the  
9 car loadings, currently, based on today's  
10 information that are available for our regulatory  
11 effort. So it's not the entire freight movement  
12 on the system that we're even talking about  
13 today, but a much smaller slice of that pie. I  
14 do think, though, that with the improved  
15 financial health of the railroad industry, it's  
16 time for the Board to give meaning to the concept  
17 of revenue adequacy. And in particular to  
18 consider what relief, if any relief, should be  
19 afforded to shippers once a carrier has become  
20 revenue adequate.

21 I have noted several times in other  
22 venues that I consider the issue of revenue

1       adequacy to be part of the issue -- excuse me, I  
2       don't consider revenue adequacy to be separate  
3       from other issues that are before the Board, such  
4       as the NITL proposal for reciprocal shipping --  
5       excuse me, reciprocal switching or the "grain  
6       rate" hearing that we had last month. And it is  
7       my belief that what we should do, at the  
8       conclusion of this hearing, as a next step, is to  
9       propose changes to the existing regulatory  
10      framework based on all of those issues that are  
11      before the Board.

12               Now whether that means a drastic  
13      rewrite, an overhaul of our regulatory framework,  
14      a few tweaks, or perhaps concluding we need to  
15      stay with the status quo, I certainly couldn't  
16      say today. I simply think it's important that we  
17      bring these proceedings to a close as soon as  
18      possible. With that, I am eager to hear the  
19      testimony and get started with today's hearing.  
20      Thank you all for being here.

21               MR. ELLIOTT: Thank you very much,  
22      Vice Chairman and Commissioner. Now we'll have

1 the first panel come up. I think we're going to  
2 note before we start that we do have Wi-Fi access  
3 now, and I believe that it's on one of the sheets  
4 that you grabbed when you came in. So we heard  
5 some mild complaints over the years that you  
6 can't look at your phones. So hopefully we've  
7 remedied that. So I urge you to try it out, see  
8 how it works. This will be the first time we  
9 used it. Okay. Now we'll hear from the first  
10 panel, Western Coal Traffic League, and you have  
11 sixty minutes.

12 MR. DOWD: Thank you. Chairman  
13 Elliot, Vice Chairman Begeman, Commissioner  
14 Miller, I represent the Western Coal Traffic  
15 League, Consumer's Energy Company and South  
16 Mississippi Electric Power Association, and  
17 they're known collectively as the Allied  
18 Shippers. With me today are Dr. John Hennigan of  
19 Micro Consulting, former director of the ICC's  
20 Office of Economics, and Dr. Harvey Levine,  
21 Independent Consultant and Former Vice President  
22 for Economics and Finance at the Association of

1 American Railroads. With our allotted time today  
2 I would like to briefly summarize the positions  
3 of the Allied Shippers on the two main issues  
4 raised by the Board in this proceeding, which are  
5 set out in detail in our comments. And respond  
6 specifically to the five questions posed in the  
7 Board's May 8th notice. Then among the three of  
8 us we hope to answer any additional questions  
9 that the Board may have.

10 The first topic on which the Board  
11 invited comments in this case is whether changes  
12 should be made to the methodology used to make  
13 annual, industry-wide determinations of revenue  
14 adequacy under the governing statute. The Allied  
15 Shippers' position is that the STB should revise  
16 its approach so that its findings catch up with  
17 the consistent assessments of the financial and  
18 investment communities, and accurately reflect  
19 the major railroad's obvious financial health,  
20 both currently and prospectively.

21 In his testimony in both phases of  
22 this proceeding, Dr. Levine demonstrated that by



1 any reasonable measure all of the major U.S.  
2 railroads have been revenue adequate as defined  
3 in Section 10704-A for a number of years, and  
4 confidently can be expected to remain so for the  
5 foreseeable future. He detailed the metric  
6 supporting this conclusion in his testimony, and  
7 I will not repeat them all here. But when one  
8 looks at such indicators as increased dividends,  
9 robust Cap X plans, combined with share  
10 repurchase programs, lower operating ratios,  
11 higher returns on equity and stronger stock  
12 prices, it is clear that the carriers have broad  
13 access to necessary capital and are earning  
14 revenues that meet the statutory criteria.

15 Dr. Levine also debunked the rather  
16 extraordinary claim advanced by Union Pacific  
17 that it and the other carriers actually face  
18 major capital shortfalls, showing that such a  
19 position can only be sustained by manipulating  
20 the test specifically to produce that answer. To  
21 bring the Board's annual determinations more into  
22 line with the proven financial realities and

1 statutory criteria, the Allied Shippers propose  
2 that the Board consider expanding its analytical  
3 model from exclusive reliance on the mathematical  
4 return on investment cost-of-capital formula to a  
5 multiple indicator approach, as was advocated by  
6 former ICC Commissioners Clapp and Gilliam in the  
7 proceeding where the return on investment cost-  
8 of-capital test was adopted. We suggest that the  
9 Board consider utilizing the six indicators  
10 discussed by Dr. Levine: market-to-book ratio,  
11 debt-to-capital ratio, operating ratio, return on  
12 shareholder equity, cash flow return and  
13 dividend-payout rate. The general recommended  
14 approach would be to develop a composite index of  
15 these indicators and use it as a check on the  
16 results of the return on investment cost-of-  
17 capital test. Specific procedures and data  
18 sources should be developed through the notice  
19 and comment process, so that all interested  
20 parties and stakeholders can have input, and the  
21 Board can have the benefit of their evidence and  
22 viewpoints. One thing that the Board should not

1 do is entertain the railroad's arguments for  
2 adoption of a replacement-cost approach to  
3 measuring a carrier's investment base for revenue  
4 adequacy purposes. The practical obstacles to  
5 such an approach have been documented and  
6 acknowledged for the past thirty years by the  
7 Board, its predecessor, the Railroad Accounting  
8 Principles Board and railroad economic experts  
9 who are not in the employ of the railroads. And  
10 as Dr. Levine and Dr. Hennigan testified, those  
11 obstacles remain today, tellingly, with one  
12 exception. The railroads and their witnesses in  
13 this proceeding offer no solutions to the proven  
14 flaws in the replacement cost approach. They  
15 simply argue that the Board should stop using  
16 revenue adequacy for any regulatory purpose until  
17 solutions to the problems with using replacement  
18 costs are found, the same solutions which have  
19 defied discovery for thirty years. Effectively,  
20 they propose to write revenue adequacy out of the  
21 rail regulatory scheme all together now that it  
22 can no longer be used as a propaganda tool. As

1 we said in our comments, this is an argument for  
2 regulatory nullification not progress. The one  
3 exception, CSXT, suggests that the railroad could  
4 solve, or the Board could solve the replacement  
5 cost problem by performing a full stand-alone  
6 cost analysis on each railroad every ten years  
7 and index the results for the years in between.  
8 CSX does not explain how the Board would perform  
9 these analyses fairly without engaging in the  
10 multi-year, multi-million dollar proceedings that  
11 currently are required in order to determine  
12 stand-alone cost for only a portion of a single  
13 railroad system. They do not address who would  
14 pay for these proceedings, how the Board could  
15 craft accurate indices to adjust the values every  
16 year or how their approach is materially  
17 different from the one previously considered and  
18 rejected by the Board in Ex Parte 679. All the  
19 railroads also ignore the need for a revision of  
20 the cost of capital methodology to accompany any  
21 replacement cost-based investment calculation in  
22 order to avoid double counting inflation. As the

1 RAPB previously found, the lack of a solution to  
2 this problem alone makes serious consideration of  
3 a replacement cost approach futile.

4           The second major issue raised by the  
5 Board concerns implementation of the revenue-  
6 adequacy constraint under the coal rate  
7 guidelines. It bears repeating that this is not  
8 a proceeding to consider whether the Board should  
9 adopt a revenue-adequacy constraint. That was  
10 done in 1985 when revenue adequacy was  
11 acknowledged by the ICC to be the first logical  
12 constraint on a railroad's pricing on captive  
13 traffic. That finding was affirmed by the Third  
14 Circuit, applied by the ICC in a number of a  
15 cases arising in the wake of the adoption of the  
16 coal rate guidelines and remains a key element of  
17 the law of rail regulation today. The purpose of  
18 this proceeding is to affirm the methodology to  
19 implement the central principle of the revenue  
20 adequacy constraint as explained by the ICC,  
21 which is that once a railroad is revenue adequate  
22 further differential pricing on market dominant

1 traffic cannot be justified.

2 As we explained in our comments, the  
3 Allied Shippers submit that prior precedent  
4 establishes the basic constraint that should be  
5 applied. As was held in CF Industries versus  
6 Cope Pipeline, a revenue-adequate carrier should  
7 not be permitted to impose further real rate  
8 increases on a captive shipper's traffic. The  
9 constraint should be available for invocation by  
10 any shipper that brings a complaint against a  
11 rate increase and is able to establish Board  
12 jurisdiction through a showing of market  
13 dominance. Once the shipper shows market  
14 dominance and that the defendant is revenue  
15 adequate, any new rate increase imposed by that  
16 carrier on that shipper's traffic should be  
17 deemed unreasonable and unlawful subject to two  
18 limited exceptions.

19 First, a revenue-adequate railroad  
20 should be permitted to adjust captive rates for  
21 actual cost inflation as measured by the RCAF,  
22 adjusted for productivity. This will prevent the

1 constraint from threatening the carrier's  
2 revenue-adequate status and will give effect to  
3 the ICC's admonitions in the guidelines that  
4 carriers should not be subject to arbitrary rate  
5 freezes, and should not be required to adjust  
6 their rates constantly to exactly maintain an  
7 equilibrium with revenue adequacy.

8           Second, and also consistent with the  
9 guidelines, a carrier should be permitted to  
10 adjust rates on particular traffic beyond actual  
11 inflation if it can show a specific need for  
12 higher revenues, specific harm that would result  
13 if it could not recover them from the shipper in  
14 question, and an inability to raise the needed  
15 revenue from any other source. The burden of  
16 proof to establish that a rate increase in excess  
17 of actual inflation should be allowed would be on  
18 the carrier. Just as the burden of proof under  
19 the stand-alone cost test falls on the shipper.  
20 Consistent with established board precedent in  
21 this area, revenue adequacy for purposes of the  
22 guidelines should be determined on a case-by-case

1 basis. And a shipper invoking the revenue  
2 adequacy constraint should be permitted to  
3 present any evidence that it considers relevant  
4 in order to demonstrate that the railroad meets  
5 the criteria of Section 10704. However, in  
6 recognition of the long-term nature of the  
7 revenue adequacy concept and in order to avoid  
8 delay in the threshold determination, Allied  
9 Shippers propose that the Board also adopt a  
10 presumption that a railroad whose four-year  
11 average return on investment is equal to or  
12 greater than the average of the industry cost of  
13 capital, properly determined, or the multi-factor  
14 analysis threshold over the same period, is  
15 revenue adequate for purposes of the guidelines.

16 The four-year approach is consistent  
17 with the Board's three benchmark methodology and  
18 reflects a reasonable business cycle. As we did  
19 in our comments, we emphasize that the constraint  
20 we are proposing would apply only to individual  
21 movements following a showing of market dominance  
22 in a complaint proceeding, and would operate only



1 to limit the carrier's ability to increase a  
2 captive shipper's rate once it is has satisfied  
3 the revenue adequacy test. In its May 8th  
4 notice, the Board also posed five specific  
5 questions with respect to the revenue adequacy  
6 issues raised in this proceeding, and I would  
7 like to turn to those now.

8 Question 1. Reference the guidelines  
9 observation that revenue adequacy should be  
10 measured over time and ask what an appropriate  
11 measuring period would be.

12 As we stated in our comments, and as  
13 the Board and its predecessor have confirmed,  
14 whether a railroad is revenue adequate for  
15 purposes of the coal rate guidelines first  
16 constraint should be determined on a case-by-case  
17 basis. However, we endorse a four-year rolling  
18 average as a sound basis for a presumption of  
19 revenue adequacy. Four years is consistent with  
20 the time period reflected in the three benchmark  
21 methodology and it was specifically endorsed by  
22 then Commissioner Clapp, in Ex Parte number 393.

1 It is consistent with the admonition in the  
2 guidelines that railroads should not have to  
3 adjust their rates annually to precisely match  
4 the revenue-adequacy line and it is reasonable in  
5 light of our primary remedy, that rate increases  
6 beyond actual inflation would not be permitted on  
7 captive traffic. The shipper would bear the  
8 burden of persuasion both as to market dominance  
9 and revenue adequacy and if the complaint is  
10 successful, the railroad only has to cancel a  
11 specific rate increase or set of increases on  
12 that shipper's traffic. Given the practicality  
13 and limited reach of our proposed remedy, a four-  
14 year measuring period for purposes of  
15 establishing a presumption of revenue adequacy is  
16 appropriate.

17 Some of the railroads in this  
18 proceeding have criticized the use of various  
19 financial metrics to measure revenue adequacy on  
20 grounds that they are not sufficiently long-term  
21 in their outlook. A four-year analytical period  
22 addresses this alleged problem and smoothes out

1 bumps or anomalous results that might be observed  
2 in one or two indicators. The railroads have  
3 also advocated the use of exceedingly long  
4 measurement periods, such as the life of the  
5 assets employed in the rail business, but this is  
6 simply another argument against any meaningful  
7 rate constraint based on revenue adequacy. A  
8 remedy that requires the analysis of data over a  
9 20 or thirty-year period and can't be employed  
10 until the records spanning a period of similar  
11 length is established is no remedy at all.

12 Question 2 asks whether a revenue-  
13 adequate railroad should be required to pre-  
14 justify future rate increases and whether such a  
15 requirement would be consistent with the  
16 governing statute and previous case law.

17 Allied Shippers' position is that the  
18 revenue adequacy constraint must be applied  
19 consistent with the existing statute and in the  
20 context of the coal rate guidelines. Section  
21 11701 limits the Board's authority to regulate  
22 rates to complaint proceedings. An established

1 precedent clearly places the burden of persuasion  
2 on complainants, both with respect to  
3 jurisdiction and the merits of rate relief.

4 Under our proposal, therefore, a captive shipper  
5 would have the burden of demonstrating both  
6 market dominance and the revenue adequacy of the  
7 defendant before invoking the presumption that an  
8 increase in its rate beyond actual inflation is  
9 unreasonable. The railroad then would have the  
10 ability to rebut this presumption by showing  
11 either that its proposed increase did not exceed  
12 RCAFA inflation, or that it meets the specific  
13 revenue need criteria set out in the guidelines.

14 That need criteria comes straight from  
15 the guidelines, which were approved by the Third  
16 Circuit. And the remedy that we propose does not  
17 require departure either from the statute or  
18 prior precedent. The Board employs rebuttable  
19 presumptions in a variety of contexts, including  
20 the limit price rule that was adopted recently  
21 from market dominance determinations. Similarly  
22 it allows for the possibility of individual rate

1 adjustments to the revenue and the variable cost  
2 ratios identified in the three-benchmark  
3 methodology.

4 Question 3 asks whether a revenue-  
5 adequate railroad's ability to continue to  
6 differentially price should be limited to all  
7 captive shippers or just a subset of the most  
8 captive. And if the latter, how the Board can  
9 best determine those most likely to be the  
10 subjects of market power exploitation.

11 Allied Shippers would caution against  
12 adopting a revenue-adequacy constraint that is  
13 susceptible to over complication or could slide  
14 into a sack-type analysis. Under Section 10701-  
15 C, a railroad is permitted to control its own  
16 pricing unless it enjoys market dominance, in  
17 which case the rates on the market dominant  
18 traffic must be reasonable. Neither the statute  
19 nor the Board's precedence contemplate degrees of  
20 market dominance, and as we have noted, rate  
21 relief from the Board can only be secured upon  
22 complaint, which itself is a differentiating

1 process. The statutory scheme clearly  
2 contemplates that rate regulation is to be  
3 applied on an individual shipper basis. Allied  
4 Shippers' proposal reflects these rules and  
5 concepts and does not assume differentiation  
6 among shippers other than that which may result  
7 from individual choice or circumstance. Once a  
8 railroad achieves revenue adequacy all captive  
9 shippers should be eligible equally for  
10 protection against further differential pricing,  
11 consistent with the guidelines.

12           However, individual shippers must  
13 elect to raise claims. Some may choose not to  
14 complain for various reasons. Some will be under  
15 contract and cannot complain, and each must make  
16 its own showing of market dominance. Under our  
17 proposal the Board's task is not to attempt to  
18 divide a hypothetical over-recovery pie. It is  
19 to ensure that the pie does not get larger at the  
20 expense of a specific complaining shipper.

21           Question 4 asks for comment on  
22 proposals to tie revenue adequacy to the

1 availability of broader competitive access  
2 remedies. The Allied Shippers take no position  
3 on this question or on the matters at issue in Ex  
4 Parte number 711 as they may relate to revenue  
5 adequacy. However, it is our view that any  
6 expansion of the availability of competitive  
7 switching or other access relief should not  
8 compromise a captive shipper's rights to rate  
9 relief under the guidelines, or alter the rules  
10 for determinations of market dominance as a  
11 jurisdictional prelude to that relief. The  
12 availability of a potential alternative remedy  
13 should not serve to undermine those remedies that  
14 currently exist.

15 Finally, Question 5 asks about the  
16 impact of a revenue adequacy constraint on the  
17 railroad's ability to invest in their networks.  
18 As the Allied Shippers foretold in our opening  
19 comments, the railroads as a chorus have  
20 proclaimed the end of reinvestment and the demise  
21 of the industry if a meaningful revenue adequacy  
22 constraint is adopted. At least insofar as our

1       proposal is concerned, these claims are  
2       dramatically exaggerated and factually  
3       groundless. The Allied Shippers' proposal  
4       imposes no limitation on railroad returns at all.  
5       It simply limits the ability of a revenue-  
6       adequate carrier to impose further differential  
7       pricing on that relatively small segment of its  
8       customer base that is captive and takes up the  
9       burden of initiating a complaint proceeding.  
10      Inflation adjustments would preserve the  
11      carrier's margins even on this traffic. And  
12      railroads remain free to earn and retain all  
13      higher returns resulting from increased  
14      efficiencies, cost reductions, stronger pricing  
15      on competitive traffic and other sources besides  
16      exploitation of captive shippers.

17               In that regard, we note that the  
18      governing statute directs that increased revenues  
19      from competitive traffic should serve to reduce  
20      the cost burden born by captive traffic not  
21      increase it. Furthermore, under our proposal the  
22      carriers would retain the ability to attempt to



1 prove that the shipper in a particular  
2 circumstance should be exposed to a rate increase  
3 beyond real inflation if the specific need  
4 criteria set out in the guidelines are met.

5           The logical end of the railroad's  
6 argument against any constraint that would "limit  
7 returns," is that there can be no rate constraint  
8 at all predicated on a carrier's revenue  
9 adequacy. As we explained in detail in our  
10 comments, such an outcome squarely conflicts with  
11 the court-approved coal rate guidelines and the  
12 governing statute, including the rail  
13 transportation policy goals set out in Section  
14 10101(6). Moreover, as we showed in our  
15 comments, Professor Baumol, himself, has  
16 explained that stand-alone costs do not represent  
17 the gold standard for determining reasonable  
18 rates, but instead is an upper limit that does  
19 not preclude application of an alternative  
20 constraint when a monopolist already is  
21 recovering revenues at a level that allows its  
22 full sustainability.

1           The record in this proceeding,  
2       including in particular the evidence submitted by  
3       the Allied Shippers, clearly demonstrates that  
4       the railroads suffer from no shortage of capital,  
5       and that on a current and prospective basis they  
6       enjoy revenues that are more than sufficient to  
7       fund needed system investments. Their stock  
8       repurchase plans are just one indicator. In its  
9       comments the AAR argues that such programs are  
10      not indicators of excessive revenues, but this is  
11      a straw man. The issue is not whether the  
12      railroad's overall revenues are excessive, it is  
13      whether they are adequate under the governing  
14      statute such that captive shippers no longer  
15      should be required to absorb differentially  
16      higher prices.

17           Assuming honest and efficient  
18      management, a railroad's decision to commit  
19      hundreds of millions or billions of dollars to  
20      the repurchase of equity is a strong indicator  
21      that management believes that it has more than  
22      enough revenue available to meet capital

1 investment and other internal corporate needs. A  
2 revenue-inadequate railroad starved for capital  
3 that chose instead to spend money propping up its  
4 stock price could not be considered properly  
5 managed. To the extent that the railroad's  
6 recent and remaining service problems are  
7 capacity-related, we submit that they are a  
8 consequence of revenue allocation choices made in  
9 the past, such as efforts to right-size their  
10 systems and not a shortage of revenues. Dr.  
11 Levine showed on opening and in reply that the  
12 railroads have had access to all the capital they  
13 need for many years. Captive shippers should not  
14 be compelled to continue to pay higher rates to  
15 make up for the results of the railroad's  
16 elections concerning whether and how to use that  
17 capital. Allowing revenue-adequate carriers to  
18 further increase rates on captive traffic is more  
19 likely to lead to increased equity buy-backs and  
20 higher management compensation than it is to  
21 increased capacity or improved service.

22 This concludes our prepared

1 presentation. We thank the Board and invite any  
2 questions that you may have.

3 MR. ELLIOTT: Getting back in  
4 practice. Thank you for your presentation.  
5 Commissioner?

6 MS. MILLER: Thank you. So Mr. Dowd,  
7 one of the things you talked about was that the  
8 four-year period comports with a business cycle,  
9 but I'd like to hear you say a little bit more  
10 about it, because four years does seem a bit  
11 short if you're looking at -- even the last  
12 recession that we had. I forget when it was  
13 technically considered to have come to an end,  
14 but, you know, it certainly felt like it was more  
15 than four years. I'd just like to hear a bit  
16 more about why you consider that to be reflective  
17 of a business cycle.

18 MR. DOWD: Well, the concept of a  
19 business cycle can be seen as fairly elastic, and  
20 our reference to a four-year cycle, a four-year  
21 period as being reasonable is tied both to  
22 precedent, to the Board's use of four years as a

1 reasonable period in a three-benchmark  
2 methodology, and also to the limited nature of  
3 our remedy. The remedy that we're proposing is  
4 to limit the ability of a market-dominant  
5 railroad to take increases above inflation in  
6 rates on a captive shipper's traffic. That is a  
7 very limited remedy both in scope and in nature,  
8 and as a consequence the length of time that  
9 would be needed to measure the carrier's revenue-  
10 adequate status does not need to be exceedingly  
11 long.

12 MS. MILLER: I want to go back -- I  
13 think you actually said this quite clearly in  
14 your testimony, but I want to be sure I  
15 understood. So when you talk about those  
16 remedies, is this correct, that in your proposal  
17 the shipper would have to, in essence, bring the  
18 complaint, they would have to show market  
19 dominance and they would have to show through  
20 their pleadings that the railroad was revenue  
21 adequate? Is that the way you laid that out?

22 MR. DOWD: Yes. And that's consistent

1 with how we read the statute. The shipper has  
2 the burden of proof in order to secure rate  
3 relief from the Board, and whether that relief is  
4 in the form of a rate prescription under the  
5 stand-alone cost constraint or a rate increase  
6 limitation under the revenue-adequacy constraint,  
7 the shipper would in either case bear the burden  
8 of presenting evidence to support that.

9 MS. MILLER: And then your proposal  
10 that the limitation be that the rate can't be  
11 greater than inflation, absent a showing by the  
12 railroad of why they need that increase, would  
13 apply then only to those captive shippers who  
14 have, in fact, brought a complaint before the  
15 Board?

16 MR. DOWD: That's our proposal. Yes.

17 MS. MILLER: Yes. Thank you.

18 MS. BEGEMAN: I think you actually  
19 clarified a couple of the questions I had as  
20 well. With respect to your comment about  
21 replacement costs, which I know can get a lot of  
22 people exercised just by saying those words. I

1 think Dan and Deb are real familiar with that,  
2 but help me understand your perspective of why  
3 it makes sense that the Board judges rates,  
4 through the SAC process for example, using  
5 replacement costs, but that we shouldn't use it  
6 to judge revenue adequacy? You know, we also  
7 typically almost always allow replacement costs,  
8 or rather the asset base, to be marked up after  
9 mergers, et cetera. So I'm just trying to  
10 understand the inconsistency, why it makes sense  
11 to judge rates one way, but to judge railroad  
12 revenue adequacy another.

13 MR. DOWD: I'd like to ask Dr. Levine  
14 to chime in here. I've been dominating this  
15 panel so far.

16 DR. LEVINE: Yes. Thank you. It's my  
17 pleasure to be here. In regard to revenue  
18 adequacy and replacement costs, what we're  
19 dealing with here is essentially investor  
20 expectations. And when investors look at the  
21 array of opportunities, they're not looking at  
22 replacement costs at all. They're looking at

1 historic book-value cost for all companies.  
2 General accounting principles and financial  
3 principles and best practices are really the  
4 language of the business community. If you, for  
5 instance, if you access Jim Cramer on Mad Money  
6 on television, you'll never hear him mention  
7 replacement costs.

8           If you look in the railroad's annual  
9 reports, the shareholders or their proxy  
10 statements, you'll never see return on an  
11 investment based on replacement costs. I've  
12 never seen a Wall Street analyst say don't buy  
13 the stock because the return on investment using  
14 replacement cost is so much lower than the return  
15 on investment using book value. That's the  
16 language of the business community. It's the  
17 language that the investor sees and analyzes, and  
18 virtually all companies across the board use it.  
19 And I've used the replacement cost in their  
20 annual reports or in their financial reporting.  
21 Now let me say also that railroads -- and I would  
22 urge the Board, aside from reviewing the annual



1 reports, the R1 reports that it receives, look at  
2 the annual reports and the proxy statements that  
3 the railroads file with shareholders in mind.

4 Replacement costs are not a consideration.

5 So to even the playing field, it's an  
6 analysis of return on investment traditionally  
7 for virtually the entire S&P 500 and everybody  
8 else. And that's, I think, what the difference  
9 is.

10 DR. HENNIGAN: Commissioner Begeman,  
11 just to add a comment to your question about the  
12 how and why of this, the revenue adequacy is a  
13 top-down approach where you're dealing with the  
14 entire entity, the entire railroad. And the  
15 replacement cost issue is what is the cost of  
16 that entire railroad now and for the future? In  
17 a stand-alone cost constraint test it's a  
18 bottoms-up approach, where what you do is you  
19 create a hypothetical railroad that is sort of  
20 custom made, custom-made hypothetical railroad.  
21 So it's bottoms-up. You know exactly what you're  
22 pricing and you price it directly. So there is

1 an ability to say we have the following  
2 equipment, services and whatever and price it.  
3 So it's much easier. That's how it's done.

4 In terms of mergers, the market  
5 actually puts a price on the value of that  
6 merger. So what's missing in the top-down is a  
7 market, an easy to reach market price. In  
8 mergers a price is stated. You know what you're  
9 dealing with in terms of the price. Bottoms-up,  
10 you have a specific railroad that you're pricing.  
11 So as the Commissioner has said for the past  
12 thirty years, the practicality of reaching a  
13 replacement cost, you know, estimate for  
14 railroads is very very difficult.

15 MS. BEGEMAN: Well that I'm certainly  
16 familiar with, but I guess this is a topic that I  
17 hope throughout the hearing the various witnesses  
18 will feel free to comment on, because I do see  
19 something of a disconnect, and I'm really trying  
20 to get as fully informed on the topic as I can.  
21 As for the specific proposal you had with regard  
22 to how the constraint could be applied to judge a

1 rate, if you could just give me a little more  
2 clarification. If the rate is found to be  
3 unreasonable -- the shipper has shown market  
4 dominance and the carrier is revenue-adequate,  
5 and supposedly assuming a railroad is unable to  
6 meet the other two tests, which would allow it  
7 raise or to defend its rate against the shipper -  
8 - is this only brought under an increase? I  
9 mean, how is a rate prescribed? You haven't --  
10 we haven't really determined what the rate should  
11 be. So is it that the shipper is only  
12 challenging an increase?

13 MR. DOWD: Well that would depend on  
14 the claim brought by the shipper. Under the  
15 guidelines --

16 MS. BEGEMAN: How would the court  
17 determine what the rate should be?

18 MR. DOWD: Well under the guidelines  
19 and the Board's prior precedence, it's very clear  
20 that the individual constraints under the coal  
21 rate guidelines can be brought collectively or  
22 individually. So if a given shipper experienced

1 a rate increase and made the determination that  
2 it was unwilling to invest the time and the cost  
3 of seeking a rate prescription under the stand-  
4 alone cost constraint for example, but its  
5 railroad, who was believed was revenue-adequate,  
6 it could elect to file a complaint and attack  
7 only the increase that it had absorbed, which as  
8 we foresee it, would be probably a shorter and  
9 considerably less expensive undertaking than a  
10 full-blown sack analysis. In the alternative, a  
11 shipper who, and there's actually a case before  
12 the Board now where this is the case, a shipper  
13 could bring a complaint, both under the stand-  
14 alone cost constraint and under the revenue-  
15 adequacy constraint where it's urging rejection  
16 of a rate increase based on revenue adequacy, and  
17 then further a prescription of a lower maximum,  
18 reasonable rate based on the stand-alone cost  
19 test. So in the first instance it would be up to  
20 the shipper to decide what relief it chose to  
21 seek and then present a case consistent with  
22 that.

1 MS. BEGEMAN: So, not to put words in  
2 your mouth, are you saying that you're  
3 envisioning the revenue-adequacy constraint  
4 approach only to be used for challenging an  
5 increase? It's not to actually determine the  
6 rate, for example, that SAC does, in which you  
7 would you get all the way to a prescription,  
8 where you determined what the rate should be, but  
9 rather you would bring a revenue-adequacy case in  
10 order to fight an increase? Is that right?

11 MR. DOWD: Yes. Our proposal would  
12 constrain the ability of the railroad to take  
13 additional rate increases on a particular  
14 shipper's traffic. I know that others in this  
15 proceeding have proposed remedies that would  
16 involve perhaps rolling back existing rates, and  
17 I'll certainly defer to them to address that.

18 MS. BEGEMAN: And then if you could  
19 also just clarify something for me. The two  
20 things that the railroad would have to prove are  
21 the increased costs, and the second one was that  
22 you could only get it from, I think you said that

1 shipper. But I think I read in your written  
2 testimony or written comments or filings that you  
3 could only get it if you couldn't get it from any  
4 other source but captive traffic. To me that's  
5 two different things. Is it just that specific  
6 shipper or is it about captive traffic in  
7 general? I mean are we going to be picking  
8 winners and losers of captive shippers?

9 DR. LEVINE: No. I don't think that  
10 you would be picking winners or losers among  
11 captive shippers.

12 MS. BEGEMAN: Would we only be looking  
13 at that particular shipper or is the proposal  
14 that the railroad looks at, says that one of its  
15 defenses is, that it needs it from captive  
16 traffic or is it from that shipper? It wasn't  
17 clear.

18 DR. LEVINE: Our proposal, it would be  
19 shipper-specific. The railroad would need to  
20 demonstrate that for this particular traffic it  
21 requires revenues that are greater than those  
22 that would be earned with inflation-adjusted

1 rates, and then has to demonstrate what the need  
2 is, the specific need for the revenue, the reason  
3 why it has to get that revenue from this traffic,  
4 and why it cannot raise that revenue in any other  
5 way. And if the railroad is revenue adequate, it  
6 may be the unusual circumstance where those  
7 factors arise, but if they did then the carrier  
8 would have the option to demonstrate the need.

9 MS. BEGEMAN: And then, I guess, one  
10 final question, at least for now. You mentioned  
11 with respect to the question of whether or not  
12 somehow revenue adequacy should be tied to  
13 competitive access -- although you said you  
14 didn't really have a position -- the one thing  
15 that you did stress was that if a shipper were to  
16 have competitive access it should not affect  
17 their ability to challenge rates. I think that's  
18 what you said -- you could still bring the rate  
19 case.

20 DR. LEVINE: Our position on that is  
21 that the adoption --

22 MS. BEGEMAN: You shouldn't be

1 prevented from seeking remedies. I think that's  
2 what you said.

3 DR. LEVINE: Yes. Our position is  
4 that if the Board were to adopt expanded  
5 competitive access relief, the fact that that  
6 remedy was potentially available should not be  
7 used to undermine the shipper's ability to  
8 demonstrate market dominance in their particular  
9 circumstance and challenge the rate.

10 MS. BEGEMAN: But how are you market  
11 dominant if you have competitive access? That's  
12 what I'm trying to get to. I'm just not  
13 understanding. It seems to be a disconnect. You  
14 either have competition or you don't. Either  
15 you're market dominant or you're not.

16 DR. LEVINE: If the Board were to  
17 expand the availability of competitive switching  
18 for example, there would still be a question in  
19 any particular circumstance whether that option  
20 actually provided legitimate effective  
21 competition. The switching fee could be set at a  
22 level that makes it unattractive for another



1 carrier to come in, for example. So our position  
2 is simply that the adoption of an expanded  
3 competitive access remedy in and of itself should  
4 not undermine the existing market dominance  
5 analysis. Whether and under what circumstances a  
6 specific shipper may have effective competition  
7 available would be based on the facts, you know,  
8 presented in that case.

9 MS. BEGEMAN: Thank you for clarifying  
10 that.

11 MS. MILLER: I wanted to ask a follow-  
12 up question related to competitive access. So I  
13 might be putting words into your mouth, but is  
14 the position of your clients that they didn't  
15 have a statement to make on competitive access  
16 today, is that an indication that they just don't  
17 see competitive access as having significant  
18 value?

19 MR. DOWD: No. Our statement should  
20 be interpreted simply as the Western Coal Traffic  
21 League, Consumer's Energy Company and South  
22 Mississippi Electric Power Association don't take

1 a position on tying revenue adequacy to a  
2 competitive access remedy.

3 MS. MILLER: And, excuse me, one last  
4 question. So I wasn't here when the competitive  
5 access issue was before the Board. Did WCTL take  
6 a position on competitive access then?

7 MR. DOWD: The position that the  
8 Western Coal Traffic League took in Ex Parte 711  
9 is consistent with the position it's taking here.

10 MS. MILLER: Which means that ---

11 MR. DOWD: That it should, that the  
12 availability of an expanded competitive switching  
13 option should not be used to undermine the  
14 existing market dominance model.

15 MS. MILLER: But does WCTL support the  
16 idea of expanded competitive switching?

17 MR. DOWD: I did not specifically  
18 participate in that proceeding.

19 MS. MILLER: Okay.

20 MR. DOWD: And I would be reluctant to  
21 characterize the details of its comments at this  
22 time.

1 MS. MILLER: Okay.

2 MR. DOWD: We can acquire that as a  
3 supplement.

4 MS. MILLER: Okay. Thank you.

5 MR. ELLIOTT: Quick question. I'm  
6 taking it back to the burden issue. I see that  
7 the shipper would be establishing revenue  
8 adequacy and market dominance, but then at that  
9 point it sounds like it flips to the railroad.  
10 Wouldn't that create an Administrative Procedure  
11 Act burden, problem, by shifting the burden back  
12 to the railroads, because it would seem to me  
13 that the burden initially would be on the  
14 railroads to show whether or not that increase  
15 was reasonable or not?

16 MR. DOWD: No. I don't believe so,  
17 Mr. Chairman, because the constraint as we  
18 proposed would require the shipper to demonstrate  
19 market dominance and demonstrate that the  
20 defendant is revenue adequate. And that would be  
21 the merits phase if you will of a challenge to a  
22 rate increase under the revenue-adequacy

1 constraint. So the demonstration of revenue  
2 adequacy would give rise to then a rebuttable  
3 presumption that the rate increase is  
4 unreasonable. The railroad would then have the  
5 option of seeking to rebut that presumption, but  
6 that is not the same thing as putting the burden  
7 of proof on the railroad in the first instance.  
8 The shipper will have already carried its burden  
9 of proof under the two prongs for the constraint,  
10 market dominance and revenue adequacy.

11 MR. ELLIOTT: So if we impose  
12 something like you're proposing it's your  
13 position that we would be able to withstand an  
14 appeal, because I assume that's something that  
15 the railroads would raise at that point, that  
16 there has been a shift.

17 MR. DOWD: Yes. We believe that the  
18 constraint that we've proposed is fully  
19 consistent with the statute, and should be  
20 sustained on review.

21 MR. ELLIOTT: And is there any case  
22 law in a similar position? I know this is a very

1 unique regulatory scheme, but are you aware of  
2 any case law that would support that?

3 MR. DOWD: I can't cite specific  
4 decisions for you, but the ICC and the STB in the  
5 past have used rebuttable presumptions in a  
6 variety of contexts and the courts have not upset  
7 them.

8 MR. ELLIOTT: Okay. And then  
9 following-up on that part, it sounds to me, okay,  
10 it flips over to the railroad once you establish  
11 revenue adequacy. So it sounds like unless the  
12 railroads come back with something, more or less,  
13 that the rate increase, when it's revenue  
14 adequate -- I mean, for the most part it's not  
15 going to take place. What I worry about is that,  
16 okay, we stop them going over revenue adequacy as  
17 far as revenues, but what happens on the flip  
18 side when they're not revenue adequate? There's  
19 nothing that balances the two. So here you're  
20 cutting them from going up, but there are going  
21 to be times when they're below the number and  
22 they're not going to be able to do anything to

1 make that up. So it seems like they're going to  
2 be at a disadvantage. Do you understand what I'm  
3 saying?

4 MR. DOWD: I think I understand your  
5 question, but I ---

6 MR. ELLIOTT: You don't like it?

7 MR. DOWD: No. To be perfectly frank  
8 I don't share your concern.

9 MR. ELLIOTT: Okay.

10 MR. DOWD: The constraint would apply  
11 to a single captive shipper's traffic.

12 MR. ELLIOTT: Sure.

13 MR. DOWD: And the railroad, and in  
14 our example we presume the railroad is revenue  
15 adequate, the railroad would have inflation  
16 protection on even that traffic going forward.  
17 If the fortunes of the railroad in the future  
18 changed and the railroad became revenue  
19 inadequate, and it desired to focus on that  
20 shipper, that individual shipper's rate and  
21 increase it. The Board, as it does in all of  
22 these adjudications, retains the authority to

1       reopen the matter.

2                   Under that example, one of the  
3       underpinnings of the relief is no longer  
4       effective. To wit the railroad is no longer  
5       revenue adequate, and I would think the railroad  
6       would have an argument on reopening that the  
7       constraint on its ability to increase that  
8       shipper's rate should be lifted. So there would  
9       be a remedy in that circumstance, but I think  
10      that given the narrow scope of the remedy that  
11      we're talking about, where it is a limitation on  
12      rate increases beyond inflation for an individual  
13      shipper who is part of a subset that Commissioner  
14      Miller suggested was only five percent of  
15      traffic. Let's assume that it's ten percent.  
16      It's still a small segment of the railroad's  
17      overall traffic base.

18                   So the notion that the constraint  
19      we're proposing is going to somehow impact the  
20      overall revenue adequacy of the carriers, I don't  
21      think, there's no logic there. I don't see that  
22      happening.

1 MS. BEGEMAN: Can I ask a question?

2 MR. DOWD: Sure.

3 MS. BEGEMAN: How long does the rate,  
4 I'm just going to say cap, because it's the only  
5 thing I can think of, but how long does it stay  
6 in effect? I realize that the Board still has  
7 control to some degree, that it could reopen  
8 probably on its own or on a petition by the  
9 carrier. But, under SAC, a weight prescription  
10 is for 10 years. How long would this rate, which  
11 isn't really a prescription, apply? Is it  
12 forever until there's some change in revenue  
13 adequacy or change in the need --- I guess, the  
14 costs? How does it get to fluctuate?

15 MR. DOWD: Well to answer that  
16 question I think you need to look at it in the  
17 context of what actually goes on out there in the  
18 marketplace. And if you look at, for example,  
19 the Board's rate prescriptions, in the majority  
20 of cases where the Board has prescribed rates,  
21 the full prescription period, which used to be  
22 twenty years, now it's ten years, very frequently



1 does not run out. What happens is the parties  
2 are able to negotiate a contract which takes  
3 over, or there is a change in the nature of the  
4 traffic, or there are other changes that impact  
5 that commercial relationship.

6 So while hypothetically, so long as  
7 the carrier was revenue adequate and so long as  
8 the shipper was continuing to make the same  
9 movement of the same traffic over the same route,  
10 the limitation on supra inflation rate increases  
11 would remain in effect. Forever, I think, is not  
12 realistic because you're likely to have  
13 commercial relations between those two parties or  
14 other changes that will impact the rates.

15 MS. BEGEMAN: One concern I have from  
16 what you're saying -- and feel free to try to  
17 convince me otherwise, and I hope others will  
18 comment on it as well -- but you know one of the  
19 things that you said from the beginning part of  
20 your testimony is that you're sort of envisioning  
21 this new rate process, you know, an easier  
22 process, not SAC -- which for that I commend you

1       -- but this certainly would have the potential to  
2       be utilized much more than the few SAC cases that  
3       have come before the Board in the past twenty  
4       years. This could become something that gets  
5       used quite frequently, and so there could be a  
6       whole lot of rates capped.

7               I can understand you using just the  
8       one shipper example. That doesn't seem  
9       necessarily to affect the network and the ability  
10      to invest, but if this should become a very  
11      popular rate capping process it could have a  
12      really big impact. So I'd like you to comment on  
13      that.

14             MR. DOWD: Well I think that the  
15      impact is quite limited because you start with a  
16      small subset of the railroad's traffic which is  
17      even eligible for the constraint. So whether  
18      it's ninety percent or ninety-five percent of the  
19      railroad's traffic ---

20             MS. BEGEMAN: But it could affect  
21      every captive shipper if ---

22             MR. DOWD: And then within that subset

1       you have to eliminate those captive shippers  
2       whose traffic is moving under contract. And a  
3       considerable amount of captive traffic does move  
4       under contract. Parties are able to reach  
5       agreement on contracts even if there's no  
6       competitive alternative. So those are the ruled  
7       ---

8                   MS. BEGEMAN: I haven't heard that  
9       very often.

10                  MR. DOWD: I'm sorry?

11                  MS. BEGEMAN: I haven't heard that  
12       very often.

13                  MR. DOWD: Well in the marketplace it  
14       is not at all uncommon for a single-served  
15       shipper, in particular an electric utility, to  
16       still have a contract with its serving carrier.  
17       So you eliminate the contract traffic, and then  
18       of course you have the traffic which is captive  
19       but is otherwise exempt. So there is a  
20       relatively small universe of traffic ---

21                  MS. BEGEMAN: I think that's how Deb  
22       got down to the five percent figure.

1 DR. HENNIGAN: Okay. Commissioner,  
2 let me just make this a bit more broad. The  
3 purpose of revenue adequacy is to constrain  
4 ultimately the Ramsey pricing that's allowed for  
5 these captive shippers under the Staggers Act.  
6 So there's always been the notion of revenue  
7 adequacy that at some point in time the rates at  
8 this five percent, or whatever the number is, are  
9 paying to cover the overhead and fixed costs of  
10 these railroads. There will come a time perhaps  
11 where it's not necessary for them to be paying  
12 these high differential rates. So where we are  
13 right now is that it may be that time, that the  
14 railroads are revenue adequate.

15 So these rates that you're worried  
16 about for the future are historically much higher  
17 than the incremental cost of moving the traffic.  
18 Staggers allowed, the Congress allowed regulation  
19 to allow the railroads to recover their costs  
20 from these captive movements, and the stipulation  
21 in Staggers was that if, and the ICC and STB, if  
22 the railroads become revenue adequate then these

1 captive rates should be constrained, you know, in  
2 the future. So I think there was always this  
3 notion, sort of this quid pro quo that when you  
4 become revenue adequate you shouldn't expect to  
5 be charging as much for these movements as you  
6 have in the past, because your rates are much  
7 higher than the incremental cost.

8 So it's just a broader perspective on  
9 why this issue, why we're dealing with this  
10 issue.

11 MS. BEGEMAN: Right. And that's what  
12 this is all about.

13 DR. HENNIGAN: Yes.

14 MS. BEGEMAN: Trying to figure out  
15 what was intended, what is intended, what makes  
16 sense. All right. Thank you.

17 MR. ELLIOTT: I had another procedural  
18 question. With respect to, okay, let's say you  
19 do the test that you've proposed and in this  
20 instance the railroad wins. And the increase is  
21 not found to be unreasonable. So at that point  
22 would the shippers still be able to challenge the

1 bottom rate from the increase? So let's say you  
2 lose on the increase itself, but what about the  
3 rate at that point?

4 DR. HENNIGAN: Well if the shipper's  
5 initial complaint included a claim that the  
6 existing rate was unreasonable under the stand-  
7 alone cost constraint, for example, then a  
8 finding that the railroad, for example, was not  
9 revenue adequate and therefore the rate increase  
10 would not be constrained under the revenue-  
11 adequacy constraint, the shipper would still be  
12 left to try to press its claim for rate relief  
13 under the stand-alone cost constraint.

14 The Board and its predecessor held  
15 numerous times in the years following the  
16 adoption of the coal rate guidelines, when it  
17 routinely considered rate challenges under all  
18 three constraints: management efficiency, stand-  
19 alone cost and revenue adequacy and frequently  
20 found that relief was not available under one or  
21 two of those constraints but then provided relief  
22 under the third. In the Arkansas Power and Light

1 case, for example, where the railroad was found  
2 to be revenue inadequate and the shipper's case  
3 under the management- efficiency constraint was  
4 not upheld, but its claim under stand-alone cost  
5 was.

6 So in your example, if the shipper had  
7 also pleaded a challenge to the underlying rate  
8 under a different constraint, that challenge  
9 could go forward.

10 MR. ELLIOTT: I just want to clarify.  
11 So in my hypothetical the railroad actually would  
12 be considered to be revenue adequate although  
13 they saw the increase that they made to be  
14 reasonable because the railroad, let's say, lost  
15 a bridge and they had to put a bridge in. As a  
16 result they had to increase their rates. That  
17 would be their argument, I guess. So at that  
18 point, if they determine that the increase was  
19 reasonable and the railroad was revenue adequate,  
20 wouldn't it be difficult to have a SAC test at  
21 that point, because how can you say the rate's  
22 reasonable and then, I mean the increase is

1 reasonable but the rate itself is not?

2 DR. HENNIGAN: Well I wouldn't want to  
3 speculate on the quality of the evidentiary  
4 presentation that a shipper in your hypothetical  
5 could present under the SAC test, but what I will  
6 say is that our proposal, consistent with agency  
7 precedent, is to add the revenue adequacy  
8 constraint as an available remedy for rate  
9 increases. The availability of the stand-alone  
10 cost constraint as a remedy for unreasonable  
11 rates generally and as a vehicle for rate  
12 prescriptions would remain fully available and  
13 fully in effect. Whether and to what extent a  
14 shipper's inability to demonstrate that it's  
15 entitled to relief under the revenue-adequacy  
16 constraint could impact its stand-alone cost  
17 case, that's speculative and I wouldn't go down  
18 that road without seeing the evidence.

19 MR. ELLIOTT: Okay, one final  
20 question. Your proposal, and I think Ann hit on  
21 it, that it creates a simpler way for you to  
22 challenge something, a rate. In this case an



1       increase. Very recently, the TRB came out with a  
2       study that I'm sure everyone in this room is  
3       familiar with, and they suggested an alternative  
4       method, obviously through arbitration, a rate-  
5       comparison test. Let's assume that we can  
6       somehow bring that within the confines something  
7       similar to a 3B test, but just more a simple rate  
8       comparison test. If we do something like that in  
9       a revenue adequate instance would you find that  
10      to be satisfactory, something along those lines?

11               DR. HENNIGAN: I just want to make  
12      sure I understand your question.

13               MR. ELLIOTT: Sure.

14               DR. HENNIGAN: Are you asking our view  
15      on a revenue adequacy constraint where once the  
16      carrier has shown to be revenue adequate the rate  
17      is evaluated by reference to other comparable  
18      rates?

19               MR. ELLIOTT: Yes. I guess --- let me  
20      even broaden that. Let me just say, generally  
21      speaking, we create an easier way to bring a rate  
22      case. I mean now we have the SAC test. Everyone

1 knows that those are very complex and difficult  
2 to handle. So what if we move more towards the  
3 rate comparison approach as opposed to a SAC  
4 approach generally?

5 DR. HENNIGAN: Well we ---

6 MR. ELLIOTT: I left you speechless.

7 DR. HENNIGAN: I don't want to appear  
8 to be avoiding your question, but the Western  
9 Coal Traffic League and Consumers Energy and  
10 South Mississippi, you know, I couldn't express a  
11 position on that. We would have to see a  
12 specific proposal from the Board and consider it.  
13 I'm sure we would participate in a proceeding to  
14 consider it, but I wouldn't be able to speak on  
15 their behalf here on that subject.

16 MR. ELLIOTT: Sure. Okay. I know it  
17 was a little off the track, but since it was out  
18 there and I have you here I thought I'd ask you  
19 the question. Deb?

20 MS. MILLER: Before we let you go I've  
21 got two more questions I'd like to ask. So I  
22 want to go back to the inquiry Ann was making but

1 ask it a little different way. So, you know,  
2 based on the numbers in the handy little pie  
3 chart I have in front of me, currently, today  
4 about five percent of the traffic based on  
5 carloads is subject to our regulation. There's  
6 roughly another fourteen percent of it that's  
7 under contract, but if not under contract could  
8 be subject to our regulation. So I think where  
9 Ann was going and the concern is if this process  
10 becomes simpler, faster, quicker, are we going to  
11 start to see a lot of traffic that currently is  
12 not subject to our regulation but moving to put  
13 itself into a position to be subject to our  
14 regulation because they find that to be a better  
15 way to hold down their rates? And then would we  
16 not be talking about a small slice of the  
17 traffic, still not, you know, a majority of the  
18 traffic, but a much bigger slice of the pie?

19 MR. DOWD: Well first of all our  
20 experience does not support the notion that  
21 shippers go out of their way to put themselves in  
22 a position where the regulatory scheme is their

1       remedy. If they have the ability to contract, if  
2       they have the ability to negotiate acceptable  
3       commercial arrangements they will do it.

4               With respect to the scope issue, I  
5       would echo, you know, Dr. Hennigan's response,  
6       which is that the notion that once carriers  
7       became revenue adequate their ability to continue  
8       to differentially price their captive traffic was  
9       imbedded in the coal rate guidelines. It has  
10      always been understood that when the time came,  
11      that the carriers achieved revenue adequacy, they  
12      would then no longer be able to exercise  
13      continued differential pricing on their captive  
14      shippers. And if that time has come, and we  
15      believe that it has, that is the predicted and  
16      intended consequence of the coal rate guidelines  
17      as initially promulgated and court approved.

18             DR. HENNIGAN: Commissioner, whether  
19      it's five percent or nineteen percent that you're  
20      concerned about, any shipper in that category, if  
21      they wanted to make, to avail themselves of this  
22      procedure we're talking about, would have to come

1 and file a complaint against the rate, determine,  
2 you know, prove market dominance and then prove  
3 that the railroad's revenue adequate, which may  
4 already be a fact. But that's an affirmative  
5 burden on those nineteen percent of traffic to  
6 come forward in a regulatory proceeding to, you  
7 know, to take advantage of it. It's not  
8 difficult, but it's not a simple process. And  
9 it's shipper by shipper on particular traffic.  
10 So there's a constraint on sort of the use of  
11 this as a regulatory tool. It's leverage for the  
12 shipper in a way, but it doesn't necessarily  
13 translate into outcomes at the commission level.

14 MS. MILLER: Thank you. And then one  
15 final question. The way you have this process  
16 set up, that the burden is initially on the  
17 shipper to come in to show that there's market  
18 dominance, revenue adequacy and then what's the  
19 term, rebuttal presumption or ---

20 DR. HENNIGAN: Rebuttable presumption,  
21 yes.

22 MS. MILLER: -- rebuttable presumption

1 would be on the railroad. So what do you  
2 envision would be the kind of an argument a  
3 railroad might be able to make that would justify  
4 a rate increase above inflation?

5 MR. DOWD: There are a number of very  
6 experienced and talented railroad counsel in the  
7 room today, and I would encourage you to ask them  
8 that question.

9 MS. MILLER: Okay. Thank you.

10 MR. ELLIOTT: Thank you very much. We  
11 really appreciate your testimony.

12 MR. DOWD: Thank you.

13 MS. MILLER: Thank you.

14 MR. ELLIOTT: And we'll now call up  
15 Panel II.

16 MR. ELLIOTT: Okay. You may begin.

17 MR. SIPE: Good morning Chairman  
18 Elliott, Vice Chairman Begeman and Commissioner  
19 Miller. My name is Sam Sipe. I'm outside  
20 counsel for the Association of American Railroads  
21 in Ex Parte 722. AAR appreciates the opportunity  
22 to appear before the Board today. With me on

1 this panel are Edward Hamberger, President and  
2 CEO of AAR and two distinguished economists,  
3 Professor Joseph Kalt and Dr. Roger Brinner.  
4 Each of us will be offering testimony on  
5 different aspects of the Board's inquiry into  
6 revenue adequacy. I will make some brief  
7 introductory remarks and will later conclude our  
8 panel's presentation by responding to the  
9 questions set out in the Board's notice of  
10 hearing.

11           The premise of this proceeding appears  
12 to be that it could be appropriate to regulate  
13 railroad rates based on whether a railroad's  
14 overall revenues are deemed to make that railroad  
15 revenue adequate. AAR firmly believes that that  
16 premise is categorically wrong. Under the  
17 governing statute, revenue adequacy is an  
18 aspirational goal rather than a ceiling on rates.  
19 The concept was introduced into the statute when  
20 the nation's freight railroads were in a state of  
21 financial collapse. Congress' clear desire was  
22 to remove the regulatory shackles that had led to

1 financial peril and had instructed the ICC to  
2 adopt policies that would allow railroads to  
3 pursue and achieve financial health.

4 Congress expected the railroads to do  
5 that through reliance on prices determined by the  
6 railroad's set in response to shipper demand.

7 Rate regulation standards like those advocated by  
8 the shippers in this proceeding that do not  
9 replicate competitive market outcomes would  
10 result in misallocation of resources and a  
11 gradual contraction of the rail network.

12 Congress freed the railroads to act like other  
13 firms in competitive markets and to set rates in  
14 response to market demand. This freedom was  
15 implemented, in part, by significantly limiting  
16 the scope of rate regulation. The Board is  
17 limited to evaluating individual rates for  
18 specific movements and may do so only upon  
19 complaint and only when a railroad has market  
20 dominance over the traffic. A top-down  
21 determination that a railroad earns adequate  
22 revenues across its entire system does not reveal



1       whether any individual rate is reasonable.

2               There has been much discussion in this  
3       proceeding of the suggestions in the coal rate  
4       guidelines that in a regulated setting a railroad  
5       need not earn returns greater than its cost of  
6       capital on a system-wide basis. But as explained  
7       in AAR's comments, this inchoate revenue-adequacy  
8       constraint was not grounded on any statutory  
9       authority or sound economic principle. Moreover,  
10      it has no coherent application to freight  
11      railroads, whose traffic is predominantly  
12      unregulated. Let me emphasize that the specter  
13      of earnings regulation is not a straw man  
14      concocted by the railroads. The revenue adequacy  
15      constraint of guidelines could be characterized  
16      as contemplating earnings regulations and that  
17      constraint is heavily relied on by shippers in  
18      this proceeding.

19             All of the revenue adequacy rate  
20      regulation proposals advanced by the shippers are  
21      premised on the notion that there is something  
22      wrong with railroads earning more than their cost

1 of capital. That notion points in the direction  
2 of earnings regulation, and it is incorrect. Now  
3 it's possible that we will hear over the next two  
4 days, under questioning from the Board, some  
5 disavowals of earnings regulation by shipper  
6 interests. And that would be an encouraging  
7 development. Nevertheless, the Board should  
8 recognize that shipper proposals from making rate  
9 relief available on virtually all market dominant  
10 traffic of revenue-adequate carriers are  
11 arbitrary, punitive and economically unsound.

12 Existing rate standards, most notably  
13 SAC, are predicated on economic principles that  
14 promote efficient allocation of resources through  
15 reliance on prices set in response to shipper  
16 demand. At this point I'm going to turn it over  
17 to Mr. Hamberger and I will conclude the panel's  
18 presentation later by responding to the specific  
19 questions the Board noted for this hearing.

20 MR. HAMBERGER: Thank you, Sam.  
21 Chairman Elliott, Vice Chairman Begeman,  
22 Commissioner Miller, on behalf of the members of

1 the Association of American Railroads, thank you  
2 for the opportunity to appear before you this  
3 morning. AAR's members build and maintain the  
4 nation's coast-to-coast freight rail network,  
5 thereby insuring that the U.S. economy functions  
6 efficiently and effectively, and that millions of  
7 passengers have reliable transportation on Amtrak  
8 and commuter trains that access our rail lines.  
9 As Commissioner Miller noted in her opening  
10 comments, the partial deregulation that Congress  
11 and the Carter Administration put in place 35  
12 years ago literally transformed a dying industry  
13 into one widely recognized as the best in the  
14 world.

15 Partial deregulation laid the  
16 foundation for the industry's success, and  
17 allowed the railroads to earn enough to make  
18 massive investments in rail infrastructure. This  
19 private investment allowed rail productivity to  
20 surge, leading to lower rates that in turn  
21 attracted larger volumes of new traffic with  
22 freight rail competing head-on against other

1 modes of transportation, such as trucking,  
2 pipelines, air cargo and barges.

3           These two days of hearing at the STB  
4 on revenue adequacy, quite naturally, are of huge  
5 importance to our companies, because whatever  
6 action you take will directly impact the  
7 financial well-being of the freight rail network  
8 and the industries and the customers that we  
9 serve across America. Make no mistake, as you  
10 take up revenue adequacy you are painting on a  
11 much larger canvas than just the inside of this  
12 room. What you are considering and may decide in  
13 this hearing room, just a stone's throw from the  
14 U.S. Capitol, will ripple across the economy and  
15 ultimately impact almost every American. This is  
16 not a hearing about an arcane formula of what  
17 constitutes adequate revenue at any given freight  
18 railroad. It is a hearing about the future of  
19 the U.S. economy. It is a hearing about whether  
20 our nation will continue to have a world-class  
21 freight rail system to propel its economic  
22 success. And yes it is a hearing about whether

1       you will let the U.S. freight rail system back on  
2       a trajectory of failure, back to where it was  
3       before the Staggers Act. And that is exactly why  
4       Congress in 1980 established revenue adequacy as  
5       a goal and not as a mandate to constrain the  
6       revenues of freight railroads.

7               Now comes a handful of interest groups  
8       that want you to cut their transportation costs  
9       by direct government intervention at the expense  
10      of the greater good. Let's call it what it  
11      really is. They want you to institute a regime  
12      of wide-ranging price controls on freight  
13      railroads. The reason economists, and you'll  
14      hear later, are skeptical about price controls is  
15      that they distort the allocation of resources.  
16      When the marketplace cannot respond to increased  
17      demand you get shortages and quality  
18      deterioration. And to try to prevent erosion of  
19      quality the agency controlling prices then has to  
20      actively regulate the service quality as well.

21              At the end of the day what that means  
22      for the rail industry is very simple. If you cut

1 rail rates you discourage innovation,  
2 productivity initiatives and diminish revenue.  
3 And if you diminish revenue you curtail the  
4 amount the rail companies are able to return to  
5 their networks, which currently is huge, twenty-  
6 nine billion dollars in 2015 alone, 575 billion  
7 since 1980. If you curtail this level of  
8 spending then this agency could very well be  
9 responsible for the frustration of a number of  
10 important government policies and national goals.  
11 And I'm not being theoretical here. Seven very  
12 specific policy goals in danger should the Board  
13 cap the revenue that railroads can earn by  
14 misapplying the concept of revenue adequacy.

15 First, of course, is the policy of  
16 improving service. Less money to invest means  
17 that railroads will have to make hard choices.  
18 They will not be able to invest in building  
19 capacity in as many locales as shippers demand.  
20 That will result in less reliable service. Look  
21 at how the railroads responded to the service  
22 challenges in 2013 and '14, rapidly and with a

1 huge infusion of capital. Demand will only  
2 increase. That's because the U.S. population is  
3 projected to grow by seventy million people by  
4 2035, generating 2.8 billion more tons of  
5 freight, a 22 percent increase.

6           Number two, the policy of increasing  
7 exports: exports help drive job growth and  
8 sustain the economic recovery. U.S. producers  
9 rely on our effective and affordable freight rail  
10 system to get their goods to U.S. ports to  
11 compete on world markets. Fully one-third of  
12 U.S. exports get to market by rail.

13           The policy of achieving energy  
14 independence: freight railroads are a key  
15 contributor in the effort to wean America off  
16 foreign sources of oil. By providing safe and  
17 reliable transportation they have played a large  
18 role in allowing domestic oil production to  
19 flourish and for U.S. energy independence to  
20 become tantalizingly close. They accomplish this  
21 by being able to apply massive resources to the  
22 market to meet the changing commodity demands.

1 They have also contributed to this goal by  
2 becoming the most fuel-efficient mode of land  
3 transportation with each new, greener locomotive  
4 costing between 2.5 and three million dollars.

5 The policy of enhancing safety: safety  
6 investments by freight railroads and tracks,  
7 switching and signaling systems, and yes  
8 including ten billion dollars for positive train  
9 control, bridges and tunnels and equipment have  
10 been and remain one of the most important ways to  
11 enhance rail safety. It is not a coincidence  
12 that the accident rate has declined 80 percent  
13 since 1980. A well-maintained railroad is a  
14 safer railroad.

15 The other equally important factor to  
16 improving safety is recruiting and training the  
17 world's best rail work force, the combination of  
18 investments and a well-trained, dedicated  
19 employee base lead to 2014 being the safest year  
20 on record.

21 Number five, the policy of  
22 increasing freight railroad's share of freight



1 traffic: in order to lessen highway congestion  
2 and to use a mode that is more energy efficient,  
3 reducing greenhouse gases, the national rail  
4 plan, prepared by the U.S. Department of  
5 Transportation, proposes a goal of having rail  
6 move fifty percent of all freight traffic  
7 transported over five hundred miles. I will  
8 remind you that the cost of a new intermobile  
9 yard can easily exceed two hundred million  
10 dollars.

11           The policy of improving on time  
12 performance for Amtrak and insuring reliable  
13 service for commuters: demand for freight and  
14 passenger service will increase in the next  
15 twenty years. Since freight railroads serve as  
16 the operational foundation for much of America's  
17 passenger service, investments in the network  
18 must keep pace or else service for Amtrak and  
19 commuter services hosted on our lines will  
20 deteriorate.

21           And finally, the policy of increasing  
22 the resiliency of the national freight network.

1 Two major hurricanes that struck the Gulf Coast  
2 in 2005 demonstrated that the cost would be  
3 extraordinarily high for strengthening freight  
4 rail facilities vulnerable to the threats of  
5 rising sea levels and severe weather events.  
6 This lesson was driven home when Hurricane Sandy  
7 devastated the East Coast.

8 I submit to you that these seven very  
9 specific policy goals have broad, bipartisan,  
10 executive and legislative branch support. The  
11 common theme in meeting all of these policy goals  
12 is adequate revenue to maintain and expand the  
13 one hundred forty thousand mile rail network, and  
14 there is a direct correlation between what you  
15 decide in this proceeding and whether railroads  
16 will in fact have the necessary resources and  
17 correct incentives. In short, this Board would  
18 be putting the attainment of these goals at risk  
19 by acceding to the demands of the handful of  
20 interest groups seeking to use revenue adequacy  
21 as a means for achieving far-reaching price  
22 controls.

1           The U.S. Senate recently signaled the  
2       way forward for the STB. The STB Reauthorization  
3       Act of 2015, which is forcefully supported by  
4       many shipper groups testifying in this  
5       proceeding, was passed by the full senate by  
6       unanimous consent in June. It would provide  
7       commonsense process improvements to allow the  
8       Board to work more efficiently and at the same  
9       time recognizes the need for freight railroads to  
10      provide billions of dollars in private spending  
11      so tax payers don't have to. In fact, the bill  
12      explicitly states that in considering the concept  
13      of revenue adequacy, the Board must consider the  
14      infrastructure and investment needed to meet the  
15      present and future demand for rail services.  
16      Nothing could be clearer. The U.S. Senate fully  
17      recognizes that if this Board caps our revenue,  
18      thus moving in the opposite direction of this  
19      bill, then freight railroads will, in fact, not  
20      be able to meet the present and future demand for  
21      rail services.

22           It took decades for the railroads to

1 rebound from the brink of ruin, decades and  
2 massive private investment. Indeed the industry  
3 is an example of how private companies can  
4 provide sweeping public benefits, but decades of  
5 progress could be undone in the blink of an eye.  
6 Over these two days you will hear detailed legal  
7 and economic arguments. They are important to be  
8 sure. But let me urge you not to get caught up  
9 in the minutia of these arguments so that you  
10 lose sight of the bigger picture that I have  
11 tried to paint here this morning. America wants  
12 to remain a global economic leader. U.S.  
13 government officials want to insure energy  
14 independence. Passengers need to have access to  
15 state-of-the-art rail lines, and U.S. companies  
16 want to ship their products to new markets and  
17 create new American jobs. Right now freight  
18 railroads are able to help attain these goals.  
19 We are able to help attain these goals right now  
20 because of thoughtful governmental leadership.  
21 Freight rail success today is due to the  
22 foresight of the government leaders in 1980 who

1       unleashed the transformational power of the  
2       marketplace through partial deregulation.  
3       Subsequent federal involvement in rail economics,  
4       both in the legislative and regulatory arenas,  
5       honored the belief that a developed nation  
6       requires a top-notch freight rail system, and  
7       that that system is best provided by private  
8       companies in control over their resources rather  
9       than through the government.

10               The message to you is clear. Continue  
11       to honor that belief. Thank you for your  
12       attention, and I'll now turn it over to Roger  
13       Brinner.

14               MR. BRINNER: Good morning, Chairman  
15       Elliott, Vice Chairman Begeman and Commissioner  
16       Miller. My name is Roger Brinner. I appreciate  
17       the opportunity to appear before the Board in  
18       this important proceeding. I have a PhD in  
19       Economics, and I taught Economics at both Harvard  
20       and MIT. I've spent the bulk of my professional  
21       career consulting foreign advising U.S. firms on  
22       how to position themselves for financial success

1 in competitive markets. My experience is  
2 directly relevant to what I understand to be one  
3 of the central issues in this proceeding, which  
4 involves what policies the Board should promote  
5 in light of the improved financial performance of  
6 the nation's freight railroads and the  
7 possibility that they will achieve what the Board  
8 calls revenue adequacy.

9 The first point I would like to make  
10 is that comprehensive evidence confirms that  
11 railroad industry rates of return are not greater  
12 than market norms. They are less. The rail  
13 industry rate of return investment has  
14 consistently for the past decade been  
15 substantially lower than that achieved in the  
16 private sector by other relevant, referenced  
17 industries. As I described in my written  
18 testimony, my calculation is based on widely used  
19 Bloomberg data, and I cite that just because it  
20 is a high quality source that's checked by firms  
21 themselves, because they want to make sure the  
22 reporting is accurate. So it's a widely-

1       respected database. It shows that railroads  
2       earned a 7.2 percent return on average in the  
3       past decade, 2004 to 2013. Other industries with  
4       similar economic characteristics have fared far  
5       better. Aerospace and defense earned 15.7  
6       percent, pharmaceuticals, 15.4 and electrical  
7       equipment manufacturers earned 15.6 percent.  
8       Exhibit 1B from my opening statement shows that  
9       the railroad industry return on invested capital  
10      has been consistently below that of these other  
11      industries since 1998, and the exhibit we  
12      reproduced here just reminds you of that.

13               In contrast to the large gaps between  
14      rail and peer returns, each of these peer sectors  
15      has cost of capital very close to that of rail.  
16      Exhibit 2 reproduced here, compares the weighted  
17      average return on invested capital to the  
18      railroad and to industries with similar economic  
19      characteristics. With the phrase similar  
20      economic characteristics, we're referring to the  
21      critical characteristic that each of these  
22      comparables to rail requires massive capital

1 expenditures in the course of ordinary business  
2 operations relative to other sectors. In other  
3 words, the rail industry has achieved a lower  
4 rate of return is not attributable to a lower  
5 cost of capital or other economic characteristics  
6 that would logically differentiate its normal  
7 dependable return from returns of meaningful  
8 peers. The highlighted area there just shows you  
9 comparable costs of capital. And you'll note  
10 that rail sits about half the 15 percent level of  
11 these reasonable referenced industries.

12 So that leads us to the second  
13 important point I would like to make. It's  
14 perfectly normal for an industry to regularly  
15 earn more than its cost of capital, both as a  
16 matter of economic theory and empirical  
17 experience. The rates of return in most other  
18 industries clearly show that firms in a  
19 competitive market are not limited to earning an  
20 average return equal to the weighted cost of  
21 capital. For most industries, the ROIC is well  
22 above the corresponding cost of capital



1 identified by the diagonal line. This is  
2 certainly most dramatically true when the economy  
3 is near full in employment and all invested  
4 capacity is fully utilized, but it's equally true  
5 in looking through the full business cycle. In  
6 competitive markets the average ROIC should  
7 exceed the weighted average cost of capital  
8 according to theory, and does so according to  
9 sound data.

10 A critical socially beneficial role of  
11 firms in the U.S. economy is to seek and develop  
12 attractive investment opportunities and pursue  
13 those that have expected returns at least equal  
14 to the cost of capital, equal to or exceeding.  
15 By simple arithmetic, if you pursue all projects  
16 promising more than or at least equal to the cost  
17 of capital and you pursue none offering less than  
18 the cost of capital, your average expected return  
19 must be greater than the cost of capital. It  
20 really is that simple. The prospect of returns  
21 exceeding the cost of capital spurs innovation  
22 through proven risk-taking, and these investments

1 will lead to the productivity improvements  
2 necessary to raise the American standard of  
3 living.

4 Now the notion that a firm subject to  
5 regulatory oversight might be penalized for or  
6 prevented from achieving an average return above  
7 the cost of capital is irrational. What would  
8 the regulator want industry executives to do to  
9 match but not exceed the cost of capital? Would  
10 you like them to pursue too many projects,  
11 including those not expected to cover the cost of  
12 capital so as to reduce the average? No. Would  
13 you want them to execute those opportunities  
14 potentially, earning more than the cost of  
15 capital, but do so in an inefficient and cost-  
16 squandering manner so as to cut the realized  
17 return? No. Instead, wise regulation would  
18 encourage rail executives to pursue the right  
19 opportunities efficiently, earn a higher than  
20 cost average return and be able to attract the  
21 market capital that will obviously sustain the  
22 rail industry America needs. Capping returns of

1 the cost of capital would undeniably create truly  
2 perverse incentives and asymmetries versus the  
3 rest of the economy. This would undeniably lead  
4 to too little capital attracted to rail, and that  
5 capital which was attracted would be encouraged  
6 by the regulator to be poorly managed. This  
7 discussion broadly explains why successful firms  
8 can be expected to earn more. Moreover, it  
9 summarizes detailed firm-specific behavior  
10 witnessed in the budget cycle of very many well-  
11 managed firms. In the next exhibit I show you  
12 the type of discussion I have witnessed and which  
13 railroads and every industry pursues during their  
14 budget cycle. They get requests for new  
15 investments from all their divisions. They sort  
16 them. They rank them, and in this example I say  
17 all right, the top yielding project number one is  
18 asking for \$700,000. The scale doesn't matter.  
19 They're illustrative with reasonable weights of  
20 return and relative values. And this project,  
21 because it perhaps is very important to this  
22 firm, yields a twenty-three percent rate of

1 return. In a rail industry example perhaps this  
2 would be relieving a bottleneck that's come  
3 because of a surge of unexpected traffic. So if  
4 the high volume with affixing a bottleneck would  
5 give you a high rate of return. So that twenty-  
6 three percent is associated with the \$700,000.  
7 So the cumulative of RIC is just the RIC on that  
8 project. If you keep layering in the incremental  
9 projects, you'll see by the time you get to the  
10 sixth project, which has an 11 percent rate of  
11 return with a comparable investment, the  
12 investments have cumulated to four million but  
13 the average return is 17. 17 is just the average  
14 of the 23, 21, 19, 16, 14 and 11. That goes on  
15 everywhere. And then they look at the next  
16 project and they say you're only offering us  
17 eight percent. Now our cost of capital is a  
18 given number. We know from experience that not  
19 all projects work out as well as they hoped, that  
20 project managers have a certain amount of  
21 unbridled optimism perhaps when they bring  
22 forward a project in their division. So we set a

1 hurdle rate that's a little bit above our  
2 official cost of capital. So in this example I  
3 say eleven. So that's their cut-off point and  
4 they reject all below a level. That's how you  
5 get to an average return if it's higher than the  
6 cost of capital.

7 Now this is for one project cycle, one  
8 year's budget meeting. You repeat that over the  
9 life of the enterprise and, of course, the  
10 average of the average is the number that you  
11 come up with. Now this isn't just tied to  
12 capital budgeting. I'd be happy in Q&A to show  
13 you how this phenomenon of the average value  
14 being far higher than the cost is pervasive in  
15 your own personal behavior. It's a notion known  
16 as consumer surplus. So we can explore that if  
17 you feel uncomfortable with this.

18 So if railroads were regulated to cap  
19 their average rate of return of their costs they  
20 would be put at a disadvantage as they strive to  
21 attract sufficient extra investment dollars,  
22 because they'd be asked to do something very

1 different from what every competitive industry  
2 does.

3 Now let me switch topics and speak  
4 briefly about the subject of financial metrics.  
5 The Board correctly looks at return on invested  
6 capital to assess railroad revenue adequacy.  
7 Although I do believe it measures the asset  
8 values somewhat incorrectly. Some commentators  
9 and testifiers suggest that the Board should  
10 abandon the use of ROI or extend the beyond it  
11 and look at short-term financial metrics that are  
12 prevalent in the media, like railroad stock  
13 performance or the six other metrics that Mr.  
14 Levine suggested. I often tell the students in  
15 my economics and finance classes, if you just  
16 read the paper your economics I.Q. is severely  
17 threatened. The journalists, the journalists  
18 aren't trained in finance or economics. People  
19 will talk about anything that seems to them to be  
20 interesting whether it has any theoretical  
21 relevance. And I'm afraid, as I remarked in my  
22 counter to Mr. Levine's testimony, that's what it

1 feels like he was doing today, doing to you.

2 Railroad stock performances improved  
3 over the last decade, and those who invested at  
4 the right time have certainly benefited, but the  
5 improved performance of railroad equities  
6 reflects improved rail performance from a very  
7 depressed starting point, not supernormal  
8 earnings. This exhibit shows you the price  
9 earnings ratio and you see from 2000 to 2013 this  
10 was the data that was available, and I prepared  
11 my testimony in the middle of last year.

12 Finally, the rail price earnings ratio came up to  
13 match that of the standard Forbes 500 aggregate.  
14 For 2014, last week I pulled the data together  
15 and rail has once again fallen below. I show you  
16 this not because I'm recommending it, but just to  
17 show you that the multiple of earnings today is  
18 in the neighborhood of the aggregate but it's far  
19 from being regarded as excessive.

20 Other financial metrics like return on  
21 equity or operating ratios provide only partial  
22 and often distorting information about financial

1 performance. ROIC is the core measure of  
2 financial performance that must be assessed to  
3 determine long-term financial viability and to  
4 provide meaningful comparisons of financial  
5 results across industries. Some commenters point  
6 to the railroad's ability to pay dividends and to  
7 repurchase stock as evidence that railroads have  
8 excessive earnings, but such uses of funds are  
9 appropriately pervasive throughout the economy.  
10 Investors look to firm to provide both short and  
11 long-term returns for the investor's commitment  
12 of capital. In the short run, investors often  
13 want to see a portion of cash flows immediately  
14 returned to them as dividends or reflected in  
15 improved prices created by current share  
16 repurchases. In the long run, investors also  
17 expect sufficient funds to be reinvested in the  
18 firm to keep the firm competitively modern and to  
19 expand its capacity commensurate with market  
20 growth. Such reinvested capital eventually  
21 improves earnings and thus improves share prices  
22 to give the investor a long-term return. As I



1 note in my testimony, the exact chosen mix of  
2 these three uses of funds, dividends, repurchases  
3 and capital spending, at any point in time for  
4 any firm, depends on the economic and financial  
5 situation of each firm and of the national macro  
6 economy. But despite the Board's appropriate use  
7 of an ROI standard, its current approach to  
8 evaluating railroad ROI produces misleading  
9 results. The Board's calculated results are in  
10 my opinion systematically overstated to the use  
11 of depreciated original cost to asset values and  
12 the treatment of deferred taxes. Economists and  
13 investors both know that the rate of return  
14 should be calculated using the replacement cost  
15 of assets. Investors evaluate investment  
16 opportunities based on the current cost and  
17 market value of assets rather than the original  
18 decades-old cost of assets.

19 The Board's treatment of deferred  
20 taxes is also not consistent with the manner in  
21 which investors consider deferred taxes when they  
22 evaluate investment opportunities. Investors in

1 other industries expect to earn a return on  
2 deferred taxes. So deferred taxes are left in  
3 the asset base when measuring return on  
4 investment, such as in the Bloomberg calculations  
5 I shared with you. The Board, on the other hand,  
6 excludes deferred taxes from the railroad's  
7 investment base and thereby overstates the  
8 potential attractiveness of railroad industry's  
9 investments relative to other industries.

10 The final point I would like to make  
11 today is that railroad revenue adequacy should be  
12 evaluated over the full service life of assets.  
13 The economic value of an investment needs to be  
14 determined over an appropriate life, such as its  
15 service life. By examining investment, excuse  
16 me, by doing so the returns can be calculated  
17 across a full and relevant range of economic,  
18 financial and competitive conditions. Use of the  
19 shorter snapshot time frame to assess performance  
20 can and probably will result in an incomplete and  
21 unreliable assessment with no guarantee that, as  
22 they say in the financial press, past performance

1 are indicative of future performance.

2 As I explained in my written testimony  
3 in this proceeding, railroad assets have  
4 exceptionally long lives. According to the  
5 statistics published by the Bureau of Economics  
6 of the U.S. Department of Commerce, rail  
7 equipment service lives are twenty-eight years,  
8 and railroad structure lives range from thirty-  
9 eight to fifty-four. To determine whether  
10 returns are sufficient to replenish rail assets  
11 the STB would need to take account of the long  
12 lives of these rail assets. This morning the  
13 shippers alleged, contrary to all facts, that  
14 four years is a reasonable business cycle. I  
15 stifled laughing. Since 1959 we have seven  
16 recessions of various degree. So we got fifty-  
17 six years and seven recessions. I would call  
18 that eight. All right? And, in fact, some of  
19 those were minor recessions. If you look from  
20 when the economy got the full employment in 1969  
21 at four percent, the next time we got to four  
22 percent was 1999, thirty years. There are wide

1 varieties in business cycles, and picking just  
2 one with an average of eight years will give you  
3 a somewhat arbitrary representation for an  
4 industry whose service lives are so long.

5 In conclusion, I would emphasize that  
6 the available evidence indicates the railroads  
7 are not earning excessive returns, and should not  
8 be punished for improved financial performance by  
9 restrictive regulation that inhibits them from  
10 behaving the way other firms reasonably do in  
11 competitive markets. Thank you very much.

12 MR. KALT: Thank you very much, and  
13 thank you for allowing me to speak to you today.  
14 My name is Joe Kalt and I'm the Ford Foundation  
15 Professor Emeritus of International Political  
16 Economy at the John F. Kennedy School of  
17 Government at Harvard University. Throughout my  
18 career the economics and regulation of the  
19 railroad industry have been key issues addressed  
20 in my work. And at the risk of sounding a bit  
21 like a pedantic professor, which I am, I'd like  
22 to begin with some discussion of some of the

1       basic economic principles at work here.

2                   In particular this proceeding raises  
3       the broad issue of whether the Board will  
4       continue to embrace economically-sound methods of  
5       rate regulation.   The starting point for  
6       addressing that question is the core principle  
7       that the public interest is best served by rate  
8       regulation that seeks to replicate competitive  
9       market prices.   Competitive markets compel  
10      sellers of goods and services to produce what  
11      they offer consumers at the lowest possible cost.  
12      Competitive markets also propel sellers of goods  
13      and services to figure out what the consuming  
14      public wants and needs, inducing sellers to  
15      tailor their goods, their services and their  
16      pricing appropriately.   Competitive markets  
17      operate by price and profit signaling, showing  
18      consumers low prices where supplies are more  
19      abundant and higher prices where cost makes  
20      supply more difficult to provide.   At the same  
21      time competitive markets show sellers  
22      opportunities for higher profits through

1 expansion where strong demand is tending to hold  
2 prices above costs, and to discourage supply  
3 where the opposite occurs.

4           Based on these most basic of economic  
5 principles, rate regulation which serves the  
6 overall public's interest in a healthy and  
7 efficient economy only imposes rate caps where  
8 competition is absent and where regulation can be  
9 more effective in pushing prices to the levels  
10 they would have if competition were present. The  
11 centrality of competitive market prices to the  
12 public's interest in a healthy and national  
13 economy is not some mere ideological  
14 predilection. It is undergirded by decades of  
15 Nobel prize-winning economic research. In fact,  
16 the competitive pricing standard is behind the  
17 revolution in economic regulation that has taken  
18 place in the U.S. and in most of the rest of the  
19 world over the last several decades. Old style  
20 public utility or earnings-based regulation that  
21 is franchise monopolies with their rates or  
22 prices regulated to produce revenues just

1       adequate to cover their accounting book asset  
2       values plus a cost of capital. That old style of  
3       regulation has reluctantly been abandoned because  
4       it distorted market forces and ultimately harmed  
5       the consuming public.

6               In fact, the Staggers Act is a premier  
7       example of the successes of regulation, which  
8       employs the standard of letting markets determine  
9       rates when competition is present, and seeking to  
10      reproduce competitive pricing through regulation  
11      only when it is demonstrated that market  
12      dominance is present and being abused. Various  
13      shipper proposals in this proceeding would have  
14      the Board impose rate caps of some form based on  
15      a carrier's overall level of revenues or  
16      earnings. These proposals are not founded on the  
17      principle that regulation should separate with  
18      equal competitive prices. Indeed these proposals  
19      are not even founded on economically coherent  
20      principles of revenue adequacy.

21              I say this for several reasons. As  
22      Dr. Brinner has just discussed, the economic

1 evidence does not support assertions that  
2 carriers are or soon will be revenue adequate.  
3 Such assertions are based on improper and  
4 economically flawed measurement of the concept of  
5 revenue adequacy. Proper measure of revenue  
6 adequacy would be based upon the answer to the  
7 question of what overall revenues are  
8 contestable, that is a competitive market would  
9 provide to want a written system, a system-wide  
10 stand-alone railroad. That is a system-wide SAR  
11 seeking to provide a same service, perhaps more  
12 efficiently, as the incumbent. As Dr. Brinner  
13 noted, this basic economic principle is  
14 contradicted by attempts to measure and assert  
15 revenue adequacy based on comparisons of  
16 carrier's market cost of capital to their rates  
17 of return calculated on the basis of depreciated  
18 book values of often long ago invested capital.  
19 We often illustrate the flaw and its much abused  
20 historic book value approach with the case I  
21 discuss in my verified statement. Consider the  
22 case of an older, fully depreciated apartment



1 building. Based on historic book value, a fully  
2 depreciated apartment building will be calculated  
3 to be earning an infinite rate of return even if  
4 it can and does charge no more than competitive  
5 market rents for its units. If that apartment  
6 building's rental rates were capped based on  
7 revenue adequacy defined by historic depreciative  
8 book value, our depreciated apartment building  
9 would have grossly excess revenues and would have  
10 its rental rates driven towards zero. We would  
11 then expect the quality and eventually the very  
12 existence of that capacity to deteriorate. Such  
13 regulation would be economic nonsense. The  
14 public interest demands that the apartment  
15 building be able to charge the rental rates  
16 determined in the competitive unregulated  
17 marketplace. Holding prices below competitive  
18 levels ignores the fact that the owners of the  
19 capital, whether it be railroads or an apartment  
20 building have to themselves compete in capital  
21 market for the capital they need. Tying their  
22 hands with below competitive prices ties their

1 hands in competing for capital. Initially, of  
2 course, in my hypothetical here, customers love  
3 it. That is, the renters in the apartment  
4 building love having rents depressed below  
5 competitive levels. But the example that I'm  
6 giving is not just the teaching device of this  
7 pedantic professor. It is, in fact, the  
8 disastrous lesson behind every inner city in the  
9 United States where the argument has prevailed  
10 that those landlords are rich enough, they have  
11 enough money, we can depress their rental rates  
12 below competitive levels. Applied to railroads,  
13 the principle of competitive pricing and healthy  
14 and dynamic industry means basing revenue  
15 adequacy on the revenues of a contestable market,  
16 would generate to cover the replacement costs of  
17 an efficient system-wide czar. It is telling in  
18 this proceeding that no responsible party is  
19 telling you that replacement cost is not the  
20 economically correct measure. Rather, you're  
21 being told that it's too hard to calculate and  
22 implement. But engaging in economic nonsense

1 because doing what is correct is too hard is the  
2 foundation for unsound policy in which parties  
3 from any side, carriers, shippers have the  
4 ability to manipulate policies that are  
5 untethered from sound economic principles. An  
6 economic coherent concept of revenue adequacy  
7 recognizes that in a dynamic and ever changing  
8 economic environment, the revenues of a  
9 contestable competitive market would yield to an  
10 efficient stand-alone railroad, would represent a  
11 minimum target of policy. As. Dr. Brinner has  
12 stressed, sometimes professor, the competitive  
13 market standard does not preclude as shipper  
14 commenters in this proceeding universally assume,  
15 a competitive market standard does not preclude a  
16 railroad's realizing earnings greater than its  
17 cost of capital even over an extended period.  
18 When they provide superior service,  
19 responsiveness, innovation and/or skill  
20 anticipating shifts in market dynamics, shifts in  
21 customers' demands, competitive markets can  
22 readily earn and sustain revenues in excess of

1       their cost of capital. You've seen Dr. Brinner's  
2       data. Under such circumstances earnings in  
3       excess of the cost of capital will be associated  
4       with expansions of capital and the services the  
5       public demands. This is a good thing. It  
6       represents the market using its profit signals to  
7       channel services and investment toward where  
8       consumers are signaling they want more service.  
9       What we should worry about is not earnings in  
10      excess of the cost of capital that arise because  
11      a carrier is meeting consumers' demands and  
12      expanding services to consumers. Instead what we  
13      should worry about is earnings in excess of the  
14      cost of capital that arise because a company has  
15      market power and is forcing prices higher by  
16      artificially withholding supplies from the  
17      marketplace and thereby driving prices and  
18      earnings above the competitive levels. The  
19      latter does not describe the railroad sector.  
20      Far from withholding investment and supply under  
21      the Staggers Act the Class I railroads have been  
22      second to no other industry in investing and

1       expanding service to consumers. Over the last  
2       decade, investment as a share of revenue by Class  
3       I railroads has been three times or more than  
4       most any other industry in the U.S. economy. In  
5       addition in echoing this the professional  
6       research literature consistently concludes that  
7       the economic evidence does not support assertions  
8       to the effect that the improvements in carriers'  
9       financial health over the last decade whether to  
10      the point of relative adequacy or not, the  
11      research does not say that these improvements in  
12      financial health have been the result of abuses  
13      of market power, which have gone uncurbed by the  
14      Board's rate regulation authority. Indeed, for  
15      the reasons I have stated a finding of revenue  
16      supra-adequacy, earnings in excess of the cost of  
17      capital as it is currently interpreted would not  
18      tell us that any of our railroads rates were  
19      above competitive levels. Whether nor not market  
20      power abuse is present can only be determined by  
21      factual inquiry and if the conditions pertinent  
22      to the specific traffic in specific markets. The

1 Board's policies have consistently recognized  
2 this. There is no economically meaningful metric  
3 that would enable a quick wholesale  
4 identification of traffic that is subject to  
5 abuses of market power. For example, there is no  
6 basis precluding that just because particular  
7 traffic has rates which yield revenue cost ratios  
8 in excess of 180 or some trigger value of R-SAM  
9 or any other test metric just because that metric  
10 has exceeded cannot tell us whether such traffic  
11 is actually captive and being victimized by some  
12 railroads' exercises of market power. In short,  
13 I find that the shipper proposals to implement  
14 revenue adequate constraints are unsound.  
15 Proposals to regulate rates based on a carrier's  
16 overall level of revenues would untether rate  
17 making from the Board's longstanding policy of  
18 employing rate maximums only where they are  
19 needed because abuses of market dominance are  
20 preventing prices from being kept at the levels  
21 the competitive markets would otherwise set. A  
22 cornerstone of the Board's SAC test approach to

1 rate making has been the recognition that by  
2 invoking the standard of contestable markets it  
3 prevents distorted cross subsidies. Attempting  
4 to regulate individual rail rates based on  
5 system-wide revenues as opposed to competent  
6 analysis of individual markets competitiveness,  
7 and testing rates relative to a competitive  
8 standard as provided by the SAC test would  
9 certainly create undesirable cross subsidies.  
10 Proposals for example to rebate punitively excess  
11 revenues to purportedly captive traffic would  
12 inevitably leave competitive traffic subsidizing  
13 regulated traffic. Similarly, limits on  
14 differential pricing triggered by punitive  
15 findings of revenue adequacy as opposed to being  
16 triggered by violation of a competitive price  
17 standard such limits on differential pricing  
18 would be expected to leave traffic on lower cost  
19 high density lines subsidizing traffic on higher  
20 cost low density lines. Differential pricing on  
21 the basis of other than the kind of Ramsey  
22 pricing that contestable markets would generate

1 inevitably falls back on non-economic assertions  
2 of fairness and this inevitable devolves into  
3 expensive litigatory and political contests among  
4 interested parties. Suggestions that rate  
5 capping based on some application of system-wide  
6 revenue adequacy would hold down regulatory costs  
7 are unfounded and unproven. Perhaps even more  
8 importantly untethering rate regulation from  
9 coherent economic principles would emaciate the  
10 standards that can otherwise be employed to reign  
11 in the demagogues and to cut off the extremities  
12 of purely self-interested argument. Specific  
13 shipper proposals to freeze rates or to impose  
14 rate caps on punitively revenue adequate carriers  
15 are not consistent with competitive market  
16 standards. One way or another such proposals  
17 would entail the imposition of price controls on  
18 part or all of the carriers' traffic, competitive  
19 or captive. As such, they inevitably interfere  
20 with the critical role of prices in signaling  
21 rational behavior by sellers and buyers. The  
22 track record of price controls from the regimes



1 of price controls tried by President Nixon to the  
2 dilapidated rent controlled apartments in many  
3 inner cities is quite clear from mountains of  
4 economic research. Where price controls hold  
5 prices below the levels the contestable  
6 competitive markets would generate the outcome is  
7 inevitably one of discouraged investment,  
8 artificially encouraged demand and ultimately  
9 shortages of quality and quantity. As one Nobel  
10 Prize winning economist put it, "We economists  
11 don't know much, I don't like him saying that, we  
12 economists don't know much but we do know how to  
13 create a shortage. If you want to create a  
14 shortage of tomatoes, for example, just pass a  
15 law that retailers can't sell tomatoes for more  
16 than two cents per pound. Instantly you'll have  
17 a tomato shortage." The railroad industry is no  
18 way immune from these economics. In fact, the  
19 industry is inherently susceptible to what has  
20 been called regulation of a sitting duck.  
21 Because of its extremely long life capital the  
22 industry is a sitting duck for policies in which

1 myopically self-interested parties gradually eat  
2 away at the system with destructive policies  
3 whose disastrous consequences do not show up for  
4 years or decades. In fact, this pretty much  
5 describes what happened to the railroad industry  
6 in the pre-Staggers era. Railroads were first  
7 encouraged to invest and build. By the early  
8 twentieth century they were the envy of the  
9 world. But once the investments were in place we  
10 began a long process of eating away at the  
11 installed capital until the system, the sitting  
12 duck, was effectively killed. We left it to  
13 later shippers and later policy makers to deal  
14 with the consequences. Let me conclude by saying  
15 that none of this is to say that the Board should  
16 not be vigilant in regulating where exercised  
17 market power are demonstrated. Quite the  
18 contrary, the fundamental principle of  
19 replicating competitive prices demands such  
20 vigilance. At the same time moving away from the  
21 Board's longstanding principles of using  
22 regulation to set railroad rates where abuses of

1 market power prevent prices from being set at  
2 levels competition would otherwise dictate.  
3 Moving away from that standard would be directly  
4 contrary to the public's interest in a healthy  
5 national economy. Doing so would also threaten  
6 the gains that have been made under the Board's  
7 implementation of the Staggers Act. The ongoing  
8 expansion that the nation's economy demands of  
9 the rail sector would be directly threatened by  
10 prices which distort shippers' choices over  
11 quality and modes of transportation and which  
12 distort carriers' investment decisions. Rate  
13 regulation, misguided or by mis-measured and  
14 misapplied criteria of revenue adequacy employed  
15 to impose price controls could only exacerbate  
16 the challenge of generating the capacity needed  
17 to avoid shortages. We could pretend that the  
18 industry's long life capital will last forever  
19 and that we already have enough to meet the  
20 growing demands of the nation's economy, but the  
21 rail industry has to compete in the capital  
22 market for investors' dollars. Employing some

1       notion of revenue adequacy to limit rates below  
2       competitive levels because railroads purportedly  
3       already make enough money could only tie their  
4       hands in the competition in the capital market.  
5       The Board's SAC test already provides an  
6       objective standard for assessing whether rates  
7       for specific rail traffic which are found to be  
8       subject to market dominance are consistent with  
9       the competitive market standard. An objective  
10      measure is necessary to control demagoguery and  
11      outright stupidity and to avoid arbitrary and  
12      economically unsound regulation. The challenge  
13      that remains is to work directly on improving the  
14      Board's procedures for implementing its SAC test  
15      and the associated standard of competitive market  
16      pricing. My experience that the Federal Energy  
17      Regulatory Commission with the use, for example  
18      of technical working groups, i.e. not lawyer  
19      working groups, all due respect suggests that  
20      there are, in fact, viable processes that  
21      minimize disputes and could aid in the approach  
22      to such challenges as coming up with, in fact,

1 workable and implementable systems of a  
2 competitive market pricing standard but calls  
3 for jettisoning such standards and the other  
4 elements of the Board's competitive market  
5 pricing standard are a diversion from this task  
6 and threaten the public interest. Thank you.

7 MR. SIPE: Thank you, Joe. Let me  
8 finish our panel's presentation by addressing the  
9 questions the Board identified in its notice of  
10 this hearing. You've heard our other witnesses  
11 already address some aspects of the specific  
12 questions posed by the Board, but I want to  
13 address each question sequentially so that AAR's  
14 position is clear on the record. First, you  
15 asked the parties to address the proper timeframe  
16 for evaluating revenue adequacy. I would  
17 distinguish here between evaluating and  
18 regulating because as you've probably gleaned, we  
19 don't think it's appropriate for the Board to be  
20 regulating rates based on a finding of revenue  
21 adequacy over any time period. As for  
22 evaluating, Dr. Brinner has demonstrated that

1       railroads have very long lived assets. These  
2       asset lives considerably exceed the length of a  
3       business cycle however you might measure it. It  
4       would, therefore, be more appropriate to evaluate  
5       railroad financial performance with reference to  
6       average railroad asset lives than business  
7       cycles. As AAR pointed out in its written  
8       comments, the railroads' electric utility  
9       customers have taken that very position before  
10      their own regulators. Second, you asked whether  
11      the Board should consider requiring a revenue  
12      adequate railroad whose increased rate has been  
13      challenged to justify the increase on a  
14      complaining captive shipper and I believe,  
15      Chairman Elliott, your question about burden of  
16      proof under the Administrative Procedure Act may  
17      have some relevance to that question and let me  
18      just state so the record is clear that we believe  
19      that the proposal Mr. Dowd was setting out this  
20      morning would be inconsistent with APA  
21      requirements by shifting one critical element of  
22      the proof of unreasonableness from the railroad

1 to the shipper. Professor Kalt has explained  
2 imposing what could amount to a rate freeze on  
3 market dominant traffic by requiring revenue  
4 adequate railroads to justify rate increases on  
5 such traffic would be unsound policy from an  
6 economic perspective nor could such a requirement  
7 be reconciled with not just the APA but with  
8 ICTA. That statute does not permit the Board to  
9 assume a rate is unreasonable just because a  
10 railroad is market dominant nor does the statute  
11 permit the Board to conclude that an individual  
12 rate is unreasonable simply because a railroad's  
13 system-wide earnings exceed the cost of capital.  
14 A nexus between a particular rate and a  
15 railroad's earnings in excess of the revenue  
16 adequate level cannot be assumed. This is  
17 especially the case since the substantial  
18 majority of railroad revenues are attributable to  
19 unregulated traffic and that proposition has  
20 already been the subject of some observations by  
21 Commissioner Miller and some back and forth as to  
22 what the actual percentage of unregulated traffic

1 is vis-à-vis regulated traffic. All of us agree,  
2 whatever the precise number is, all of us agree  
3 that the substantial majority of rail traffic is  
4 unregulated not within the Board's purview and  
5 the notion that we somehow could be having  
6 system-wide earnings determining the outcome of  
7 individual rail rates presents, to use another  
8 word that has come up a couple of times this  
9 morning, a disconnect. Third, you asked whether  
10 a revenue adequate railroad's ability to  
11 differentially price should be limited for all  
12 captive shippers or for a subset of captive  
13 shippers that are most likely to be subject to  
14 the railroad's market power and I should insert a  
15 caveat here that my use of the term captive  
16 shippers violates a commandment I've received  
17 from one of my co-counsel, but I do so because  
18 the Board used the term. I don't want to be  
19 hoisted on that petard. In any event, the answer  
20 to that question is emphatically no. Limits on  
21 differential pricing should be based on whether a  
22 rate is reasonable, not on whether a railroad



1        earns revenues that exceed the cost of capital.  
2        The statutory prerequisite to a rate  
3        reasonableness inquiry is a finding of market  
4        dominance. There is no shortcut to determining  
5        whether a rate is reasonable via some presumption  
6        regarding the extent to which a shipper is  
7        subject to market power. Fourth, you asked what  
8        competitive access remedies would be appropriate  
9        and consistent with the Board's governing statute  
10       when a railroad is revenue adequate. Our  
11       position is that there is no logical connection  
12       between access remedies and revenue adequacy and  
13       no basis for a connection in the statute and as  
14       the case law makes clear, the Board is not  
15       empowered to regulate rates through access  
16       remedies. That's the Mid-Tech case both before  
17       the ICC and the D.C. Circuit. Access remedies  
18       were intended by Congress to address market power  
19       abuses that were not related to the level of the  
20       rate charged. AAR and its member railroads also  
21       presented overwhelming evidence in the Ex Parte  
22       711 proceeding about the service problems that

1 would arise under a forced access regime such as  
2 the switching proposal presented by NIT League.  
3 Those problems would exist whether or not a  
4 railroad is revenue adequate. Fifth, and a  
5 question apparently addressed to shipper  
6 interests, you asked about the impact of revenue  
7 adequacy proposals on railroads' ability to  
8 invest in their networks taking into account the  
9 service issues that arose last year and Mr.  
10 Hamberger has already spoken to that. You heard  
11 from him about the importance of and need for  
12 additional investment in railroad infrastructure.  
13 You've heard from Professor Kalt and Dr. Brinner  
14 about the economic principles that govern market  
15 driven investment decision. The math is simple.  
16 Firms don't make capital investments unless the  
17 investments have the potential for earning  
18 returns that exceed the cost of capital. That  
19 potential is necessary to offset the inevitable  
20 shortfalls that occur, for example, when we have  
21 a deep recession as we did within the past ten  
22 years. Regulation that prevents railroads from

1 consistently earning at least their cost of  
2 capital will result in less railroad investment  
3 than the market calls for. Lower investment  
4 levels have obvious implications for the quality  
5 of service that railroads are able to offer and  
6 the amount of capacity they are able to provide.  
7 Finally, I would like to address the question you  
8 raised regarding the Board's methodology for  
9 determining revenue adequacy that appears to  
10 straddle the line between Ex Parte 722 and Ex  
11 Parte 664 sub 2. As you've heard from Professor  
12 Kalt and Dr. Brinner, accounting rates of return  
13 based on a historic book value do not give an  
14 accurate picture of the economic returns being  
15 earned by a company. Economic rate returns can  
16 only be determined using the replacement cost of  
17 assets. In conclusion, let me reiterate the  
18 three main points AAR would like you to take away  
19 from our panel's presentation. Mr. Hamberger  
20 explained why the Board's implementation of a  
21 revenue adequacy constraint would pose a serious  
22 risk to several vital national policy goals

1 including preeminently the need to continue to  
2 invest in an expanding rail network that is a  
3 vital engine of American economic growth. Dr.  
4 Brinner demonstrated that far from being  
5 excessive, rail returns have been below the norm  
6 for the past decade and that railroads need to  
7 have the incentive and opportunity to earn  
8 substantially more than their cost of capital as  
9 most firms in competitive markets regularly do.  
10 And Professor Kalt explained why shipper  
11 proposals to regulate rates based on a carrier's  
12 overall level of revenues through various forms  
13 of price controls are inconsistent with  
14 competitive market principles and would lead to  
15 misallocation of resources, underinvestment and  
16 gradual deterioration of the rail network, albeit  
17 very slow deterioration perhaps. None of us  
18 might be around but that doesn't mean that we  
19 shouldn't be worried about saddling future  
20 generations of transportation users with a system  
21 that is not going to make it in the long run.  
22 The Board has the opportunity in this proceeding

1 to promote the broad public interest by endorsing  
2 the continued growth of a rail industry that is  
3 able to replenish its assets and expand to meet  
4 market demand through private capital investment.  
5 The Board should seize this affirmative  
6 opportunity. It shouldn't penalize railroads for  
7 having made progress toward sustainable financial  
8 health. Thank you very much for your attention  
9 and our panel will be happy to try to answer any  
10 questions you may have.

11 MS. BEGEMAN: Thank you all for your  
12 testimony. I hope that my questions aren't  
13 interpreted that I wasn't listening, but I have a  
14 couple of questions I'd like to ask because you  
15 were fairly clear on your testimony and, Mr.  
16 Sipe, you really did consolidate the main points  
17 for us, so thank you, as far as what you wanted  
18 to convey. I would like to know what the  
19 industry's perspective is as far as what you  
20 believe the purpose is behind the Board's annual  
21 determination of revenue adequacy, which we do  
22 according to the statute?

1           MR. SIPE: The purpose is to get some  
2 sense of rail financial performance whether that  
3 financial performance is on the uptick, whether  
4 railroads are making progress in terms of  
5 becoming financially healthy, whether there is a  
6 reasonable prospect that they're going to achieve  
7 the congressional goal of being able to recover  
8 their full costs and invest in replacing and  
9 expanding their assets. It's like a yardstick or  
10 a measurement. How are we doing year to year? In  
11 fact, I think the very fact that the statute  
12 calls for a yearly determination indicates that  
13 they weren't thinking of some, you know, long-  
14 term assessment of should there be a category for  
15 determining how we regulate rates that is based  
16 on financial health because everybody agrees that  
17 can't be limited to a one year view but if you  
18 take a trend line of snapshots, and that's what  
19 we've done since Staggers, the message is very  
20 clear to everybody, that the railroads have been  
21 getting financially healthier, and that's a good  
22 thing.

1 MS. BEGEMAN: You mentioned the other  
2 proceedings somewhat tied with this, such as the  
3 Board's methodology for determining the cost of  
4 capital, which, of course goes into revenue  
5 adequacy, et cetera. I think your message was  
6 that replacement costs are something that the  
7 Board should consider, or the combination of your  
8 messages was that just because it's hard doesn't  
9 mean that it's not accurate. Could you comment?  
10 Before my time on the Board I know that AAR had  
11 petitioned this agency to do a proceeding and to  
12 look at replacement costs and ultimately I think  
13 it was rejected somewhat for being too hard. I  
14 don't want to misrepresent that, since I was not  
15 here at the time, but please comment, how could  
16 it even be accomplished reasonably?

17 MR. SIPE: Well, let me take an  
18 initial crack at that and then maybe Professor  
19 Kalt would like to speak to it. I was counsel to  
20 AAR in that ill-fated petition. You've silenced  
21 me, Mr. Hamberger. So and I think your  
22 characterization of why the Board rejected our

1 replacement cost approaches is accurate. It's  
2 probably fair to say there were some holes in our  
3 proposal but I don't think it was Swiss cheese.  
4 It wasn't riddled with holes to the extent that  
5 it's irreparable. I think that if we had a  
6 serious proceeding designed to come up with a  
7 methodology for determining what, in effect,  
8 would be something like a system-wide SAC for the  
9 railroads that we could get there and if you have  
10 any inkling that you might want to regulate rates  
11 based on revenue adequacy and that you could  
12 lawfully do so which we disagree with those  
13 propositions but if you have any inkling that you  
14 might do that, then you better get the measure of  
15 revenue adequacy right and use the right asset  
16 base so you're not imposing remedies on carriers  
17 that are not, in fact, revenue adequate.

18 MR. BRINNER: Well, I'm newer to this  
19 than many of my colleagues and when they asked me  
20 to help understand rates of return and so forth  
21 compared to other industries I didn't know it was  
22 difficult to do replacement cost accounting, so I



1       turned to my familiar turf, the Department of  
2       Commerce Data. They regularly report for every  
3       industry what the historic cost and the  
4       replacement cost of the assets are. As a macro  
5       economist, I understand how they do that. They  
6       simply look at the investment in a given year,  
7       multiply that by the change of the Bureau of  
8       Labor Statistics measure of prices for specific  
9       assets of that type and inflate it and they  
10      subtract the part of it that's been depreciated  
11      and they move forward to the next year and they  
12      do the same. So that's what my team in less than  
13      two weeks to look at rail total replacement costs  
14      versus historic costs so I wouldn't find it to be  
15      an impossible task. I would fear Professor  
16      Kalt's notion that if you have a technical  
17      working group that could explain procedures such  
18      as I used, such as the Bureau of Labor Statistics  
19      and the Department of Commerce used you could  
20      find a way to get a very good representation of  
21      replacement costs.

22                   MR. KALT: I would just add to that

1 from my experience, I'm actually personally  
2 involved right at the moment in a proceeding at  
3 the FIRC in which generically I can't talk about  
4 the competition, I'll hit parts of it, but  
5 generically the same issue is being faced.

6 Historic book accounting showing the pipeline  
7 earning more than adequate revenues and yet the  
8 market demanding extensions of capacity and  
9 recognition that some parties want it to be hard  
10 to give the regulator a reason to reject the use  
11 of replacement costs because no one recognizes  
12 here that it would change the nature of these  
13 revenue adequacy calculations and the direction  
14 of Dr. Brinner's data show, but through staff to  
15 staff discussions again not to criticize my  
16 colleagues that I work a lot with but, you know,  
17 not disputatious lawyer to lawyer or expert  
18 witness to expert witness kind of discussion, but  
19 the FIRC has made very good use of technical  
20 working groups, staff to staff kind of  
21 conversations between these interested parties  
22 and I can't go into the details but the finding

1 of mechanisms using data of the type that Dr.  
2 Brinner has just mentioned are available, and but  
3 I actually think that the challenge is one of  
4 finding a process that allows one to have a non-  
5 disputatious process to actually work on the  
6 problem rather than a litigatory process that  
7 makes it so much harder.

8 MR. HAMBERGER: I would just observe  
9 that what made it particularly meddlesome was it  
10 was like a summary judgment. We filed the  
11 petition to open up a proceeding and rather than  
12 have a hearing, rather than open up a proceeding,  
13 allow some of the difficulties to be aired and  
14 perhaps worked out, the Board, and none of you  
15 was there at the time, the Board just basically  
16 said no, we're not even going to attempt to try  
17 to work our way through the challenges and that  
18 was I think the most disappointing part of the  
19 decision.

20 MS. MILLER: I want to ask a follow-up  
21 question because this replacement cost issue has  
22 been on my mind since I've been at the Board and

1 perhaps I would have flunked both of your  
2 economics courses because Dr. Kalt, you said that  
3 no one questions the philosophy or the efficacy  
4 or the benefit of using replacement costs. It's  
5 just that it's too hard, but since I've been here  
6 and thought about it I strongly question the  
7 logic of replacement costs when you're talking  
8 about something like a railroad as I would if you  
9 were talking about a highway system. It's  
10 something that's been built over 200 years ago, I  
11 mean I would question could you even build it  
12 today and if you built it today how could you  
13 possibly charge a rate to the users of that  
14 system that would keep you internationally  
15 competitive? It would be absolutely impossible to  
16 do so so if you start looking at the replacement  
17 costs you've so driven up the total cost that  
18 you've just put it completely out of reason and  
19 I'm struggling to see how that's a rational  
20 approach at all for the system that we're looking  
21 at. It might make a lot of sense in other  
22 businesses and I can see that it makes sense in

1 other businesses but I don't see it in long lived  
2 infrastructure that's been built literally over  
3 hundreds of years and the only reason its  
4 affordable today is because it's been built over  
5 hundreds of years.

6 MR. BRINNER: Well, the service lives  
7 that are referred to for the Bureau of Economic  
8 Analysis aren't infinite and they do say the  
9 service life extends to 54 years for the maximum  
10 so we wouldn't be looking back ---

11 MS. MILLER: Well, what's that based  
12 on? A bridge is probably 100 years. The right  
13 of way is forever or the rail is a different  
14 life.

15 MR. BRINNER: They have different  
16 service lives for different aspects but in my  
17 testimony I showed that there are countervailing  
18 effects. You were just referring to the fact  
19 that you would expand the denominator  
20 tremendously by looking at replacement costs and  
21 I noted that you'd also expand the return, the  
22 numerator of a return on capital because at the

1 same time that you're making the base bigger by  
2 looking at the replacement cost you're also  
3 counting as a return in the numerator the  
4 appreciation of the assets that remain because  
5 prices went up and the difference as I cite on  
6 page 15 of my testimony is not huge like I think  
7 you feared but it's 2-1/2 to 3 percentage points.

8 MS. MILLER: So you're saying that in  
9 the approach you would take you would also take  
10 existing assets that may have been built seventy-  
11 five years ago and you would appreciate them up  
12 to today's market value, is that what you're  
13 saying?

14 MR. BRINNER: Well, let's take a  
15 locomotive. What's the typical service life for  
16 a locomotive?

17 MR. HAMBERGER: Twenty-five years.

18 MR. BRINNER: Twenty-five years. So  
19 let's say that you've got a locomotive that's 12-  
20 1/2 years old. I would say when you bought it,  
21 it cost one million dollars. Today's value of a  
22 full locomotive, you know, if the inflation has

1 doubled, right, it's doubled, but you've only got  
2 half of that locomotive because you've  
3 depreciated it, but you would include in your  
4 income that appreciation of the remaining half of  
5 the locomotive that still has a service life and  
6 that works to avoid what I think you feared that  
7 you're expanding the denominator so much that  
8 it'll give you a trivial rate return. I cited  
9 that the STB average of 7 Class I railroads is  
10 9.6 percent '04 to '13 and if you do the full  
11 adjustments you get, I'm sorry, looking at the  
12 wrong exhibit, you get the Bloomberg number is  
13 7.2, so Bloomberg at least is historic if you use  
14 the replacement cost you can get to a different  
15 number so it's not, the differences aren't huge.  
16 There's a direction of the bias that says you're  
17 suppressing the return but the difference isn't  
18 huge because of the compensating adjustments you  
19 make.

20 MR. SIPE: Commissioner Miller, if I  
21 may and I realize this may sound a little  
22 confrontational, but I'm actually kind of

1       astonished by your observation because if you  
2       believe that railroads can't charge prices that  
3       would allow them to sustain, replenish and expand  
4       their networks, that's tantamount to saying they  
5       shouldn't be in this business.

6               MS. MILLER:   Sustaining and  
7       replenishing is quite different from replacing.

8               MR. SIPE:   Excuse me.

9               MS. MILLER:   Sustaining and  
10       replenishing is different from replacing and I  
11       would absolutely agree you have to be able to  
12       charge a rate of return so that you can fully  
13       maintain and sustain your network but that's  
14       different than saying you're going to charge a  
15       rate of return that is big enough that you could  
16       fully replace your network.   That's the question  
17       that I'm raising.

18              MR. SIPE:   Sustaining means replacing  
19       over time and if you look, I don't want to get  
20       too deep into economic modeling, but if you look  
21       at the assumptions that go into the Board's  
22       discounted cash flow model that is used in SAC



1 cases, which by the way one of the successes of  
2 the SAC process, we all know it's been very  
3 difficult, it has lots of challenges. Many of  
4 the problems with SAC have been overcome  
5 including the universal agreement now on a  
6 workable DCF model. If you look at the logic of  
7 that model you'll see that it contemplates, it  
8 uses replacement costs and it contemplates  
9 replacing them over time and sustainability  
10 entails replacement over a long timeframe.

11 MS. BEGEMAN: Can I go back to ---

12 MS. MILLER: Sure.

13 MS. BEGEMAN: -- asking some  
14 questions? Mr. Sipe, there are two things  
15 actually I wanted you to comment on. One, and  
16 probably with the next panel whose going to be  
17 appearing, I think they'll be talking a lot about  
18 the competitive access feature of what the Board  
19 had asked in the hearing announcement.

20 MR. SIPE: I bet you're right.

21 MS. BEGEMAN: One of the things that  
22 you mentioned just briefly was your view of what

1 the Board's authority is and you commented on  
2 Midtec and the circuit court ruling. Could you  
3 just elaborate a bit on that? You know we had our  
4 hearing a year and a half ago, but just if you  
5 could comment on some of that.

6 MR. SIPE: Well the specific point I  
7 was making that involved the reference to Mid  
8 Tech is that back in Mid Tech, the complaining  
9 shipper party was making an argument that  
10 competitive access was in effect another way of  
11 getting at a reasonable rate and the ICC and the  
12 court both held that access remedies are not a  
13 substitute for rate regulation. Access remedies  
14 as approved by the ICC in the mid-1980s were  
15 designed to address different kinds of  
16 competitive abuse from abusive market power and  
17 pricing so the notion underlying the access  
18 remedies that were adopted had to do with conduct  
19 type competitive abuses rather than pricing and  
20 that's what I was alluding to. Midtec I think  
21 bought into that distinction.

22 MS. BEGEMAN: Thank you, and then just

1 one last question. At least I'll try to make it  
2 my last. Could you comment on -- I may butcher  
3 this a little bit -- but Mr. Hennigan, on the  
4 previous panel, had mentioned the expectation of  
5 what revenue adequacy meant and that when it was  
6 achieved what it would mean. Again, I don't want  
7 to say this inaccurately, but something to the  
8 extent of differential pricing would no longer  
9 continue or it would be limited or reduced. I  
10 think his view is that that's reality, that's  
11 exactly what it meant. Could you comment on what  
12 you believe the statute provides and the history  
13 provides from what the ICC said in coal rate  
14 guidelines?

15 MR. SIPE: Well that's a complicated  
16 question and I don't want to go on and on. I  
17 probably could but I don't think that would be  
18 wise of me. But let me just say I don't start  
19 with the statute. I don't think there's anything  
20 in the statute you could find that amounts to an  
21 expectation that when railroads achieved revenue  
22 adequacy differential pricing would somehow abate

1 or become less differential if you will. I just  
2 don't see anything in the statute. Now obviously  
3 we have coal rate guidelines and we have that  
4 constraint in coal rate guidelines which is  
5 obviously the major reason we're here and we  
6 don't seem to know for sure what it means. The  
7 shippers take it as a given that it means when  
8 you become revenue adequate the regulatory regime  
9 changes and we say I don't know how you get that.  
10 I mean there is an inchoate revenue adequacy  
11 constraint but it's not flushed out and nobody  
12 has come up with a meaningful explanation of how  
13 that could be implemented consistent with the  
14 sound economics that have governed the Board's  
15 rate regulation through SAC up to this point and  
16 let me make another point about coal rate  
17 guidelines. You said two things this morning I  
18 think, Vice Chairman Begeman, that were connected  
19 and your point of departure was replacement costs  
20 and you talked about the inconsistency of using  
21 replacement costs in SAC but depreciated book  
22 values for revenue adequacy and then you talked

1 about the disconnect between I believe the  
2 revenue adequacy notion and inability to use  
3 replacement costs. I think it's fair to say that  
4 coal rate guidelines builds in a kind of  
5 disconnect but not literally. The disconnect is  
6 built in because we use replacement costs in SAC,  
7 we use, the Board uses depreciated original cost  
8 in revenue adequacy and if you're trying to get  
9 at the same thing, i.e. a reasonable rate from  
10 two different perspectives, top down bottom up  
11 but you use two different standards for valuing  
12 assets, you're not going to get the same answer  
13 and that doesn't make any sense to me. So I  
14 think there is kind of a historical anomaly in  
15 what guideline says about revenue adequacy and if  
16 you go back and read the decision you don't find  
17 a lot of discussion about that disconnect between  
18 two different measures of cost. I don't think you  
19 find any discussion. So it hasn't been  
20 reconciled anywhere. We raised it in the Koch  
21 case. That's another one I lost and my only  
22 solace is the guy who argued the case to the D.C.

1 Circuit because the client was so tired of me was  
2 a fellow named John Roberts and we lost there,  
3 too, but the Board carefully avoided engaging on  
4 the disconnect in the Koch case and there were  
5 reasons why it could come out the way it did in  
6 that case which I think is very instructive in  
7 terms of what we have in the rail sector. That  
8 was a pipeline case where the pipeline had set a  
9 system-wide rate increase across the board for  
10 all of its shippers, so a top down approach fit  
11 because we're talking about everybody and we're  
12 talking about a one rate increase to the entire  
13 pipeline rate structure. In the railroads it's  
14 completely different. It is from the bottom up  
15 in the railroads. The rate structure consists of  
16 thousands of individual rates, many of them  
17 negotiated and inserted into contracts, all sorts  
18 of different rates on different traffic. There's  
19 no one size fits all in terms of rate regulation  
20 and so the reliance on the Koch case as a  
21 precedent for rail rate regulation based on  
22 revenue adequacy is simply unfounded.

1 MS. BEGEMAN: Thank you.

2 MR. SIPE: That was a long answer.

3 MS. BEGEMAN: Thank you.

4 MR. ELLIOTT: Just to follow-up on  
5 that, I'm hearing clearly that the revenue  
6 adequacy constraint is number one we don't have  
7 to do it. There's nothing in the statute that  
8 says we have to, and number two, I'm hearing from  
9 the economist and you that it doesn't make sense,  
10 it doesn't work, it makes no economic sense. So  
11 the third question is, this is a legal question  
12 more than an economic question, but can we do it  
13 legally? Is there a way legally that we can do  
14 it because we have this language in Coal Rate  
15 Guidelines. Third Circuit was okay with it so  
16 I'm just wondering what the railroad position is  
17 as far as can we do it?

18 MR. SIPE: I'll answer that two ways.

19 MR. ELLIOTT: Sure.

20 MR. SIPE: We don't think you have the  
21 legal authority to do it but I can understand why  
22 someone on the other side might say we have a

1 powerful precedent in guidelines and we have a  
2 good precedent in Koch and I've just tried to  
3 explain to you why I don't think either of those  
4 precedents would hold up. So the second part of  
5 my answer is as a tactical matter, you know,  
6 might you get by with it if you tried to do it, I  
7 would say, you know, there's a chance we would go  
8 down with guns blazing, and why would you want to  
9 do that if you could find a way to make what  
10 everybody agrees, well not everybody, not  
11 Professor Faulhaber and a few others, but what  
12 most people including most on the shippers side  
13 still agree is at least an economically valid  
14 framework for rate regulation using the stand  
15 alone cost test. If we could find a way to make  
16 that easily administrable you absolutely know  
17 that would pass muster with the courts because  
18 it's already passed muster and it would be  
19 economically sound and it wouldn't threaten  
20 upending the rail renaissance. Why wouldn't that  
21 be the way to go?

22 MR. HAMBERGER: Maybe this is



1 tangential to your question, Mr. Chairman, but I  
2 would also point to the fact that I believe the  
3 S808, should it get enacted, would be the first  
4 amendment to the revenue adequacy provision of  
5 your statute in 35 years and that the report says  
6 that this section emphasizes the clarifying  
7 standards of procedures for evaluating revenue  
8 adequacy, emphasizes the infrastructure needed in  
9 order for rail carriers to be able to meet the  
10 present and future demand for rail service so it  
11 seems to me that the Senate and presumably the  
12 House and the President signs it, the policy is  
13 made clear that in taking a look at revenue  
14 adequacy you have to take into account the  
15 ability to meet the future needs and you were I  
16 thought on a very interesting line of questioning  
17 with the previous panel about the asymmetric risk  
18 that is there when a railroad would be faced with  
19 a decision to invest in a project above the cost  
20 of capital would not be able to receive the  
21 benefit of that risk but should the proponent as  
22 the professor here pointed out be a little bit

1 too optimistic and it comes in under the cost of  
2 capital the railroad bears that risk but doesn't  
3 get the benefit if it exceeds the cost of capital  
4 so if you combine all that it seems to me whether  
5 or not you have the legal authority and as Sam  
6 said we would dispute that. Congress has made it  
7 pretty clear where they would like to see you go.

8 MS. MILLER: So, Mr. Hamberger, can I  
9 ask you a question? So is it AAR's position, is  
10 this the correct understanding that revenue  
11 adequacy under the law doesn't in any way trigger  
12 any change in the regulatory framework? There's  
13 nothing inherent in the railroad's accomplishment  
14 of revenue adequacy that should accomplish or  
15 that should trigger a regulatory change?

16 MR. HAMBERGER: Yes.

17 MS. MILLER: And then is it also AAR's  
18 position that if we calculate revenue adequacy we  
19 should do that based on replacement costs?

20 MR. HAMBERGER: Yes.

21 MS. MILLER: And why does that matter  
22 to use a complicated difficult process to

1 calculate revenue adequacy if in your view  
2 revenue adequacy has basically no meaning under  
3 the regulatory framework?

4 MR. SIPE: May I address that at the  
5 risk of --

6 MR. HAMBERGER: Oh, please, go on.

7 MR. SIPE: -- incurring Mr.  
8 Hamberger's displeasure. He rehired me once  
9 when I lost.

10 MS. MILLER: You can go to lunch with  
11 me then.

12 MR. SIPE: I'm picking fights with  
13 everybody this morning it seems. It's not my  
14 nature. I think that if you were to agree with  
15 us that revenue adequacy doesn't trigger a  
16 different regulatory regime then frankly we  
17 wouldn't care very much about replacement costs  
18 because it's like are you measuring it in  
19 centimeters or inches, right? It goes back to my  
20 response to Vice Chairman Begeman's question what  
21 is this annual revenue adequacy inquiry about.  
22 It's about measuring. Are they making progress?

1 You know, what's the slope of the line look like  
2 in terms of progress? If you measure progress if  
3 you're not going to do anything with that  
4 measurement other than to say things are working  
5 under our overall regulatory regime the way  
6 Congress had hoped that's a pretty good thing, we  
7 should be happy about that. If you're going to  
8 do that and you're not going to implement rate  
9 regulation based on the magnitude of your cost to  
10 capital determination, then I don't think we  
11 really would need to change to replacement costs.  
12 I think we have made the argument in recognition  
13 that something could happen down the road this  
14 very hearing, so in 2008 we weren't revenue  
15 adequate but we said, you know, let's take a shot  
16 at replacement costs because the day may come  
17 when some subsequent Board says we want to  
18 regulate on the basis of revenue adequacy. We  
19 ought to put ourselves in a better position if  
20 that ever comes to pass. Now the question is on  
21 the table and others aligned with me on the  
22 railroad side might not give you an identical

1       answer. I'm not purporting to speak for everybody  
2       but that's my answer to your question.

3               MS. MILLER: Because, you know, as you  
4       know I've been here for about 15 months, so maybe  
5       if I'd been a long-time practitioner, you know,  
6       I'd have a different view but, you know, what it  
7       seems like based on my understanding of the way  
8       the concept and the importance of revenue  
9       adequacy had been explained to me as I was coming  
10      on to the Board that AAR has changed their  
11      position or is much more forcefully advocating a  
12      position that revenue adequacy doesn't basically  
13      have meaning and maybe that's, I mean honestly,  
14      maybe that's always been your position. Maybe  
15      that's been clearly and publicly stated but up  
16      until the Staggers hearing before the T&I sub-  
17      committee, it's the first time I heard anyone say  
18      revenue, you know, it doesn't matter if they're  
19      revenue adequate. That just shouldn't have an  
20      impact and so I'm curious if this is, in fact, a  
21      change in position as the railroads have gotten  
22      closer to what some might consider revenue

1       adequacy or am I just misunderstanding and that's  
2       always been the viewpoint?

3               MR. SIPE: I don't think it's a change  
4       in position. I think what you've seen and heard  
5       is that the issue has come into focus in a pretty  
6       concrete way via this proceeding and in the past  
7       we speculated, you know, could something happen  
8       in the future but there was never to use a legal  
9       term, the issue wasn't right except in the Koch  
10      case, which AAR was not a party to that. Those  
11      were private parties. The issue was somewhat  
12      teed up there but other than that the issue has  
13      never been teed up. I mean when you introduced  
14      this proceeding, when Chairman Elliott started  
15      this proceeding it focused our attention, you  
16      know, very acutely on the issue.

17             MR. HAMBERGER: I think that's right.  
18      I think if there are some colleagues who were  
19      around when the guideline case came down I think  
20      there was probably some theoretical consternation  
21      at the time, but it was theoretical and I think  
22      it has become ripe as the industry is finally

1 beginning to achieve some good sustained  
2 financial health so I wouldn't characterize it as  
3 a change in policy but perhaps more a change in  
4 having to address it partially because of this  
5 proceeding.

6 MS. MILLER: So in your testimony  
7 today really, and in many ways all four of you  
8 have used pretty strong rhetoric, price caps,  
9 unable to accomplish the national goals for  
10 transportation, those kind of things as the WCTL  
11 laid out their proposal they used language like,  
12 you know, a narrow scope to this remedy, an  
13 approach that really applies to a small sliver of  
14 the railroad traffic and I'm wondering if you  
15 could talk a bit about why you look at a proposal  
16 like that but think that it could have system-  
17 wide implications for the ability of the  
18 railroads to continue to operate?

19 MR. SIPE: I think Joe Kalt should  
20 speak to that under the rubric of the duck.

21 MR. KALT: I will say your question,  
22 before you asked if I was thinking the same

1        thing. I realize there is a difference in tone.  
2        I think it's because, you know, in the less  
3        strongly worded part of what I had to say you  
4        heard me talk about so called old style public  
5        utility regulation or earnings based regulation  
6        and I think that independent of whether this is  
7        right for the AAR or not, when I talk to other  
8        transportation, other regulatory economists it is  
9        kind of striking that the Board is considering or  
10       is being, you know, there are serious proposals  
11       being made, to undertake some form of return to  
12       earnings based regulation. One way or another  
13       looking at aggregate company-wide revenues  
14       relative to some major cost of capital, what's  
15       the major cost of capital, and as I said in what  
16       I said here and I think I said in my written  
17       statement as well, all of the world policy  
18       makers, left, right, conservative, liberal, free  
19       marketeers, people in still non-capitalist  
20       countries have been abandoning earnings based  
21       regulation because of three things I think. I'm  
22       going to summarize a lot of, you know, research



1 and everything from electric power to railroads  
2 to pipelines to telephones and everything else.  
3 What's really behind it? Number one is that, and  
4 Dr. Brinner touched on it, you introduce severe  
5 distortions. It's not just like oh, they're  
6 little minor things. When you engage in earnings  
7 based regulation if there's an opportunity to  
8 engage in padding of your costs, there's actually  
9 a word in famous research known as the Average  
10 Johnson Effect, if you've got an opportunity to  
11 pad your costs because if you don't pad your  
12 costs you're going to be found to be revenue  
13 super adequate and something's going to get  
14 rolled back somewhere someday rate or revenue is  
15 going to get rolled back, then we found  
16 throughout United States and elsewhere people  
17 padded their costs, not because they were evil or  
18 anything else, but because they were being  
19 rational and responding to the capital markets  
20 or, as Dr. Brinner suggests, you're less diligent  
21 in taking care of costs and so you end up with  
22 famous cases that were used in the electric

1 sector, for example, San Onofre Nuclear Power  
2 Plant, they just forgot to read the architectural  
3 plans and installed the retaining walls backwards  
4 to the tune of a \$5 billion error. Why? Because  
5 the pressure to hold your costs down gets  
6 reduced. There's a sense in these proceedings  
7 that oh, if we went to something different it'd  
8 be easier. What it does, and it's the second  
9 reason that we got so concerned about this  
10 regulation, you end up having to have prudence  
11 decisions because they're not going to say they  
12 padded their costs. You're going to have a  
13 prudence hearing and you'll have different kinds  
14 of experts and probably different lawyers in  
15 front of you fighting over these things of  
16 whether the investments make sense. The revenues  
17 commissioners, members of the Board, the revenues  
18 are too high because they've been inefficient in  
19 building their system. Well, that leads to a  
20 whole other kind of layer of regulation. And  
21 then lastly, this point I know it's easy for it  
22 to sound like waving the Staggers' flag is what

1 we transportation economists sometimes call it in  
2 our seminars. This has been a tremendous success,  
3 everyone recognizes that. But there is that  
4 danger and these analogs I draw to things like  
5 long lived rental apartments in New York City or  
6 something. They're real because we have gone  
7 through cycles of this where a system gets  
8 frustrated, entices the capital in. It takes a  
9 long time beyond our cycles as industry people,  
10 as experts, researchers, as lawyers, you as  
11 regulators, the really bad consequences are going  
12 to happen after all of us are not here anymore.  
13 I've always viewed, this is me talking, I can't  
14 speak for the AAR. I've always viewed the revenue  
15 adequacy recognition of that as a problem. I was  
16 a young economist but still involved to some  
17 extent, during the late 1970s we had the big  
18 sitting duck problem. We had killed the duck  
19 through decades of regulation untethered from  
20 sound economic principles of competitive pricing,  
21 protecting the customers against pieces of  
22 monopoly and so forth and quite reasonably you

1 would have a system that would say to the  
2 policymakers, to yourselves, to the regulators,  
3 let's not do that again. We'd like you to not  
4 adopt policies to force you down that path.

5 MS. MILLER: Dr. Koch, can I ask you  
6 a question, though? I mean I grasp what you're  
7 saying and I certainly appreciate the concern of  
8 that approach and would understand that generally  
9 people are moving away from it and if this was a  
10 proposal that said that once railroads were  
11 revenue adequate they couldn't raise rates beyond  
12 inflation across the board, I think all of those  
13 things you've said would end up happening and it  
14 would be disastrous. What I'm trying to  
15 understand, you know, taking in the totality of  
16 your testimony, if we're talking about this thin  
17 slice of the pie of railroad traffic which is  
18 truly captive and that is subject to STB  
19 regulation and if you apply this sort of an  
20 approach to it, do you see that having some  
21 ripple effect? I mean is there some economic  
22 reason to think that that remedy to a very small

1       portion of the traffic could have the kinds of  
2       consequential impacts that you're talking about?

3               MR. HAMBERGER: I guess I would defer  
4       to Joe in a second but I'd like to just challenge  
5       the basic foundation that it is a very narrow  
6       approach. If you add the fourteen percent and  
7       the five percent, you've at nineteen percent and  
8       that's of car loadings. I think if you take a  
9       look at it I'd be willing to bet because of  
10      Ramsey pricing and differential pricing and  
11      elasticity of demand that that nineteen percent  
12      of car loadings might be a little bit higher in  
13      terms of revenue, so even if it is, even if you  
14      say it's equal, one-fifth of the revenue then  
15      would be capped and so I don't consider that to  
16      be a narrow approach and that is one proposal. I  
17      believe another proposal that has been made is  
18      that there would be a rebate to the captive  
19      shippers from the excess profits received from  
20      the competitive traffic, so that then goes much  
21      beyond a narrow approach and so, you know,  
22      depending on where all of this comes out we're

1 not talking about just a sliver of traffic or a  
2 sliver of revenue so I think that is what is  
3 driving our perceived and your, as you perceive  
4 it, a major concern.

5 MR. KALT: And I would just say I  
6 think your basic intuition is right. The primary  
7 area of distortion would be where you create  
8 distorted incentives, let's say twenty percent of  
9 car loading, whatever it is, but the other thing  
10 we worry about is, duh, this is a network  
11 industry and so if you're having distorted  
12 decisions being made in this section of track or  
13 this form of IT, whatever it might be, you're  
14 potentially affecting hence distorting the  
15 pricing, the supply availability in other sectors  
16 and so you, it's not just allocation of railroad  
17 resources but allocation of our freight  
18 transportation resources more generally and so  
19 you would expect some spill-over effect if you  
20 will because it's a network industry and like a  
21 really important railroad network industry.

22 MS. MILLER: And I'm wondering, too,

1 if either of the economists, if you could address  
2 this question: one of the things I've, you know,  
3 tried to understand in my own mind is in this  
4 industry we talk about, you know, setting market  
5 rates and the power of a market set rate, which  
6 makes a great deal of sense to me, but when  
7 you're looking at captive shippers, truly captive  
8 shippers, and there are those out there, in fact,  
9 is it possible to set a market rate because there  
10 is no market or that's what I would conclude and  
11 I always thought that's the basis for the sliver  
12 of regulation that continues to exist in this  
13 county around railroads because there's a  
14 recognition that for some traffic there simply  
15 isn't really a market component to allow a rate  
16 to be set, but is that a misunderstanding on my  
17 part of what it means to set market rates?

18 MR. KALT: No, I think in some sense  
19 you're right, that is, we would say in certain  
20 situations there may be no competitive market.  
21 There may be true market balance going on. They  
22 never like me to say that but that's why you have

1 your proceedings, right? Consequently, what  
2 you've done, what the Board has done with the SAC  
3 test framework is essentially run a hypothetical.  
4 It's running a hypothetical of okay, we don't  
5 have a market. There are barriers to entry at  
6 certain places. But what if there weren't? How  
7 would that operate and I know it seems like just  
8 a teaching example but it's actually a lot of  
9 research about these kinds of things. Think of  
10 my apartment house. If I'm an apartment house  
11 owner in Washington, D.C. I've got a fully  
12 depreciated building. I'm in a very competitive  
13 market. There are thousands of these things  
14 around. The market will set my rate, because  
15 it's a healthy and growing market, will set my  
16 rate sufficient to draw in capital of equivalent  
17 quality from new entrants and that's actually  
18 what your SAC test framework is doing. It's  
19 creating a market. It's a hypothetical construct  
20 and many of the difficulties arise because it's  
21 hypothetical meaning I know that we should have  
22 concerns about how difficult it can be to



1       implement how, how detailed it gets and so forth  
2       and is it usefully detailed, but that's what  
3       you're doing. You're actually saying what you're  
4       saying. There's not a competitive market. We'll  
5       create a hypothetical market where entry, you  
6       know, it's just basically by the way it's anti-  
7       trust economics. You know, it's just anti-trust  
8       economics, a market with free entry, no one can  
9       exercise market power. Its prices are going to  
10      be set by what the entrant is holding them at and  
11      so it's just basically, we stressed about the  
12      contestable markets but it's basically anti-trust  
13      economics.

14               MR. BRINNER: I think, sorry, in such  
15      proceedings you're not devoid of market  
16      information. You can refer to what's the market  
17      cost of labor to run this railroad. You can  
18      refer to what's the market cost of tracks, of  
19      locomotives, of all that and then adding on a  
20      reasonable return, you can say what is the price  
21      and there is no market price that is a  
22      competitive market, but what's the price that

1 would have been produced in a competitive market  
2 with those market based costs, so you do have a  
3 lot of market information. The only competitive  
4 market piece you don't have is the price and you  
5 use your calculator to come up with that after  
6 you feed in everything else.

7 MS. MILLER: So, I'm sorry, I know  
8 this is getting a little bit long, but as we have  
9 two economists here, I'm interested in going back  
10 to an earlier question that Dan asked and that  
11 was about the TRB study. Have either of you seen  
12 or heard of the recommendations and what I  
13 thought was interesting about the approach they  
14 were recommending as an alternative to SAC was  
15 that what you would instead do is you would, as I  
16 understand it, look where you have competitive  
17 rates, create a model that could then forecast  
18 what a competitive rate would be even where you  
19 don't have them and then use that as a way to  
20 compare a rate to say is this an appropriate  
21 market rate and I'm wondering what your  
22 assessment is of that sort of an approach.

1                   MR. KALT: In some ways essentially  
2 what you just asked is very closely related to  
3 your prior question about the absence of a  
4 competitive market.

5                   MS. MILLER: Right.

6                   MR. KALT: I think as colleagues and  
7 I have talked about it, you know, of course it's  
8 in theory or as a starting point it's not a crazy  
9 thing to think that well, let's go look at the  
10 price of tomatoes over there and see what the  
11 price of tomatoes ought to be here, but as  
12 colleagues and I have talked about are the kind  
13 of thing we concern ourselves although it would  
14 probably increase the demand for economists  
15 pretty considerably rather than those engineering  
16 types who do the SAC stuff. It would be more the  
17 economists. Here's the thing that we worry  
18 about. We tend to have captive customers,  
19 problems with market dominance where the classic  
20 thing that you always get spit back at you by  
21 economists, economy as a scale and scope are such  
22 that the market doesn't support multiple

1       railroads for example, and in that situation then  
2       what that actually means is oh, some other place  
3       where I see some multiple railroads competing  
4       well that's actually not comparable to where I  
5       need to set the rate now, or I see railroads  
6       competing with trucks but that's probably not  
7       going to be comparable because if you're  
8       competing with trucks you wouldn't be market  
9       dominant and so the problem in other words arises  
10      because it's not anybody's fault in some sense.  
11      The technology of economies of scope and scale  
12      mean that those pockets where you're concerned  
13      about market dominance aren't going to have ready  
14      comparables and some colleagues and I have been  
15      talking it would probably default back into well,  
16      I know how to create a comparable. Let's think  
17      of a free entrant and we're back in a SAC world.  
18      In other words, you sort of find yourself going  
19      back to I'll have to adjust apparent comparables  
20      for the costs of entry where these economies of  
21      scale and scope make this situation not  
22      comparable to any readily observable actual

1 market.

2 MS. MILLER: Although I mean in the  
3 TRB study it seems like they allowed for that  
4 because that's just the way you kind of get in  
5 the door and then once in the door both parties  
6 have the opportunity to make their arguments  
7 either about why the rate's too high and doesn't  
8 make sense or why this is an appropriate rate for  
9 this particular ---

10 MR. KALT: Yes, but that's ---

11 MS. MILLER: -- it seems like it gives  
12 you the opportunity to both, you know, create  
13 the threshold of who gets looked at but then once  
14 looked at you can bring in the qualitative  
15 reasons why a rate might need to be higher and  
16 why that's justified.

17 MR. KALT: I think what I'm trying to  
18 convey, I guess is the more we've thought about  
19 it, I've thought about it, at least some of my  
20 colleagues, bringing those other things into the  
21 room wouldn't just be qualitative. You'd start  
22 to be talking about the economies of scope and

1 scale of this service and you're immediately back  
2 into a SAC world. In other words, it would give  
3 the argument I'm not comfortable because my costs  
4 are so different because I'm in this kind of  
5 network rather than the one you have used as your  
6 comparables test. So the adjustment for  
7 comparability that the TRB talks about I think  
8 the logic of our profession leads you very  
9 quickly back to worrying about are there kinds of  
10 scope and scale particular that are non-  
11 comparable in this service compared to whatever  
12 might be offered as comparable. So that's the  
13 logic of where the living additional arguments  
14 end takes you, damn, we're right back into SAC.  
15 Pardon my English.

16 MR. ELLIOTT: One other question  
17 regarding replacement costs and this just kind of  
18 hit me when we were discussing it. Has the  
19 concept of replacement costs in the revenue  
20 adequacy area ever been challenged in the courts,  
21 versus historical costs? Was the 2008 case taken  
22 up? I just don't know or have the revenue

1 adequacy decisions that we put out every year  
2 ever been taken up?

3 MR. SIPE: There certainly has not  
4 been a direct court challenge focused on the use  
5 or denial of use of replacement costs that I'm  
6 aware of. I can't tell you for sure whether any  
7 of the ICC's revenue adequacy decisions that were  
8 reviewed on appeal may have tangentially raised  
9 those issues. We can take a look at that and  
10 answer the question, but I don't think there is a  
11 rich case law in that vein.

12 MR. HAMBERGER: We did not challenge  
13 the denial.

14 MR. SIPE: Oh, no. I'm sorry, no.  
15 Yes, no case.

16 MS. BEGEMAN: I think I'll just close  
17 by saying I didn't sit down here at 9:30 thinking  
18 I was going to talk about replacement costs. It  
19 just kind of came about, and for all of you folks  
20 in the room who are all nervous, I'm not  
21 championing the use of replacement costs, but I'm  
22 bothered by the disconnect. I'm also bothered

1 every time I hear Mr. Kalt mention SAC. I  
2 realize that many consider it the gold standard.  
3 I also have seen it in practice and I know that  
4 not only do shippers have frustrations, I think  
5 Board members and even Board staff have  
6 frustrations in the fact that it has turned into  
7 such an enormous undertaking -- the costs, the  
8 time, the expense. Cases started before I got  
9 here that won't end before I leave. You know,  
10 I'm not good with that. And so, Deb had mentioned  
11 that she sees a lot of things connected as far as  
12 different proceedings. Well, I don't see them  
13 fully connected, but I certainly do want a  
14 process for really small shippers that is  
15 meaningful and fair. I'll just leave it at that.

16 MR. ELLIOTT: I guess also on that  
17 note you've really focused a lot on the SAC test,  
18 Mr. Kalt, and in that TRB report, they were  
19 pretty hard on it as far as URCS and some other  
20 economic theories and I'm not going to ever  
21 debate economics with you because I don't think  
22 I'd do very well but I assume the gentlemen that



1 came up with these ideas are your colleagues, the  
2 kind of people that you would debate these kind  
3 of issues with and I'd just be curious to hear  
4 your thoughts on their criticisms of the SAC  
5 test.

6 MR. KALT: Well, I think they're very  
7 similar when you, where I read and actually  
8 talked to some of the people, very similar to  
9 what was just raised. That is that the kinds of  
10 inputs and the processes that kind of modeling  
11 and so forth are proving to be extremely  
12 expensive, extremely contentious, detailed beyond  
13 kind of all comprehension sometimes, you know,  
14 should we have one more crew man on a twenty-mile  
15 move from Toledo to, you know, and as a  
16 regulatory economist, we should always be looking  
17 for ways and I know the Board has taken up issues  
18 of simplifying SAC and so forth. What I come  
19 away with from all of that is no one's going to  
20 honestly project the idea that a free entry  
21 market will be competitive and those competitive  
22 prices are the right ones. How do you get to

1       them? I would say at this point that, and I  
2       talked a little bit about like these technical  
3       working groups that have been used rather than a  
4       rulemaking and so forth, maybe things, the  
5       researcher in me says maybe we should be doing  
6       some serious research in a non-disputational way,  
7       non-litigatory way and looking at that challenge  
8       of okay, if IRCS is not work what's an  
9       alternative or, you know, on any of these  
10      components as Mr. Sipe mentioned, you know,  
11      things like finally reaching an agreement on the  
12      DCF approach in SAC is like a big deal. These  
13      things evolve but it takes, you know, leadership.  
14      It also takes some cool heads to focus on these  
15      in a systematic way to see how to improve a  
16      process and so I keep thinking this is right at  
17      the moment in the history of this industry is a  
18      process problem, that is how do we come to a  
19      better way of implementing both ideas like  
20      replacement costs and a SAC test.

21                   MR. ELLIOTT: I think we're done.

22      Thank you very much. I really appreciate your

1       answers and your testimony. I think you've been  
2       very helpful.

3               MR. SIPE: Thank you very much.

4               MR. ELLIOTT: Why don't we have the  
5       next panel come up so we can just get situated.  
6       Okay, why don't we get started with Panel number  
7       III.

8               MS. BOOTH: Good afternoon. Thank you  
9       for letting us get situated. I'm Karyn Booth.  
10      I'm a partner at the law firm of Thompson Hine  
11      and I'm general counsel to the National  
12      Industrial Transportation League. It is my  
13      pleasure to appear before the Board today to  
14      address the important policy issues involving  
15      revenue adequacy. With me is Mr. Eddie Johnston,  
16      III, from the Chemours Company which is a  
17      successor company to the performance chemicals  
18      business of DuPONT. Mr. Johnston and I will  
19      split the fifteen minutes allocated to NIT League  
20      this morning or this afternoon and will be very  
21      pleased to answer your questions at the  
22      conclusion of our testimony. The League's

1 testimony will focus on a single issue raised by  
2 the Board in its Notice of Hearing. That issue  
3 is whether railroads revenue adequacy status  
4 should impact the availability of competitive  
5 access remedies including the League's  
6 competitive switching proposal, which is the  
7 subject of the Board's Ex Parte 711 proceeding.  
8 We will address this issue based on the Board's  
9 governing statute, important policy  
10 considerations and in light of recent service  
11 issues faced by the industry as you requested.  
12 So beginning with the governing statute, it is  
13 clear that neither Staggers or the reforms  
14 subsequently adopted in the ICC Termination Act  
15 directly link competitive switching remedies to a  
16 carrier's overall financial status. These  
17 concepts appear in completely different sections  
18 of the statute and there's no direct reference or  
19 even an inference that connects the two. Mary,  
20 would you mind? I did bring with me just a few  
21 slides. Whoops. You can see it here. So just  
22 by way of example and really for the record

1 because we don't have a lot of time, this is the  
2 reciprocal switching statute and as you can see  
3 it's, you know, just a broad public interest  
4 standard or one in which where switching would be  
5 practical or in the public interest or what's  
6 underlined here, where such agreements are  
7 necessary to provide competitive rail service.

8 So at least in the switching statute itself  
9 there's no direct link to revenue adequacy. In  
10 contrast, other provisions of the statute such as  
11 the National Rail Transportation policy directly  
12 link revenue adequacy to rate reasonableness  
13 determinations demonstrating that Congress has  
14 made those connections where they are intended.

15 Next slide, Mary. So here you have one of the  
16 transportation policies where we see this to be  
17 the case and again, just underlined kind of the  
18 relevant language here indicating that to  
19 maintain reasonable rates where there's an  
20 absence of effective competition and most  
21 importantly where rail rates provide revenues  
22 which exceed the amount necessary to maintain the

1 rail system and attract capital. Additionally  
2 the statutory provision directing the Board to  
3 establish standards and procedures for  
4 determining railroad revenue adequacy has no  
5 relationship to competitive access. Next slide.  
6 I'm not going to read this. This is really just  
7 for the record but a lot of text there, but  
8 again, no connection between the two. Going  
9 beyond the clear text of the statute, there's no  
10 legislative history that otherwise shows Congress  
11 intended to restrict the Board from authorizing  
12 competitive switching if the defendant railroad's  
13 overall financial status was determined to be  
14 revenue inadequate. Now, what I'd like to do  
15 next is just turn to the last slide, Mary, and it  
16 basically touches on not just the statute but the  
17 Board's current competitive access rules. I'm  
18 sorry, what happened? Oh, okay, well, this next  
19 slide, which you can't see and it'll be submitted  
20 in the record, is a provision from the Board's  
21 current rules and it's the rule that deals with  
22 prescription of switching arrangements as well as

1 through roots and that specific rule that exists  
2 today has expressed language which basically  
3 prevents the Board from considering revenue  
4 adequacy. It basically states here that the  
5 overall revenue inadequacy of the defendant  
6 railroad will not be a basis for the denying  
7 prescription of reciprocal switching. Thus, as a  
8 legal matter, there's no statutory provision that  
9 requires the Board to link competitive switching  
10 and railroad revenue adequacy. In fact, the  
11 Board's current rules expressly prohibit the  
12 agency from denying a switching remedy even if  
13 the defendant carrier is revenue inadequate. So  
14 there you go. Thanks. So despite the fact that  
15 there's no statutory linkage, as a policy matter  
16 the NIT League believes that the Board should not  
17 condition a switching remedy based on the revenue  
18 adequacy status of the carrier and that's because  
19 when evaluating whether to grant a competitive  
20 switching remedy the League believes that the  
21 Board should focus on the characteristics of the  
22 rail movement at issue, and particularly its

1 captive status rather than the overall financial  
2 status of the defendant carrier. This is  
3 precisely the approach followed by the League in  
4 its competitive switching proposal filed with the  
5 Board four years ago and currently under  
6 consideration. The League CSP already limits a  
7 captive shipper's ability to obtain competitive  
8 switching by requiring that shipper to meet  
9 certain conditions. Specifically under the CSP,  
10 a shipper that can show that its rail movement is  
11 captive and subject to monopoly power is charged  
12 rates well above competitive traffic and is  
13 located near a working interchange may be  
14 eligible to obtain the competitive switching  
15 remedy even if the defendant carrier has been  
16 found to be revenue inadequate. Similarly, a  
17 shipper that cannot demonstrate an improper  
18 exercise of market power by its rail carrier may  
19 not obtain a switching remedy under the CSP even  
20 if the serving carrier is deemed to be revenue  
21 adequate. Accordingly the League CSP is narrowly  
22 tailored to address an unreasonable assertion of



1 market power over a specific rail movement and  
2 the overall financial status of the defendant  
3 carrier should not stop the Board from solving  
4 the problem by introducing a competitive  
5 alternative as contemplated under the switching  
6 statute. Moreover, the League CSP would provide  
7 captive shippers and the Board with an  
8 alternative remedy to a rate case. This remedy  
9 would be entirely consistent with the National  
10 Rail Transportation Policy published at 49 USE  
11 101011 which is to allow to the maximum extent  
12 possible competition and the demand for rail  
13 services to establish reasonable rates for  
14 transportation by rail. Nevertheless, in  
15 evaluating whether to move forward with the  
16 League CSP the Board should not ignore the fact  
17 that three of the nation's big 4 rail carriers  
18 have been revenue adequate under the Board's own  
19 high standards for measuring that tool and that's  
20 been the case for the past three years. Based on  
21 other financial performance measures all of the  
22 major railroads are financially strong and

1 continuing to grow stronger. The current  
2 financial strength of the rail industry should  
3 give this Board greater comfort that adoption of  
4 the CSP will not harm this industry financially,  
5 and we will be addressing also operationally.

6 The League has already demonstrated in the 711  
7 proceeding that the CSP would potentially result  
8 in only a very modest increase in switching  
9 arrangements. Only 4.6 percent of carloads would  
10 be impacted and I think it's very important to  
11 note that that was really all eligible traffic  
12 and as we, you know, I think argued ad nauseam in  
13 711 not all of those carloads would even be  
14 switched. The League has also demonstrated in  
15 711 that the CSP would have a very small impact  
16 on railroad revenue. Only 2.6 percent, again of  
17 the big four railroads gross revenue would be  
18 impacted under that proposal. The railroad's  
19 achievement of revenue adequacy or for those  
20 carriers that haven't gotten there yet still  
21 recognizing their very strong financial condition  
22 along with the CSP's modest impacts on rail

1 traffic and revenue demonstrate that the railroad  
2 investment would not be unreasonably curtailed if  
3 the CSP were to be adopted. We believe  
4 competition will spur investment. Thus, the  
5 League respectfully urges the Board to move  
6 forward with the rulemaking on the CSP. We would  
7 also like to make a comment on the recently  
8 released study by the Transportation Research  
9 Board already brought up here today. The League  
10 believes that overall the TRB researchers did an  
11 excellent job fulfilling the congressional  
12 mandate to DOT to provide the study on the  
13 economic regulation of the U.S. Freight Railroad  
14 Industry. The study includes a number of very  
15 interesting recommendations to help modernize  
16 rail regulation of which the League is still  
17 reviewing. However, the League would like to  
18 address one specific statement included in the  
19 report which followed a discussion of the League  
20 CSP and which offered a suggestion for  
21 implementing competitive switching today  
22 presumably under the current regulatory system.

1 Specifically on page 112 of the report, I'm not  
2 sure we're going to get our slide here, but I did  
3 want to put this language up so everybody could  
4 see it. This is what the suggestion was by the  
5 TRB and you'll see here that it recommends as a  
6 starting point for STB to consider reciprocal  
7 switching. It could be used as an optional  
8 remedy for rates that have already been ruled  
9 unreasonable and thereby offer an alternative to  
10 a prescribed rate. This statement seems to  
11 suggest that today competitive switching should  
12 be implemented by the Board only in the context  
13 of an unreasonable rate dispute, only as an  
14 optional remedy to rate prescriptions and only  
15 after a rate has already been found to be  
16 unreasonable. Our understanding of the TRB  
17 suggestion is that the shipper would be required  
18 to first prove market dominance and litigate and  
19 win a SAC case before a switching remedy would  
20 even be available. This approach would make the  
21 regulatory process even longer, more complex,  
22 more expensive than it is today and would only

1 discourage shippers from even attempting to  
2 secure competition through switching. This  
3 approach would have the opposite effect of the  
4 League CSP which is designed to provide a more  
5 simplistic and cost effective approach to  
6 implementing the switching statute. Accordingly  
7 the League opposes implementation of competitive  
8 switching as an optional rate case remedy as  
9 suggested here on page 112. I would like to  
10 conclude by briefly addressing the Board's  
11 inquiry regarding the impact of recent rail  
12 service problems and the League CSP. First, the  
13 potential for the CSP itself to create additional  
14 service problems has been vastly overstated by  
15 the railroads. The railroad service concerns are  
16 premised on an incomplete study of the CSP that  
17 lacks credibility for many of the reasons that  
18 were already discussed in that proceeding and at  
19 the prior hearing. Second, the CSP itself would  
20 provide this Board with the power to deny a  
21 request for competitive switching under the CSP  
22 if the defendant railroad shows that the switch

1 would be unfeasible, unsafe or would harm rail  
2 service. This built in protection directly  
3 addresses any service related concerns and would  
4 prevent them from ever even occurring. Third,  
5 the Board should also consider that competitive  
6 switching in some cases can actually operate as a  
7 solution to service problems by providing an  
8 alternative route if the incumbent carrier is  
9 experiencing congestion or is otherwise unable to  
10 meet the service needs of the shipper. That  
11 concludes my testimony and I'd like to turn the  
12 floor over to Mr. Johnston and I'd be happy to  
13 answer questions at the end. Thank you.

14 MR. JOHNSTON: Good afternoon. I'm  
15 Eddie Johnston, manager for sustainability and  
16 government affairs with the Chemours Company.  
17 Thank you for holding this Hearing on revenue  
18 adequacy and its impact on rate regulation as  
19 well as on competitive access remedies and rail  
20 service. Chemours is a publicly traded company  
21 that is a spin-off of the performance chemicals  
22 business that was previously part of E.I. DuPONT

1 de NEMOURS & Company. Chemours is a very  
2 substantial user of rail services in the United  
3 States and in its formal corporate organization  
4 within DuPONT has been a frequent participant in  
5 proceedings before the Board. More than seventy-  
6 five percent of Chemours facilities are captive  
7 to a single railroad. Contrary to Mr.  
8 Hamberger's impassioned testimony, we do not  
9 generally face a competitive rail industry. My  
10 company does not see or experience competitive  
11 pricing or service behavior from our rail service  
12 providers. Chemours is a member of the National  
13 Industrial Transportation League and my testimony  
14 is being provided as a League member. On behalf  
15 of the League, I will address the Board's  
16 question regarding the impact of rail service  
17 issues on the League's request for the Board to  
18 increase competitive switching between rail  
19 carriers. As you know in July 2011, the League  
20 filed a petition asking this Board to open a  
21 rulemaking to revise the existing competitive  
22 access rules and specifically to permit

1 competitive switching between rail carriers for  
2 captive rail movements that meet certain  
3 qualifications. The nation's rail carriers have  
4 opposed the League's competitive switching  
5 proposal claiming that the proposal would  
6 adversely impact rail service. Chemours believes  
7 that the League's CSP would not degrade service,  
8 but instead would offer routing alternatives that  
9 would help improve rail service. Indeed,  
10 switching arrangements under the CSP might lead  
11 to better service in situations where the  
12 incumbent's line is experiencing congestion or  
13 its route is more circuitous or less efficient.  
14 Switching arrangements occur every day during  
15 normal railroad operations. Carriers routinely  
16 work together in yards and in locations where  
17 more than one carrier has access to the tracks.  
18 We believe that rail carriers would be able to  
19 effectively cooperate and manage an increase  
20 in services that could occur under the CSP. Our own  
21 experience demonstrates that competitive  
22 switching does not degrade service but can



1 improve service while providing solutions when a  
2 carrier is not able to meet a shipper's needs.  
3 Chemours currently has four facilities in  
4 Louisville, Kentucky, Pascagoula, Mississippi,  
5 Beaumont, Texas, and Strang, Texas that are open  
6 to reciprocal switching. Rail service to and from  
7 these facilities is at least equal to the rail  
8 service at our many captive plants. The  
9 availability of a second carrier provides an  
10 alternative that can be used to address service  
11 deficiencies or disruptions. Our use of the  
12 switching options at each location varies and is  
13 based on factors including price, service, and  
14 routing efficiencies. To better meet our service  
15 and delivery needs we prefer to use the  
16 alternative carrier for a substantial portion of  
17 our traffic at two of these four locations. At  
18 the other locations we use the switching  
19 arrangement only for a minority of our traffic.  
20 Also at one of these locations we prefer to use a  
21 three carrier route instead of a two carrier  
22 route to a particular destination due to superior

1 service and favorable economics. My ability to  
2 choose an alternative routing has helped Chemours  
3 better meet the needs of valued customers.  
4 Moreover, we see no difference in the carriers'  
5 investment at our captive plants versus our  
6 competitive plants. Chemours also has two  
7 facilities in New Jersey that are effectively  
8 dual served as part of the Con-Rail shared assets  
9 area. There is an ongoing coordination between  
10 the rail carriers at the yards in those areas.  
11 In our experience service at these two facilities  
12 is generally better than at our captive  
13 locations. Accordingly we believe the nation's  
14 rail carriers are experienced and well equipped  
15 to handle additional switching arrangements and  
16 changing traffic volumes that may arise under the  
17 CSP. Let me close with one more thought for your  
18 consideration. A career in business has taught  
19 me that service can only be assessed from the  
20 perspective of the customer, yet the Board and  
21 rail carriers seem to define rail service very  
22 narrowly as transit time and system fluidity,

1 both internal railroad measures. To rail  
2 customers like me, rail service means much more.  
3 Service includes safety and accident performance.  
4 It includes predictability of deliveries.  
5 Service involves responsiveness to my business  
6 needs including how well and how promptly my  
7 suppliers respond to concerns, problems and  
8 changing business conditions. And finally, a  
9 mark of exceptional customer service, perhaps the  
10 mark of exceptional customer service, is simply  
11 how easy it is for me to do business with you.  
12 Aren't these the very ways you and I evaluate  
13 customer service as consumers? I think so.  
14 Should we expect less from the nation's  
15 railroads? I have observed that excellent  
16 customer service thrives in a vigorously  
17 competitive environment. It falters when  
18 competition is lacking. The League's competitive  
19 switching proposal would help introduce more rail  
20 to rail competition where it is needed most. It  
21 would give me and other captive shippers a  
22 service choice just as we have with other

1 suppliers. I, therefore, respectfully ask this  
2 Board to move forward with a rulemaking on the  
3 League's competitive switching proposal. Thank  
4 you very much.

5 MS. MILLER: So, Karyn, you were  
6 pretty clear but I want to go back. The NIT  
7 League's position is that we shouldn't tie the  
8 concept of revenue adequacy and competitive  
9 switching together, correct?

10 MS. BOOTH: That's correct. We don't  
11 see any intent for that in the statute.

12 MS. MILLER: Yes.

13 MS. BEGEMAN: Deb is right. Your  
14 testimony was very clear, actually, both of you.  
15 We appreciate that. Mr. Johnston, it was really  
16 helpful for you to kind of walk through the four  
17 plants that you have the ability to have  
18 competitive access, and then the two with the  
19 Con-Rail shared asset areas. So, six plants out  
20 of how many?

21 MR. JOHNSTON: Roughly twenty-six.

22 MS. BEGEMAN: Out of twenty-six.

1 MR. JOHNSTON: Yes.

2 MS. BEGEMAN: And could you just --  
3 and I know from the previous hearing and  
4 proceeding this may be a repetitive question -- I  
5 don't think that it is but I know you've appeared  
6 here a few times on different matters -- but how  
7 often do you, you sort of explained that you  
8 don't actually switch a lot but it's there if you  
9 need it. But just in practical terms, how often  
10 do you switch to another carrier, the  
11 circumstance, and how quickly do you make that  
12 decision? You know we've spent the last year and  
13 a half, not just the last year and a half but the  
14 previous year, with the service issues that were  
15 going on that were a really great, serious  
16 concern to me and to the other Board members and  
17 I'm just trying to understand from your first-  
18 hand perspective about how you have gone about  
19 your use of competitive access.

20 MR. JOHNSTON: So the four sites that  
21 I described, they range from the use of the  
22 alternative more than ninety-five percent of the

1 time at one of the sites to less than five  
2 percent of the time at one of the other four, and  
3 the other two fall in between obviously so it's  
4 use varies widely based on service performance,  
5 based on economics ---

6 MS. BEGEMAN: I mean does it change,  
7 could it change on a dime, like in a week or is  
8 it in a month or in a year? How often?

9 MR. JOHNSTON: So if there's a service  
10 disruption for any of a variety of reasons we  
11 have the alternatives to switch the traffic onto  
12 another carrier. Obviously that has to be worked  
13 out with the carrier in terms of how quickly that  
14 can be done but it's managed and it's done  
15 efficiently in these cases. Again, railroads  
16 pass traffic back and forth every day. This is  
17 simply another instance of their doing that. Is  
18 that responsive to your question?

19 MS. MILLER: Has it affected your  
20 rate, I mean, as a consequence in those  
21 facilities where you have competitive shipping,  
22 do you think you've got a more competitive rate?

1                   MR. JOHNSTON: In some cases we have  
2 better rates, yes.

3                   MR. ELLIOTT: Just one question. It  
4 probably goes back to a question I've already  
5 addressed, but in the reciprocal switching  
6 provision itself it requires once reciprocal  
7 switching is put in place, that the two railroads  
8 meet. How do you see that working, having the  
9 two railroads and obviously if they don't reach  
10 an agreement then they have to come to us, but  
11 does that make you nervous at all that that puts  
12 you in that position?

13                  MS. BOOTH: Well, as you know, the  
14 statute has that requirement. The railroads  
15 certainly in the first instance are to come to  
16 their own agreement on what the switch fee should  
17 be in a given situation. If they can't agree,  
18 then of course, either one of them or a shipper  
19 could come to the Board, but look, our view is  
20 that introducing competitive switching is not  
21 likely to be introduced in every possible  
22 scenario and there may be instances, there are

1       lots of shippers who worry about whether or not  
2       railroads will aggressively compete so there is  
3       some concern related to the switch fee, but I  
4       think from NIT League's perspective, we believe  
5       that it will work, it'll get started, folks will  
6       get comfortable with it and there'll be a process  
7       for it and it may be that there are pockets where  
8       the competition isn't vigorous enough and it may  
9       be, we hope and we believe that there'll be many  
10      other locations where it would work.

11               MR. ELLIOTT:   Thank you.

12               MR. JOHNSTON:   So I'm not a lawyer or  
13      an economist.   I'm just a businessman and so I  
14      tend to think in just common sense kind of every  
15      day terms and so to me it's a question of having  
16      a choice versus not having a choice and more  
17      times than not it's better to have a choice and  
18      be able to exercise that choice whether I  
19      actually exercise it not than it is not to have  
20      the choice at all and so just from a common sense  
21      sort of perspective to me that's what this is  
22      about and as I say at 20 of the 26 plants I have



1 no choice. I have no choice whatsoever and so if  
2 I could pick up a choice at even a couple of  
3 those that I might at some time be able to take  
4 advantage of for the benefit of my customers who  
5 I serve that's a good thing.

6 MR. ELLIOTT: Thank you very much. We  
7 really appreciate you coming here today.

8 MR. JOHNSTON: You're welcome.

9 MR. ELLIOTT: Especially someone  
10 that's not an economist or a lawyer. We  
11 appreciate that. As I said earlier, we are going  
12 to take a thirty-minute break, so why don't we  
13 get back here around 1:45 and we will proceed  
14 with Panel number IV. Thank you.

15 (Whereupon, the above-entitled matter  
16 went off the record at 1:16 p.m. and resumed at  
17 1:51 p.m.)

18 MR. ELLIOTT: Okay, why don't we get  
19 started with Panel number IV.

20 MR. ELIASSON: Thank you and good  
21 afternoon, Chairman Elliott, Vice Chairman  
22 Begeman and Commissioner Miller. Thank you for

1 the opportunity to address revenue adequacy. My  
2 name is Fredrik Eliasson and I serve as CSX's  
3 Chief Financial Officer. I have been with CSX  
4 for twenty years and as CFO I direct all of CSX's  
5 financial activities and in my prior roles in  
6 sales and marketing, led our efforts across  
7 markets that included the industrial,  
8 agricultural and construction sectors of our  
9 economy. All of this experience gives me the  
10 insight on how customers and investors value our  
11 service and business and the expectation they  
12 hold for the future that forms my basis for my  
13 discussion today. Over the next few minutes,  
14 I'll provide some insights on the way that we  
15 manage our balance sheet to meet these  
16 expectations and how we make our reinvestment  
17 decisions. But first on slide 2, we have  
18 outlined four critical elements that we believe  
19 we must have from a regulatory perspective to  
20 meet the expectations of our shareholders, of our  
21 stakeholders, our customers, investors, employees  
22 and the communities we serve. These are

1       foundational economic pillars that are consistent  
2       with the Staggers Act that has transformed  
3       American railroads. Let me briefly touch on  
4       each. First, measure progress, don't constrain  
5       it. Any regulatory policy that employs revenue  
6       adequacy should view it as a barometer of  
7       industry health and a regulatory policy's  
8       success, not an arbitrary basis to limit pricing  
9       and investment. Second, address replacement cost  
10      imperative. I will talk more in a moment about  
11      the need to recognize returns based on  
12      replacement costs today and not the depreciated  
13      costs of the past. Third, promote differential  
14      pricing. We need the ability to price based on  
15      the marketplace value of the service we provide  
16      and not to be artificially constrained by rate  
17      caps or forced access. And, fourth, ensure free  
18      market results to foster reinvestment. As I will  
19      discuss in a moment, Staggers left intact free  
20      market incentives to promote reinvestment and the  
21      right to earn an appropriate return. U.S.  
22      railroads have progressed to where we are today

1 through high levels of sustained investments in  
2 our infrastructure that is not only meeting  
3 today's freight demand but it is also being  
4 expanded to meet tomorrow's needs. We  
5 acknowledge that others might have different  
6 perspective on these pillars but essentially they  
7 form the underpinnings of any successful  
8 business. Absent any of the four we cannot be  
9 successful. It is our contention that any sound  
10 regulatory policy must incorporate these pillars.  
11 If you look on the left on slide 3 you see that  
12 the employees of U.S. railroads are the most  
13 efficient in the world. The visionary policy  
14 makers who drafted the Staggers Act had the  
15 foresight to carefully balance the regulatory  
16 framework against free market economic incentives  
17 so that our business are properly motivated to  
18 maximize revenues and to minimize costs. It was,  
19 of course, the salvation of the U.S. rail  
20 industry which today is the envy of the world.  
21 On the right, you see that our customers have  
22 shared in these efficiencies with on an inflation

1 adjusted basis reduced rail rates that are less  
2 than sixty cents on a dollar versus 1981.

3 MR. ELIASSON: An indisputable proved  
4 point that the Staggers Act allowed free market  
5 forces to work, our customers benefitted greatly.

6 For CSX specifically our vision and  
7 core values referred to on slide 4 focuses on  
8 value creation providing a safe, efficient and  
9 environmentally beneficial means to move freight.  
10 CSX must offer benefits superior to those of our  
11 competitors in order to attract customers and  
12 revenue to our network and revenues which last  
13 year amounted to \$12.7 billion.

14 As with any American household, we  
15 first pay our bills before we can think about  
16 discretionary choices for what is left over. For  
17 CSX, it comes down to three discretionary  
18 options: Reinvest in our business, pay dividends  
19 to our shareholders, buy back shares to increase  
20 the value of the stock held by our shareholders.  
21 We do all three as part of our balanced cash  
22 deployment strategy. Clearly it is important to

1 reinvest in physical plant and equipment but it's  
2 also important for any publicly traded company to  
3 adequately reward its shareholders through  
4 dividends and share buy backs.

5 At CSX, like any public company, it is  
6 understood that we must earn the right to  
7 reinvest in our business. These reinvestments  
8 must increase CSX's value proposition and  
9 ultimately return a yield to shareholders that is  
10 higher than what can be achieved by distributing  
11 those earnings directly to them through dividends  
12 and sharer purchases. Only by increasing the  
13 value of our company can we compete for the  
14 capital from our investors who have a broad  
15 spectrum of investment choices.

16 To further clarify, slide 5 shows how  
17 our cash deployment has been allocated over the  
18 last ten years. On the left you can see that  
19 approximately sixty percent was dedicated to  
20 capital investment to both maintain and expand  
21 our network to meet the growing demand that we  
22 see. Approximately forty percent was devoted to

1 shareholder distributions. To put this in  
2 context on the right is the same allocation for  
3 the S&P 500 over that same period. Those  
4 companies on average invest less capital and  
5 reward shareholders at a higher rate.

6 As the executive team member for CSX  
7 who regularly meets with institutional investors  
8 it is clear that dividends and share purchases  
9 are critical to the valued proposition we provide  
10 our investors. Of course, their investment in  
11 turn makes it possible to keep our network and  
12 assets capable of serving our customers and  
13 America's freight transportation needs.

14 On slide 6, you see capital  
15 expenditures as a percentage of sales by many of  
16 our customers and our competitors. Railroads are  
17 at the near top of that list with an average of  
18 17 cents on the dollar dedicated to capital  
19 investment. You can see that many of our  
20 competitors and customers devote fewer of their  
21 revenues to capital investment. In fact, some  
22 substantially so than railroads.

1                   We all recognize the need to continue  
2                   to upgrade and expand our transportation  
3                   infrastructure. Railroads are doing so with our  
4                   shareholders' capital reducing the burden on our  
5                   taxpayers and publicly supported infrastructure.  
6                   This year our planned capital investment is \$2.5  
7                   billion, a CSX record and a continuation of our  
8                   commitment to a safe reliable and expanding  
9                   network.

10                   Infrastructure and equipment  
11                   maintenance account for \$1.8 billion, growth and  
12                   productivity investments \$400 million, and  
13                   positive train control and other regulatory  
14                   mandates \$300 million. To put this in  
15                   perspective, over 80 percent of our total capital  
16                   budget is already spoken for with respect to  
17                   maintenance and PTC needs even before we begin to  
18                   consider growth focused investments. In regard  
19                   to PTC specifically, by the end of this year we  
20                   will have invested \$1.5 billion with essentially  
21                   no measurable financial return. Of course, we  
22                   recognize the safety benefits of PTC and will



1 meet our obligation to implement it as quickly as  
2 possible but full roll-out is expected to take  
3 until 2020 as we want to accomplish PTC  
4 implementation without negatively impacting  
5 safety or customer service.

6 Now as you know the FRA in its final  
7 PTC rule estimated its cost to benefit ratio to  
8 be 22 to 1. We also face now the prospect of  
9 requirements of ECP bricks. All of this leaves  
10 very little capital to accommodate traffic surges  
11 such as we saw in the spring of 2014 and to  
12 generally support the growing needs of our  
13 customers.

14 Central to understanding this capital  
15 intensity is our ongoing dialogue about  
16 replacement costs versus book value. As this  
17 Board knows, we've been advocating for  
18 recognition of replacement costs as a more  
19 realistic way to assess economic value and  
20 appropriate return on investments. When we make  
21 decisions to allocate a certain percentage of  
22 cash to reinvestment we, like all companies, have

1 assumed that we can earn a return on that  
2 investment, a return that is not based on the  
3 book cost of those assets when we acquired them  
4 20 to 100 years ago, but on the economic value of  
5 that investment today. Given that reality, the  
6 current revenue adequacy methodology reliance on  
7 depreciated book value does not represent the  
8 true cost to replace those assets. As you can  
9 see on slide 8, track replacement cost is  
10 approximately three times the depreciated cost.  
11 Mind you that \$1.1 million per mile was  
12 chauffeured track replacement assumes that we're  
13 replacing rails on the corridors on which we  
14 already operate without the need to rebuild  
15 bridges or acquire additional property along with  
16 associated grading costs, all of which would  
17 drive that cost higher. It also does not factor  
18 in signals or other train control electronics.

19 Average locomotive replacement cost is  
20 approximately four times the depreciated cost and  
21 freight car replacement cost is approximately  
22 three times the depreciated cost. It is evident

1       that the difference between replacement cost and  
2       depreciated book value is tremendous. To assess  
3       our economic value on a depreciated cost basis  
4       does not acknowledge our investment realities.  
5       The Board's assessment of the railroad returns on  
6       assets must recognize replacement costs.

7               Here's another view on slide 9 of  
8       replacement costs as they pertain to major  
9       infrastructure. You may recall that in August of  
10      2005 Hurricane Katrina unleashed a devastating  
11      strike on New Orleans and the Gulf Coast. One  
12      CSX bridge that was severely damaged was the  
13      nearly two-mile long Bay St. Louis Bridge to  
14      Mississippi which was built in 1967. In 2005,  
15      the bridge was on our books for a depreciated  
16      value of \$2 million. It cost us more than \$75  
17      million to replace.

18             We have thousands of bridges of  
19      different lengths on our network that will  
20      require replacing and upgrading over the next  
21      decades. However, the implication of the current  
22      methodology is that we should only be allowed to

1       earn a return on the historical cost, which is a  
2       fraction of that investment. How is that good  
3       economic or public policy?

4               Another project currently under  
5       construction is the replacement and expansion of  
6       the 3800 foot long Virginia Avenue tunnel just a  
7       quarter of a mile or so from here, the first  
8       phase of which opened about a 130 years ago. The  
9       tunnel is essential to the delivery of goods to  
10      businesses and consumers here in the District and  
11      up in on the east coast. The tunnel has a  
12      depreciated value today of \$6 million dollars.  
13      The investment to replace it with the necessary  
14      improvements will be more than \$250 million.

15             We are making these investments at a  
16      time when our markets are in major transition  
17      with our base load coal market continuing to  
18      erode. We have endured the loss of nearly half  
19      of our utility coal volume since 2006 while  
20      domestic intermodal volume has grown sixty-five  
21      percent. The domestic intermodal increase  
22      occurred at the same time the truck traffic on

1       our already congested and maintenance starved  
2       highways increased only twenty percent. That  
3       makes a compelling point that rail investments  
4       intermodal are serving a public need.

5               As an example here on slide 11, is  
6       CSX's northwest Ohio intermodal terminal, which  
7       some of you have visited. The terminal opened in  
8       2011 at a cost of \$171 million. Northwest Ohio  
9       gives us the ability to bypass Chicago with  
10      Transcontinental intermodal shipments. It also  
11      allows for hub and spoke system that provides  
12      cost efficient service to smaller markets. It  
13      has been a great success and with the growing  
14      volume the terminal was expanded recently at a  
15      cost of \$40 million. If you cap our returns  
16      investment likes these that convert highway  
17      traffic to rail and reduce the taxpayer burden of  
18      highway maintenance are much, much less likely to  
19      occur. To better illustrate this and, excuse me,  
20      Mr. Chairman, but with your permission I'd like  
21      to finish. We'll only be about two or three  
22      minutes or so. Thank you so much

1           To better illustrate this on slide 12,  
2   to the left you see the virtuous cycle of higher  
3   returns which generate higher cash flow resulting  
4   in higher reinvestment. This is illustrated on  
5   the right by the overall Class I Railroad  
6   Investment in infrastructure and equipment.

7           In contrast to the prior slide here on  
8   slide 13 we see the vicious investment framework  
9   of capped returns that would reduce cash flow and  
10   limit our reinvestment. The result would be less  
11   access to capital, less growth investment, less  
12   productivity investment, and fewer resources.

13   Let me put this another way, how much less  
14   investment do you want CSX to make? How much  
15   less efficiency, how much less reliable service?  
16   Because those are the difficult questions that  
17   will have to be answered at a time where there's  
18   near universal agreement that more freight rail  
19   investments are needed, not less.

20           So, I'll wrap up by returning to the  
21   four pillars that I referenced in my opening. If  
22   the Board shares our belief that these pillars

1 are consistent with Staggers Act and fundamental  
2 to the viability of railroads you regulate, you  
3 must support our ability to generate adequate and  
4 competitive returns. To do otherwise would  
5 equate to transfer of earnings from one industry  
6 to another and from one company to its customers  
7 putting CSX and other U.S. railroads at further  
8 market disadvantage.

9 All we seek is a level playing field  
10 to satisfy the public demand for reduced highway  
11 congestion, less demand on public dollars for  
12 highway maintenance and cleaner air supported by  
13 reduced emissions. Revenue adequacy should be a  
14 benchmark for railroad health and not a tool for  
15 reregulation. To apply revenue adequacy to  
16 companies in a competitive market as a rationale  
17 to cap rates is to diminish incentives to aspire  
18 to innovation, efficiency, quality service.

19 Railroads today are healthier and benefits are  
20 flowing to customers, shareholders, employees and  
21 the communities we serve. Let's keep it that  
22 way. Thank you.

1                   MR. ATKINS: Members of the Board, my  
2 name is Ray Atkins and it's my pleasure to appear  
3 here today on behalf of Norfolk Southern. I am  
4 joined by Professor David Sappington from the  
5 University of Florida and Professor Brad Cornell  
6 from Cal Tech. Together we are here to urge the  
7 Board to abandon the revenue adequacy constraint  
8 that was conceived thirty years ago. Three  
9 decades later regulators worldwide are abandoning  
10 this type of constraint because it deters  
11 innovation, investment, productivity and  
12 competition.

13                   Professor Sappington has been studying  
14 this trend and this evolution and economic  
15 thinking for the better part of two decades and  
16 so he's going to start our presentation by  
17 describing his research. Professor Cornell is  
18 then going to discuss some of the significant  
19 measurement errors in how you calculate revenue  
20 adequacy on an annual basis and how even if you  
21 could correct those deficiencies a measure of  
22 system-wide revenue needs provides no guidance



1 about the maximum rates that should be charged to  
2 an individual customer and then I'm going to wrap  
3 up by talking about how you already have a  
4 targeted revenue adequacy test but one that is  
5 narrowly focused on the portions of the network  
6 that are used by the complaining customer.  
7 Professor Sappington.

8 MR. SAPPINGTON: Thank you, Mr.  
9 Atkins. Good afternoon, Chairman Elliott, Vice  
10 Chairman Begeman, and Commissioner Miller. My  
11 name is David Sappington and I'm a professor of  
12 economics and Director of the Public Policy  
13 Research Center at the University of Florida and  
14 as Mr. Atkins' mentioned my academic career has  
15 been devoted to studying issues dealing with  
16 regulation, the design of sound regulatory  
17 policy, the basic underlying principles and in  
18 particular the implementation of incentive  
19 regulation.

20 I've also had the privilege of  
21 translating these principles into practice when I  
22 served as the chief economist for the Federal

1 Communications Commission in 2001 and since that  
2 time I've had the pleasure of advising and  
3 working with both regulators and industry  
4 participants on the design of regulatory policy  
5 in several industries.

6 I understand that the Board is  
7 considering whether to implement explicit  
8 earnings regulation to ensure that railroads  
9 earnings do not exceed what are deemed to be  
10 adequate levels and in the strongest of terms I'd  
11 like to urge the Board not to proceed down this  
12 path. The Board's current regulatory policy is  
13 highly commendable on many dimensions and has  
14 stimulated substantial improvements in the rail  
15 industry. The imposition of additional explicit  
16 earnings regulation would stifle innovation in  
17 the industry and thereby impede industry  
18 performance to the detriment of railroads and  
19 shippers alike and these conclusions reflect both  
20 basic economic principles and experience with  
21 earnings regulation in other industries around  
22 the world.

1           To support my recommendation this  
2   afternoon against additional earnings regulation  
3   in the freight rail industry I'd like to first  
4   identify the key principles that underline that  
5   recommendation. Then I'd like to briefly review  
6   experience with earnings regulation in other  
7   industries and then before concluding I'll  
8   discuss the fallacy of a common myth about  
9   earnings regulation and note the implications of  
10   this fallacy for the Board's current  
11   deliberations.

12           So to begin with the key principles of  
13   regulatory policy design, perhaps the key  
14   principle of policy design as was discussed this  
15   morning is that regulations should only be  
16   imposed where competition fails to adequately  
17   discipline industry suppliers and the reason for  
18   this principle is simple. Regulation is costly  
19   and unavoidably imperfect, so competition is the  
20   preferred source of industry governance whenever  
21   competition can adequately discipline incumbent  
22   suppliers. A related principle is that in

1 settings were regulation is, in fact, needed to  
2 substitute for the missing competitive discipline  
3 then regulatory policy should be designed to  
4 replicate that discipline.

5           So in essence competition is the ideal  
6 regulator and when the ideal regulator is not  
7 available, the best substitute is one that  
8 functions much like the ideal regulator would. I  
9 believe the Board's current policy reflects both  
10 of these principles quite well. In particular  
11 the policy allows competition to discipline  
12 suppliers of rail freight services where it can  
13 do so effectively and the policy also replicates  
14 competitive discipline appropriately where  
15 regulatory intervention is deemed to be  
16 necessary. Specifically, the Board refrains from  
17 regulatory intervention when the prices set by  
18 the railroads are judged to be sufficiently close  
19 to the costs of supplying the services in  
20 question.

21           Regulatory intervention is also  
22 avoided when railroads and shippers successfully

1 negotiate mutually advantageous contracts. The  
2 Board's policy also replicates competitive  
3 discipline on several important dimensions  
4 including the following two: First, the policy  
5 affords railroads and shippers substantial  
6 flexibility to fashion mutually desirable terms  
7 of trade just as buyers and sellers do in  
8 competitive markets. Second, the policy protects  
9 shippers that lack effective competition by  
10 restricting prices below the stand alone costs of  
11 an efficient supplier of the rail services in  
12 question.

13           This policy replicates competitive  
14 forces because in competitive markets firms are  
15 typically compelled to price at or below the  
16 level of their competitors' costs. And by  
17 considering the cost of an efficient supplier  
18 this policy can implement even more stringent  
19 challenges than a railroad would face in many  
20 industry settings. And by restricting the  
21 railroad's earnings through the stand alone cost  
22 or SAC test rather than through explicit earnings

1 regulation, which limits the maximum earnings a  
2 railroad can achieve, the Board's policy avoids a  
3 primary drawback to such explicit earnings  
4 regulation. This drawback is that explicit  
5 earnings regulation limits a supplier's incentive  
6 to reduce its costs and the reason is quite  
7 simple. This diminished incentive arises because  
8 cost reductions will increase earnings which will  
9 trigger price reductions to eliminate these  
10 increased earnings. So consequently under  
11 explicit earnings regulation the regulated  
12 supplier receives no reward for reducing costs  
13 and so cannot reasonably be expected to focus its  
14 efforts on doing so. But this is only one of  
15 many important drawbacks to earnings regulation.

16 Additional drawbacks include the  
17 following three: First, explicit earnings  
18 regulation limits incentives for product  
19 innovation and other activities that shippers  
20 value highly. This is the case because once the  
21 firm has achieved adequate earnings the firm is  
22 denied the opportunity to enhance these earnings

1 even if it develops and implements new and  
2 improved services that shippers value highly.  
3 Empirical research documents that strict earnings  
4 regulation limits innovation in many industries.  
5 The diminished innovation takes several forms but  
6 it includes reduced investment in infrastructure  
7 modernization for example.

8           Second, explicit earnings regulation  
9 can create incentives to operate within efficient  
10 production technologies. This can occur for  
11 instance when earnings are restricted to a  
12 specified return on capital investment. In this  
13 case if the allowed return on capital investment  
14 exceeds the regulated firm's cost of capital the  
15 firm may have an incentive to undertake excessive  
16 capital investment. But it's the alternative  
17 possibility that is of even greater concern. In  
18 particular, if the allowed return on capital  
19 investment is less than the firm's true cost of  
20 capital then the firm will be unable to secure  
21 the financing it requires to undertake important  
22 capital investment. The resulting

1 underinvestment and critical infrastructure can  
2 lead to serious reductions in the level and  
3 quality of services delivered to shippers.  
4 Third, the implementation of earnings regulation  
5 typically is extremely time consuming and  
6 contentious. Determining a firm's cost of  
7 capital and measuring earnings both entail many  
8 subtleties particularly when some of the firm's  
9 services are subject to regulation and others are  
10 not. Thus, explicit earnings regulation can  
11 consume considerable regulatory resources, both  
12 the Board's resources and the resources of  
13 shippers and railroads alike and those resources  
14 would be better focused on the marketplace than  
15 on the hearing room.

16           Explicit earnings regulation is  
17 particularly pernicious when it is applied in  
18 asymmetric fashion, and this is the point that  
19 Chairman Elliott made this morning at the earlier  
20 portion of the Hearing. So when earnings  
21 regulation precludes earnings above an adequate  
22 level but entails no provisions to increase



1 earnings that fall below this level a regulated  
2 railroad has very little incentive to undertake  
3 ventures that involve even limited risk because  
4 under asymmetric information asymmetric earnings  
5 regulation of this form a successful venture  
6 provides no financial reward whereas an  
7 unsuccessful venture imposes financial penalties  
8 on the railroad.

9           Consequently the railroad can only  
10 lose from risky ventures and so will naturally  
11 decline to undertake them regardless of the  
12 prospective value of these ventures to shippers.  
13 By limiting a railroad's incentive to pursue  
14 promising yet risky ventures asymmetric earnings  
15 regulation would introduce incentives that depart  
16 radically from those that prevail in a  
17 competitive market where successful innovation  
18 can deliver enormous financial rewards and indeed  
19 it is precisely the prospect of these pronounced  
20 financial rewards that drives innovation in most  
21 industries so a policy that eliminates such  
22 reward in the rail industry should, in fact, be

1 expected to seriously retard innovation in the  
2 industry to the detriment of railroads and  
3 shippers alike.

4 In light of the many well-known  
5 drawbacks to explicit earnings regulation,  
6 particularly asymmetric earnings regulation,  
7 regulators in other industries have been turning  
8 away from such regulation for many years now. In  
9 the telecommunications industry, for example,  
10 many regulators have replaced explicit earnings  
11 regulation with price cap regulation and under  
12 price cap regulation a price ceiling is  
13 established that is not continually adjusted to  
14 reflect the regulated firm's operating costs.

15 A primary purpose of price cap  
16 regulation is to enhance the regulated firm's  
17 incentive to reduce its costs by ensuring that  
18 this price ceiling is not automatically ratcheted  
19 down whenever the firm discovers innovative ways  
20 to reduce its operating costs. Regulators in the  
21 electricity sector have been adopting various  
22 forms of what are called performance based

1 regulation and the key feature of performance  
2 based regulation is that a firm that delivers  
3 exceptional performance in the marketplace is  
4 rewarded financially for doing do precisely as a  
5 firm would be in a competitive marketplace. What  
6 I think is particularly important for the present  
7 purpose is to note is that the Board's present  
8 rate regulation regime already encompasses the  
9 key features of these regulatory policies that in  
10 other industries are viewed as innovative. In  
11 particular the SAC test effectively imposes a  
12 price ceiling that is not linked to the  
13 railroad's own costs but rather to the cost of an  
14 efficient supplier of rail services.

15           The SAC test thereby in fact provides  
16 strong incentives for cost reduction just as  
17 price cap regulation can be designed to do.  
18 Furthermore, because it avoids explicit earnings  
19 regulation the Board's present policy ties a  
20 railroad's financial performance to its  
21 performance in the marketplace and in particular  
22 a railroad that delivers innovative ways to

1       reduce its costs or to deliver increased value to  
2       shippers is permitted to benefit financially from  
3       its discoveries.

4               The Board's policy thereby provides  
5       incentives for the railroads to pursue promising  
6       yet risky innovative activities that can be of  
7       substantial benefit to shippers. Thus, in my  
8       opinion, the Board's present policy is reasonably  
9       viewed as being on the frontier of innovative  
10      progressive regulatory policy design but  
11      additional explicit earnings regulation would  
12      move the Board's policy away from that frontier  
13      and, in fact, in exactly the opposite direction  
14      that regulatory policy is progressing in other  
15      industries. And this movement away from explicit  
16      earnings regulation in other industries reflects  
17      a growing recognition of the fallacy of a common  
18      myth about earnings regulation and the myth is  
19      that a regulator serves consumers well by  
20      systematically precluding a regulated supplier  
21      from securing anything more than what might be  
22      judged an adequate level of earnings.

1           A corollary of this myth is that a  
2 regulator has failed to protect consumers  
3 adequately if the regulated firm ever secures  
4 more than adequate earnings. Fortunately there's  
5 a growing recognition that this myth and its  
6 corollary are not only false but, in fact,  
7 fundamentally misguided. In fact, all parties  
8 can gain, both regulated suppliers and their  
9 customers, when suppliers are motivated by the  
10 prospect of financial reward to discover  
11 innovative ways to operate more efficiently and  
12 to identify and serve the best interests of their  
13 customers. Healthy financial returns can be a  
14 sign of effective regulation that has induced  
15 innovation, which, in turn, has delivered highly  
16 valued benefits to consumers.

17           So, in conclusion, I would like to  
18 reiterate my strong recommendation to avoid  
19 additional explicit earnings regulation in the  
20 freight rail industry. Such explicit earnings  
21 regulation entails many well-known drawbacks and  
22 its implementation would stifle innovation in the

1 freight rail industry and would thereby threaten  
2 to reverse the substantial progress the industry  
3 has experienced since the passage of the Staggers  
4 Act. The Board's present policy is an  
5 enlightened progressive policy that embodies the  
6 key principles of sound regulatory policy design  
7 and that reflects recent trends in other  
8 industries and my sincere hope is that the  
9 Board's future policy will continue to be so  
10 enlightened and that the Board will resist any  
11 pressures it may face to return to the largely  
12 discredited regulatory policies of the past.

13 Thank you.

14 MR. ATKINS: Professor Cornell.

15 MR. CORNELL: Thank you for having me  
16 here today. My name's Bradford Cornell. I'm a  
17 professor of finance at Cal Tech and for the last  
18 thirty-five years or so I've been doing teaching,  
19 research and consulting on practical applications  
20 of finance theory such as the problem measuring  
21 revenue adequacy that you face today, and in the  
22 Cal Tec tradition, my testimony's pretty much

1 nuts and bolts. I'm going to look at some of the  
2 details of really trying to measure this concept  
3 and not talk at quite as high a level as some of  
4 the previous people have.

5           So let me start with a simple example.  
6 I always like to get very practical so if we can  
7 have my first slide. This very simple example.  
8 This is a device designed to measure temperature  
9 in your garden. It's standard garden thermometer  
10 and being a bit of a weather nut, I have several  
11 of these and there're two problems with this  
12 device as a measurement tool. One is that little  
13 tube that is affixed to the plastic tends to  
14 slide up and down and now let's just assume that  
15 the tube has slid down a little bit. That means  
16 whenever you measure the temperature it's going  
17 to be wrong, so if it slides down let's say four  
18 degrees, it's always going to be four degrees too  
19 low. In statistical terms that's called  
20 systematic bias and it can be a real problem if  
21 you need to know the absolute level of  
22 temperature. But there is one benefit. If you

1       only are concerned about a change, if it's always  
2       four degrees too low then the change from day to  
3       day or month to month is going to be okay. So  
4       systematic bias is a problem but not so much for  
5       measuring changes. That's point one with my  
6       thermometer. Point two is the device itself is  
7       not all that good. The expansion of the liquid  
8       in the tube doesn't precisely measure  
9       temperature. If any sun gets on it, it's a  
10      problem. If any water gets on it, it's a problem,  
11      so there's a lot of random variation between what  
12      that is reading and what the true temperature is  
13      and in statistics we call that random measurement  
14      error.

15               Now the reason I bring this up is  
16      these two types of errors determine whether or  
17      not or for what purposes you can use a tool. If  
18      you put this in your garden and you want to know  
19      if it's warmer in Washington, D.C. in July than  
20      February the tool works fine. The systematic  
21      bias cancels out and there's enough change  
22      between February and July that you will find that



1 it's warmer in July. But if you took this to a  
2 chemist at Cal Tech and said I want to use this  
3 to measure the precise temperature at which a  
4 very specific chemical reaction takes place. The  
5 reaction would be are you crazy? That device is  
6 nowhere near accurate enough for that. And the  
7 reason I bring this up, to me it relates to  
8 revenue adequacy.

9           Revenue adequacy is a bit like the  
10 garden thermometer. If what you're interested in  
11 is are railroads healthier now than they were ten  
12 years ago or twenty years ago or thirty years  
13 ago, I think it's informative. As I'm going to  
14 talk in a moment, there are significant biases  
15 and there are significant measurement errors, but  
16 if you're looking at changes the systematic  
17 biases tend to cancel out and if you're looking  
18 at long enough times the measurement error is not  
19 too critical.

20           So if the goal is to look at the  
21 health over time of the railroad industry, this  
22 probably isn't a great measure but it's not a

1       terrible one. But if you're attempting to use it  
2       to measure something very precise like whether a  
3       railroad is revenue adequate at the current point  
4       in time, I'm going to argue it's simply not a  
5       very good tool, in fact, it's a very bad tool.

6               So let me switch to revenue adequacy  
7       now and talk about some of the measurement  
8       problems that specifically arise there. And I've  
9       listed four issues here. The first one is that  
10      it fails to measure returns over the lifetime of  
11      rail assets. That is, it tends to look year by  
12      year whereas investors when you make an  
13      investment are concerned with what the returns  
14      will be over the entire life. That issue's been  
15      discussed by previous witnesses. It's going to be  
16      discussed I think by future. I'm not going to  
17      deal with it today. I just note it as a point.

18             The second is deferred taxes. How do  
19      you treat them? Do you take them out of the base  
20      when you measure total investment? Remember the  
21      return measure that is used to compare with the  
22      cost of capital is a measure of earnings divided

1 by an investment base and if you take deferred  
2 taxes out of the investment base it's clearly  
3 going to affect that ratio. I'll talk about that  
4 a little bit more.

5 The primary issue I will focus on is  
6 revenue adequacy as currently defined compares an  
7 accounting measure, earnings divided by this  
8 investment base, with an economic measure, the  
9 cost of capital which you estimate in other ways.  
10 That comparison has all sorts of dangerous  
11 measurement errors associated with it and I'll  
12 give you a specific example. And finally it's my  
13 view, even if you could overcome the measurement  
14 problems associated with revenue adequacy, I  
15 still don't see how it's optimal to use a system-  
16 wide or a nationwide measure to deal with a  
17 specific problem, and I'll give you an example of  
18 that.

19 So let's go forward and the first  
20 issue is deferred taxes and for railroads  
21 deferred taxes are very significant. I think in  
22 the case of Norfolk Southern the deferred taxes

1 are in the order of \$8 billion which is about a  
2 third of their entire invested capital so if you  
3 take that out you're going to push the measure,  
4 just like the tube slipping, you're going to push  
5 the measure of return up significantly.

6 Now if all you want to measure is  
7 changes, that's not a problem because you take it  
8 out every year. It cancels out. But if you're  
9 asking whether a particular railroad is revenue  
10 adequate, it's a real problem, particularly if a  
11 railroad has to compete, let's say, with trucks.  
12 When Congress allowed for the use of deferred  
13 taxes, it was countrywide so that all companies  
14 could benefit from it. If the trucking industry  
15 gets the benefit of deferred taxes but the  
16 railroad industry doesn't because a return  
17 measure is computed net of deferred taxes and a  
18 cap is based on that measure, then you've in  
19 effect subsidized trucks as opposed to railroads  
20 and that's a systematic bias that is not  
21 eliminated because it's not a change. It's  
22 comparing trucks with railroads and giving the

1 trucks a significant head start.

2 So let me move on to the next issue,  
3 which I've spent most of my time on, which is  
4 drilling into a little bit this measure of return  
5 that is going to be compared with the cost of  
6 capital and to do that I took the step of  
7 constructing the simplest example that I could to  
8 highlight the real principles that are at work  
9 here. So there are no taxes deferred or  
10 otherwise in this very simple example and to  
11 start there's only one asset.

12 And finally the cost of capital is  
13 assumed to be known and to be 10 percent, so for  
14 your hearings tomorrow you've reached the  
15 decision that it's 10 percent cost of capital.  
16 No measurement error, no in for sure. And what  
17 I've done is I've taken a 20 year logged asset  
18 and I've said, okay, if it's just going to earn  
19 its cost of capital and its going to earn a  
20 constant amount each year, what does that cash  
21 flow have to be each year so that the overall  
22 return is exactly the cost of capital of ten

1 percent and that is column A, and the answer  
2 Excel tells me is \$117.46 so if you buy this  
3 asset for \$1000 and it produces cash flows of  
4 \$117.46 every year until it dies the effective  
5 rate of return is ten percent, the cost of  
6 capital.

7 Now let's see what happens when you  
8 use the accounting method to compute the return  
9 on investment. So I've in column B applied  
10 straight line depreciations. It's a twenty-year  
11 asset, \$1000, \$50 a year. Then deduct the \$50  
12 from the revenue and I get a net of depreciation  
13 accounting income of \$67.46. Then the final  
14 column, column D is the book value of the asset  
15 and it comes down \$50 each year. The first year,  
16 it's a full value of \$1000, then \$950, \$900 and  
17 so forth. So now I've got the two numbers I  
18 need. I have the net income, I have the book  
19 value, I can compute the ratio, which is this  
20 return on investment, and notice it is never ten  
21 percent. It starts well below ten percent at  
22 6.75 and then as the asset gets depreciated in an

1 accounting fashion, the return on investment  
2 ratchets up until the final year it's up to 134  
3 percent, which is indicative of what Professor  
4 Kalt was talking about. When you keep  
5 depreciating things the return goes up even  
6 though that doesn't seem to make economic sense  
7 because we know what the economic answer is here.  
8 We know it's ten percent. I constructed it that  
9 way.

10 So let's go to exhibit 1B, which is  
11 exactly the same except I've now used the formula  
12 for computing economic depreciation and that's  
13 the depreciation due to the fact that as the  
14 asset ages it doesn't have as many years to  
15 produce income and it would trade for less in a  
16 secondary market. So the economic depreciation  
17 is now shown in column B. If I subtract that  
18 from the cash flows, I get the net income. And  
19 if I take the starting purchase price of \$1000  
20 and subtract the economic depreciation I get the  
21 replacement costs and I want to define the word  
22 replacement costs carefully here because it's

1       been used a lot today but maybe not defined as  
2       precisely as it should be. There's a notion of  
3       replacement costs new which is, for example, if I  
4       have a five-year-old car, you could ask what it  
5       costs me to go out and buy a new car of the same  
6       type. That would be replacement costs new, but  
7       that's not what replacement costs means in this  
8       example and I don't think in the railroad  
9       examples. It really means what would it cost to  
10      go out and buy another five-year-old car. So if  
11      my car was totaled, what would it cost me to  
12      replace it with another five-year-old car.  
13      That's what this new book value net of economic  
14      depreciation is and notice when you use economic  
15      depreciation things work out right. It's ten  
16      percent return on investment every year. So the  
17      distinction between economic depreciation based  
18      on replacement costs and book depreciation based  
19      on arbitrary rules is really important for  
20      computing the return on investment.

21                   Now you may say, well, hold on here,  
22      Professor Cornell, this is weird example because



1     you have one asset that starts new and then ages  
2     off the books to zero. That's not like a  
3     railroad. Railroads are always turning over  
4     their assets. They're constantly replacing them.  
5     They're not just letting one wear out. So what I  
6     do on exhibit 2 if we go to that is I complicate  
7     the example just a little bit. I assume that  
8     rather than one asset there are twenty of them.  
9     One's brand new, one's one-year-old, one's two  
10    years old, all the way up to one that's nineteen  
11    years old. So the railroad now has twenty of  
12    these assets and at the end of the year, the  
13    oldest one rolls over and is replaced with a new  
14    one and everybody moves down. So what that means  
15    is if I were looking at the entire railroad I'd  
16    have to add up the cash flows and the net income  
17    for all of them and if you look at my exhibit, I  
18    think that's the easiest thing.

19               Look at column C. There's now 20  
20    assets. I add the net income of all of them up  
21    and I get \$1349.20. And then I add up the  
22    depreciated value and I get \$10,500. So now I'm

1 adding it up over twenty assets and this would be  
2 the same every year because the railroad is in  
3 effect static because at the end of the year the  
4 old one goes, new one comes in and it looks  
5 exactly the same as it did at the beginning of  
6 the previous year. I compute the return on  
7 investment, 12.85 percent, so something that  
8 looks like it wouldn't introduce a significant  
9 bias, namely this use of accounting depreciation,  
10 in fact, does.

11           This hypothetical railroad here looks  
12 like its earning significantly in excess of its  
13 cost of capital though we know it isn't because  
14 I've constructed it mathematically to just earn  
15 the 10 percent. So if we go to 2B, 2B does  
16 exactly the same calculation I did in 1B. It  
17 substitutes for accounting depreciation, economic  
18 depreciation and for book value based on  
19 accounting, book value based on economic  
20 depreciation which is effectively replacement  
21 costs, not replacement costs new but replacement  
22 costs. I add the numbers up and now I get

1 exactly a return on investment of ten percent.

2 MS. MILLER: Dr. Cornell, you would  
3 say that exhibit 2B is based on the concept of  
4 replacement costs?

5 MR. CORNELL: Yes. Absolutely. So my  
6 view here is to kind of summarize where I am with  
7 respect to the revenue adequacy measure, if your  
8 goal is to use it as a tool to just assess the  
9 health of the railroad industry over time I  
10 wouldn't change anything because it has been  
11 pointed out that it would be more difficult to  
12 compute replacement costs for example than read  
13 an accounting statement and take off book value  
14 and if you're not going to use it for a very  
15 precise task, don't do it. Save your money, save  
16 your time.

17 However, if you were to say we want to  
18 use this as a thermometer to measure the chemical  
19 experiment. We're going to regulate rates based  
20 on this measure, then I think you've really got  
21 to dig into the measure and deal with the  
22 measurement errors, deal with the use of the book

1 accounting which is inappropriate, deal with the  
2 deferred taxes and there are probably other minor  
3 details as well and the question that I ask the  
4 folks at the railroad is why do that because  
5 ultimately my final point is what you're  
6 concerned with are individual shippers who are  
7 captive shippers who may have a problem because  
8 they don't have competitive outlet.

9 I thought of real estate examples. For  
10 instance suppose you were concerned with rents  
11 being charged to people in the south side of  
12 Chicago and you felt that landlords in that area  
13 were exercising undue power and charging unfair  
14 rents. Okay, why would you really care on a  
15 national average whether rents were fair?  
16 Because the nation is so big relative to the  
17 south side of Chicago, rents could be fair or  
18 unfair on a national basis and have nothing to do  
19 with whether its fair or unfair in the south side  
20 of Chicago so it seems to me that the bottom line  
21 here is that as it stands using a revenue  
22 adequacy measure for rate setting is a bit like

1       trying to use a saw for brain surgery.

2               The tool is full of measurement error  
3       which would be difficult and expensive to correct  
4       but would have to be corrected if you wanted to  
5       use it to actually measure specifically whether  
6       railroads were revenue adequate and even if you  
7       could get there and have this more accurate  
8       measure it's really not the right measure to use  
9       anyway, so it seems to me that the appropriate  
10      step would be to continue to use revenue adequacy  
11      in the way you've used as a general tool for  
12      assessing the health of railroads and focus your  
13      energies on a specific measure for giving the  
14      appropriate relief in the cases where that  
15      appears to be necessary.

16              MR. ATKINS:   So if I can recap, a  
17      system-wide revenue adequacy constraint is  
18      fraught with perils.   Hard lessons from other  
19      industries tell us that it can stifle innovation  
20      and attempts to improve service and the logic is  
21      very simple.   Once a company hits a system-wide  
22      revenue constraint, it loses the profit motive to

1       innovate, to improve productivity or to compete  
2       for new lines of business. Any increased  
3       earnings would be returned to customers through  
4       the revenue adequacy constraint and those perils  
5       are made exponentially worse if given the serious  
6       measurement errors identified by Professor  
7       Cornell.

8               So if you take a discredited approach  
9       and use measurements with serious flaws, the  
10       results are going to be predictable and somewhat  
11       tragic. You don't need to travel down this path.  
12       The Board already has a targeted revenue adequacy  
13       test that is sufficient to protect shippers from  
14       the unreasonable exercise of market power. It's  
15       the SAC and the simplified SAC tests. And the  
16       SAC test is the gold standard. It's been  
17       judicially affirmed on numerous occasions. It's  
18       been codified in the statute and the courts  
19       themselves have recognized on several occasions  
20       that SAC is the preferred approach. And several  
21       years ago, this Board said that the full SAC  
22       test, which is designed for larger disputes, and

1 the simplified SAC test, which is designed for  
2 smaller disputes, together provide a "critical  
3 restraint" on the pricing or the exercise of  
4 market power but without deterring railroads from  
5 making the needed investment to meet the demand  
6 for rail transportation and it's clear that SAC  
7 is a targeted revenue adequacy test.

8 As the Board explained in the Excel  
9 case the very purpose of the test is to determine  
10 how much money a railroad needs to charge to be  
11 revenue adequate but only on the portion of the  
12 network that is used by the complaining shipper.  
13 Now in that case the railroad challenged that  
14 characterization of the SAC test to the D.C.  
15 Circuit and they lost. The D.C. Circuit said the  
16 Board was on solid ground in characterizing the  
17 SAC test as a targeted form of a revenue adequacy  
18 test, one that implicitly takes into  
19 consideration the revenue needs of the defendant  
20 railroad. But what the reviewing court said next  
21 really cuts to the heart of this hearing. In  
22 that appeal the railroad observed that its RCM

1 figure was approximately 316 percent yet the  
2 Board had prescribed a rate well below that level  
3 and the railroad argued to the D.C. Circuit that  
4 it simply had to be able to charge Excel a rate  
5 equal to or greater than that measure of its  
6 system-wide revenue needs in order to have any  
7 prospect of being revenue adequate.

8 But the D.C. Circuit agreed with the  
9 Board that a measurement of system-wide revenue  
10 need provides "no guidance" about what a  
11 particular customer like Excel should be charged  
12 for the particular services and facilities that  
13 it uses. "No guidance." And you can see why it  
14 really provides no guidance if you look at the  
15 extraordinary scope of the Norfolk Southern  
16 network.

17 This is a map depicting their network.  
18 Norfolk Southern operates nearly 20,000 route  
19 miles through twenty-two different states. It is  
20 a truly huge network and each part of that  
21 network has unique character and unique operating  
22 characteristics. So Norfolk Southern's overall



1 financial health really does provide you no  
2 guidance about what the rates should be for a  
3 coal movement or a chemical movement or a grain  
4 shipper or any other commodity that goes over  
5 that network.

6 But in contrast, if a shipper comes in  
7 and complains about the reasonableness of their  
8 rate, the SAC test and the simplified SAC test  
9 both will examine just the portion of the network  
10 that is being used by the complaining shipper.

11 So let me give you the illustration from the  
12 SunBelt case and I'm not here to debate the  
13 merits of the case. I simply want to use it as an  
14 illustration about how the SAC test is already a  
15 targeted form of a revenue adequacy test.

16 In this case, the parties submitted  
17 evidence about how much money Norfolk Southern  
18 would need to earn to be revenue adequate but  
19 just on the 580 miles of the network that was  
20 used by the SunBelt. Another illustration would  
21 be the Duke case which was about a decade earlier  
22 and in that case the complaining movements came

1 from a bunch of coal mines in the central  
2 Appalachian mountain region and so the SAC  
3 analysis was properly focused on what did Norfolk  
4 Southern need to earn to earn adequate revenues  
5 on the coal network that was used to serve Duke.

6 Now the DuPont case, my last  
7 illustration, that was a very big SAC case. It  
8 examined over one hundred OD pairs, but what it  
9 shows you is that the SAC analysis is flexible  
10 enough to accommodate the need to look at a  
11 larger portion of the network. Now I can  
12 appreciate that it may have been a bit daunting  
13 for the parties to submit this evidence and for  
14 staff and the Board to process it, but what that  
15 effort showed you was that the rates were  
16 reasonable if you look at the replacement costs  
17 of the assets deployed to serve DuPont. Now we  
18 can stay on this slide for one moment longer  
19 because it also demonstrates how deeply flawed  
20 your annual calculation of revenue adequacy is.

21 If Norfolk Southern were truly  
22 approaching revenue adequacy on a system-wide

1 basis then this SAC analysis, which included a  
2 huge swath of the Norfolk Southern network, that  
3 analysis should have shown when you look at this  
4 core network that the rate of return was  
5 approaching their cost of capital but that's not  
6 what it showed. There is a huge disconnect  
7 between what your annual calculations show  
8 Norfolk Southern needs on a system-wide basis and  
9 what your SAC analysis demonstrated when you  
10 looked at the core part of their network. How  
11 can that be?

12 Well, I don't think it's going to  
13 surprise anybody that the discrepancy that  
14 disconnect flowed from measurement errors  
15 identified by Professor Cornell. Your historic,  
16 your annual calculations are based on historic  
17 depreciated book value of assets, many of which  
18 have been on the books for decades and if that  
19 weren't bad enough the Board then reduces that  
20 historic book value by roughly one third or \$8  
21 billion to deprive Norfolk Southern of any return  
22 on investment from investments made from deferred

1 taxes and those measurement errors explain the  
2 disconnect.

3 So give the serious measurement errors  
4 in your annual calculation and the known perils  
5 of rate of return style regulation and the fact  
6 that a system-wide measure provides you "no  
7 guidance" about the reasonableness of a  
8 particular rate, how do shippers justify imposing  
9 this constraint on the railroad industry?

10 Well, first they dismissed concerns  
11 about the incentive problems discussed by  
12 Professor Sappington, the known problems that  
13 plague rate of return style regulation. For  
14 example, NIT League and the American Chemistry  
15 Council tell you we're just trying to frighten  
16 the Board. So they boldly declare that "no one  
17 is arguing that to the extent that increased  
18 financial returns to the railroad industry result  
19 from increased returns in competitive markets  
20 that those returns should be taken from the  
21 railroads." Hogwash. That is exactly what is  
22 being proposed. NIT League and ACC are

1       advocating a rebate approach and under that  
2       rebate approach excess revenues would be returned  
3       to so called captive customers, those paying  
4       differentially higher rates.

5               So say Norfolk Southern found a way to  
6       earn additional \$100 million from competitive  
7       traffic but they were already over their revenue  
8       adequacy constraint, well then under this rebate  
9       approach that additional \$100 million would have  
10      to be rebated back to that small subset of  
11      shippers, those earning differentially higher  
12      rates and so just as Professor Sappington warns,  
13      that rebate approach Norfolk Southern would lose  
14      the incentive to compete for new lines of  
15      business.

16             Or take another illustration, what if  
17      Norfolk Southern found a way to squeeze more  
18      productivity out of its existing assets and again  
19      it might be able to earn another \$100 million.  
20      Again NIT League and ACC under their rebate  
21      approach would have you rebate those increased  
22      earnings back to a small subset of shippers,

1       those paying differentially higher rates and,  
2       again, just as Professor Sappington cautions, the  
3       railroad would lose the incentive to find new  
4       ways to become more productive.

5               Now I'm sure when NIT League and ACC  
6       take the stand tomorrow, they're going to try to  
7       characterize their approach as some kind of  
8       enlightened progressive light-handed form of rate  
9       regulation. Nothing could be further from the  
10      truth. If you have a bird that walks like a duck  
11      and it swims like a duck and it quacks like a  
12      duck, then we should just go ahead and call that  
13      bird a duck. NIT League's rebate approach is  
14      classic rate of return style regulation with all  
15      the pitfalls and all the perils.

16             Now Western Coal Traffic League makes  
17      a similar point to NIT League that you heard this  
18      morning about how the railroads are dramatically  
19      exaggerating the incentive problems and to give  
20      Western Coal Traffic League some credit they're  
21      the only customers who are not in here actually  
22      advocating some kind of rebate approach, but

1 they're advocating instead a system-wide rate  
2 freeze on all captive traffic above a certain  
3 threshold once you become revenue adequate. But  
4 that has its own kinds of ugly incentive problems  
5 and Professor Kalt already cautioned you about  
6 the problems associated with rate freezes and  
7 with the quote from Milton Friedman, but what I'd  
8 like to do is focus on a hidden feature of their  
9 proposal that I want to make sure that you're  
10 aware of.

11           Western Coal Traffic League wants to  
12 make sure that their approach applies to contract  
13 traffic so when they say that when a movement  
14 comes off contract this rate freeze should still  
15 apply and that is going to sharply discourage  
16 anyone from entering into contracts once you hit  
17 a system-wide revenue adequacy and you're subject  
18 to that constraint because why would a railroad  
19 agree to provide a lower rate maybe in exchange  
20 for some consideration from the customer if they  
21 know when it comes off contract they're not going  
22 to be able to return it to the previous level.

1           You know, these contracts are in place  
2       sometimes for decades and the prospect that there  
3       would be a rate freeze on contract traffic just  
4       because of their overall system-wide performance  
5       is really going to discourage contracting which  
6       is at the heart of many of the Board's statements  
7       about what it wants to encourage. Now the other  
8       thing that parties do is they dismiss any  
9       reservations about internal cross subsidies. So  
10      if you impose a rate cap on Norfolk Southern  
11      you're going to create a web of cross subsidies  
12      all over their network. Shippers located on  
13      light density lines are going to be subsidized by  
14      other customers. Shippers located in corridors  
15      that are complicated to operate or over difficult  
16      terrain like the central Appalachian region are  
17      going to be cross subsidized. Chairman Elliott,  
18      I notice my time's expired. Do you mind, it may  
19      take me a few moments longer to get through my.  
20      Thank you.

21           Now most just ignore these problems.  
22      But Western Coal Traffic League goes further and



1 asks you to set aside the prohibition against  
2 cross subsidies once a railroad is revenue  
3 adequate on a system-wide basis. But the  
4 principle that a customer should pay for the  
5 facilities it uses and not try to shift those  
6 costs to another customer is sound, whether or  
7 not the railroad is revenue adequate on a system-  
8 wide basis. And third, shippers dismiss the need  
9 to use current replacement costs as discussed by  
10 Professor Cornell and as Professor Kalt spoke  
11 about with his apartment complex illustration.

12 Now according to Western Coal Traffic  
13 League the proper comparison should be to rent  
14 control policies so in their pleadings they are  
15 urging you to forego current market values in  
16 favor of historic book values so their members  
17 can enjoy subsidized rail service. Rent control  
18 policies cannot possibly be the right analogy.  
19 The right public policy is clearly set forth by a  
20 remarkable group of 50 leading economists  
21 including two Nobel laureates who all urged the  
22 ICC to use replacement costs. I hope,

1 Commissioner Miller, that you'll offer us a  
2 chance to answer some Q&A about why there were so  
3 many luminaries including Professor Schmalensee  
4 from MIT who signed that statement in support of  
5 using replacement costs.

6 Finally, shippers complain that SAC is  
7 broken and I can appreciate that you have  
8 reservations about the full SAC test. It's  
9 expensive, it's complicated but it's well suited  
10 when you have millions of dollars in dispute.  
11 Norfolk Southern is worried, however, that you're  
12 being urged to adopt or embrace simple solutions  
13 over the right solution. They want you to embrace  
14 simplicity but sacrifice economic soundness and  
15 precision. Where there's a clear market failure  
16 Congress entrusted you with a very challenging  
17 task. In those circumstances this small agency  
18 is supposed to override the marketplace and  
19 dictate the maximum lawful rate that a carrier  
20 can charge. That is not an easy problem and  
21 there is no easy solution.

22 Moreover, when you're being asked to

1 transfer millions of dollars from a customer to  
2 the railroad we think it's important that you get  
3 it right. But what about the simplified SAC  
4 model? It's fast, it's simple and over the  
5 railroad's objections you imposed most of the  
6 data burden on the railroads and now provide  
7 unlimited relief. Because when you think about  
8 it the heart of everyone's criticisms about the  
9 full SAC is the need to construct a hypothetical  
10 railroad and honestly that's a difficult concept  
11 to explain to lay people that why would they need  
12 to construct a hypothetical railroad but under  
13 the simplified SAC analysis they don't need to do  
14 that.

15           There's no need for them to do hire  
16 experts to develop an operating plan. They don't  
17 need to figure out if they need hump yards. They  
18 don't need to figure out how to wrestle with the  
19 complexities of a diverse gathering network.  
20 They don't need to fight about how many computers  
21 their hypothetical railroad's going to need for  
22 their fictional IT department or how many

1 executives they're going to have to hire and at  
2 what compensation. But if I were a genie and I  
3 could rub a magic lamp, and I could deliver for  
4 you a model that perfectly and painlessly  
5 simulated the rate that would exist in a  
6 perfectly contestable marketplace, one without  
7 any barriers to entry, the shippers would still  
8 object that those are not the reasonable rates  
9 that they're looking for. Instead, they're  
10 asking you to harken back to the bad old days and  
11 impose on the industry a discredited form of rate  
12 regulation.

13 Norfolk Southern urges the Board to  
14 resist those requests. Rate of return style  
15 regulation is discredited because it stifles  
16 innovation, productivity, and investment. You  
17 already have a targeted revenue adequacy test in  
18 the simplified SAC and SAC models that targets  
19 just the portion of the network used by the  
20 shipper. You have serious measurement flaws in  
21 your annual calculation that will be difficult to  
22 fix and even if you somehow correct them as the

1 D.C. Circuit correctly noted a measurement of  
2 system-wide needs provides you "no guidance"  
3 about the reasonableness of a particular rate so  
4 no matter how difficult or politically  
5 unpalatable it may seem, Norfolk Southern  
6 strongly urges you to abandon the concept of a  
7 system-wide revenue adequacy constraint that  
8 rests on the historic depreciated book value of  
9 assets. Thank you.

10 MR. ELLIOTT: Thank you very much.

11 Deb?

12 MS. MILLER: So, Mr. Atkins, one of  
13 the things that's been emphasized today both from  
14 the economists and from yourself is that you  
15 can't use this system-wide average of revenue  
16 adequacy to set rates and certainly from the  
17 shipper groups, they've recommended multiple  
18 approaches, but I guess my question is can you  
19 use system-wide revenue adequacy to create a  
20 trigger? Is it not appropriate for the Board to  
21 look at system-wide revenue adequacy and when  
22 railroads reach that trigger then to look at

1       whether or not you regulate rates for captive  
2       shippers in a different way? Not set them based  
3       on that revenue adequacy but use a different  
4       process once they've reached that point?

5               MR. ATKINS: Right. Well, clearly we  
6       don't think it's appropriate to use it to  
7       regulate, so the question is, is really should  
8       you use it as a target to change the rate regime  
9       that you've had in place for the last thirty  
10      years and I'll tell you the analogy that comes to  
11      mind.

12             The answer is, is no, we don't think  
13      it's sufficiently precise and frankly we don't  
14      see why you should be concerned that a railroad  
15      is earning in excess of its cost to capital given  
16      that eighty percent of traffic is competitive so  
17      that's going to be the portion of their network  
18      that is driving those improved earnings but I'll  
19      give you my simple analogy and if it works, it  
20      works and if it doesn't, it doesn't, is, if you  
21      go into a doctor and you have a patient who is in  
22      poor health, the doctor will tell that patient to

1 eat well and exercise and you know what will  
2 happen over the course of time is that patient  
3 will rebound. Their health will improve.

4 But, if you go back into the doctor  
5 and the doctor takes some measurements and says  
6 look, your blood pressure's back to normal. We  
7 think you've achieved this state of real genuine  
8 health, they don't then use that as a trigger to  
9 say, well stop eating well and stop exercising.  
10 If you have in place solid regulatory policies  
11 that are ground that are based on the principals  
12 that Professor Sappington has spoken to, then  
13 using it as a trigger to change those policies  
14 does not make a great deal of sense.

15 MR. SAPPINGTON: If I might just  
16 follow-up on the point. I think your question is  
17 an excellent one and it isn't totally apparent  
18 but it's a critical point that if you use overall  
19 revenue adequacy as a target to start changing  
20 rates on just the captive shippers, for example,  
21 you really are doing system side rate of return  
22 regulation. You're saying to the railroads, if

1       you earn a substantial amount of profit or  
2       perform well financially on your unregulated  
3       services, we're going to punish you for that and  
4       make you charge less on your other regulated  
5       services. So use it as a trigger or use it  
6       explicitly to set rates, either way, you're  
7       giving the wrong signals to the railroads by  
8       telling them if you succeed, you're going to be  
9       punished for your success and that's not what you  
10      want to do in order to motivate good performance  
11      in the industry.

12               MS. MILLER: Well perhaps there is  
13      something here I'm not fully understanding and  
14      that very possibly we're talking about economics  
15      and finance but it seems, as I've been trying to  
16      understand these issues, that one, when you look  
17      at the concept of revenue adequacy and whether it  
18      does or doesn't create a trigger, you're not  
19      doing that to say railroads can't earn more than  
20      their rate of return across their system. You're  
21      doing it to say when they've reached that point,  
22      do we need to look differently at how they are



1 charging their captive shippers who have no  
2 competitive options.

3 Throughout the course of the hearings  
4 today, I've heard a lot of things that would  
5 clearly convince me one has to be very careful  
6 about broadly regulating an industry or using  
7 rate of return to set a cap and I get all of that  
8 and completely agree but what I keep coming back  
9 to is using it as a way to, in a much more  
10 surgical way, look at a very small piece of the  
11 industry that is still under our regulation and  
12 particularly for those of you who are in academia  
13 I would just really like to understand these  
14 issues a little bit better and it feels sometimes  
15 like the answers are broad brush. They apply to  
16 the whole broad concept of regulation, not to an  
17 appropriate level of regulation to a very small  
18 section of the industry.

19 MR. CORNELL: Let me just give one  
20 specific thing and then I'll turn it over to  
21 Dave, if you do want to use this measure as a  
22 trigger, then you really do have to approve the

1       measure. You can't, you have to really examine  
2       deferred taxes and make a real effort to replace  
3       accounting depreciation with some measure of  
4       economic depreciation.

5               MS. MILLER: Excuse me, and I was glad  
6       because in the earlier panel, deferred taxes came  
7       up and I meant to go back to it because I would  
8       just tell you, I do not understand that issue, so  
9       I would be interested in your saying a bit more  
10      about deferred taxes.

11             MR. CORNELL: Well, the way the income  
12      measure works is remember, when you're taking a  
13      measure of earnings and you're dividing it by a  
14      measure, the amount invested. So let's say I'm  
15      earning ten dollars and I've invested a hundred,  
16      then my rate of return is ten percent, which I'm  
17      going to compare with the cost of capital. Now  
18      the question is how much have I invested? What  
19      is the hundred dollars? And the way it's  
20      currently done is you add up all the investments  
21      the railroad has made but then you deduct out the  
22      amount of deferred taxes they have on their books

1 for complicated argumentative reasons. Now,  
2 since the deferred tax numbers that it cancels  
3 out, if you're comparing two points in time, I  
4 haven't focused on it but if you're going to use  
5 that measure as a trigger, then you've really got  
6 to think deeply about whether it's appropriate to  
7 deduct out those deferred taxes because it pushes  
8 the measure of return way up by reducing the  
9 denominator. And one of the points about deferred  
10 taxes that was, that really went back and forth  
11 when the ICC was considering it is you think  
12 about why did Congress put this program in place?  
13 They were trying to encourage investment in a  
14 broad swath of industries. Not just the railroad  
15 industry but a group of other ones. By denying  
16 the railroads the ability to earn a return on  
17 investments that they make from those deferred  
18 taxes, you're basically cutting in half the  
19 benefits. They still get the immediate tax  
20 benefits of deferred taxes. They're not going to  
21 relinquish them. I sure that sends a shudder  
22 through the heart of the CFO.

1                   So they will take the immediate  
2                   benefits but you've deprived them of the long-  
3                   term benefits and what the reviewing court at the  
4                   time was very concerned about was, are you really  
5                   frustrating what Congress intended to do with  
6                   this deferred tax program? But ultimately they  
7                   deferred to the discretion of the agency and what  
8                   we would say is it really fundamentally does not  
9                   make a great deal of sense for you to tell  
10                  Norfolk Southern that you're going to lower down  
11                  their investment base because the money came from  
12                  deferred taxes. They should get a return on all  
13                  of their investment regardless of the source of  
14                  funds, which is also a point that was made by the  
15                  luminaries when they were encouraging the board  
16                  to look at replacement costs. They said it  
17                  should be replacement costs regardless of the  
18                  source of the funds, whether it's from deferred  
19                  taxes or from shippers or from debt or from  
20                  others. You should be measuring it based on the  
21                  replacement costs.

22                  MR. SAPPINGTON: If I could just go

1 back to your original questions which I think is,  
2 again, an excellent one. My view on that is that  
3 you've already got an excellent earnings  
4 regulation regime in place. Very principal based  
5 upon sound economic analysis, which says how are  
6 we going to regulate the earnings in this  
7 regulated sector? Not industry wide but just on  
8 the shippers who need protection from the Board.  
9 Well you've got in place a wonderful system which  
10 is really rate of return type regulation but done  
11 right, not done improperly.

12 MS. MILLER: But is that wonderful  
13 system, is that SAC?

14 MR. SAPPINGTON: Yes, it is. Because  
15 what it's really saying is that what are the  
16 costs of an efficient supplier of these services.  
17 That's essentially the competitive standard and  
18 that's what regulation should be designed to do.

19 MS. MILLER: I have to say, I do  
20 understand why from a philosophical standpoint  
21 one would look at SAC and say really it's a  
22 perfect approach but when you implement SAC,

1 nothing about it feels like a gold standard or  
2 like a perfect approach. I mean, it strikes me  
3 that it's a pretty difficult way to figure out  
4 what anybody's rate needs to be and the threshold  
5 for getting in is so high, the cost of using it  
6 is so high, it really discourages people who have  
7 concerns about their rate from bringing concerns  
8 to the Board.

9 MR. SAPPINGTON: Sure. I certainly  
10 understand that but I think you've already got  
11 one remedy in place and I think Professor Kalt  
12 suggested another one this morning which I  
13 endorse entirely. First, as Mr. Atkins talked  
14 about, you've got the simplified SAC test, which  
15 I think again, it's not the gold standard but  
16 I'll let him characterize it but I would see it  
17 perhaps as a silver standard. It still does an  
18 adequate job, not perfect, but when you ...

19 MS. MILLER: Tin, it's the tin  
20 standard.

21 MS. BEGEMAN: But it's never been used  
22 so we really don't know.

1                   MR. SAPPINGTON: Okay. But it seems  
2 to be in principal and again Mr. Atkins can speak  
3 to this more than I can, this seems to be a  
4 reasonable alternative to consider if again, you  
5 believe that the SAC standard is the appropriate  
6 standard, which I do, but if that's too costly to  
7 implement perfectly you look for ways to do it  
8 reasonably well, if not perfectly.

9                   The alternative is to, I think, maybe  
10 I'm being too optimistic here, but from my  
11 experience in the telecommunications industry,  
12 they faced a similar problem when the Federal  
13 Communications Commission had to implement  
14 prices. People said well what are the reasons.  
15 Trying to replicate the prices that would prevail  
16 in a competitive market and there was controversy  
17 about exactly how you do that. But the industry  
18 as well as people from the Federal Communications  
19 Commission got together and worked on a model  
20 which then everyone could use in the regulatory  
21 hearings and again, it didn't answer all the  
22 questions but it created a framework for which

1       you could have a reasonable discussion about  
2       what's reasonable and what's unreasonable, making  
3       your job as the final adjudicators much easier.

4               MR. ATKINS:   Commissioner Miller, I  
5       have another thing just to keep in mind and I  
6       know this may not be sort of small comfort for  
7       you but you're experiences with the SAC analysis  
8       unfortunately started with the DuPont case.

9               MS. MILLER:   Uh-huh, yes.   I was going  
10      to say when you showed that and said that this  
11      shows how you can use the SAC case to cost out  
12      the system I thought hmmm.

13              MR. ATKINS:   It was a complicated case  
14      and I just, as a bit of history and one of the  
15      things that the Board has always, the SAC  
16      analysis has always been this slowly evolving  
17      process where every couple of years some sort of  
18      really complicated question comes to the Board as  
19      it gets litigated by the parties and over time  
20      with sometimes some nudging from the Board, you  
21      get a breakthrough and you settle on the approach  
22      and then they move on and then something new will



1       come along. There is a lot of examples. The  
2       best one is given the complexities of the  
3       operating plan is our operating plans. So in the  
4       90's, the shippers were really struggling to put  
5       in a case that made any sense whatsoever even for  
6       a simple coal only network. Because they kept  
7       using this silly string program as their  
8       operating plan. And so, as a result, we had  
9       cases where, well the Board would have cases, my  
10      apologies, that came in where you would have  
11      trains colliding.

12                You'd have flat railroads because they  
13      just couldn't get the operating model to work and  
14      eventually the Board wrote a decision that said  
15      stop using this model. Start using the RTC model  
16      because it's actually a much better approach and  
17      that nudge and that helped the process evolve a  
18      little bit. Right now, you're in a process of a  
19      bit of evolution where you're seeing these, this  
20      one particular large case come in with a  
21      merchandise system. With some time, with some  
22      guidance from the agencies, that too will start

1 to simplify itself out and you'll be able, either  
2 the parties will be able to prevail or not but at  
3 least the process will continue to evolve and  
4 continue to provide guidance to the parties and  
5 with that guidance, the disputes tend to fall  
6 away. New disputes come back on the table but  
7 old disputes are no longer really a part of the  
8 process.

9 MS. BEGEMAN: If I could ask a  
10 question, and maybe it's to Mr. Atkins. We'll  
11 start with you but others should feel free to  
12 chime in. One of the things I'm struggling with,  
13 and I will sound like I'm a different person  
14 maybe than I was during an earlier panel, but I  
15 can certainly understand the hesitation of the  
16 unknown from the industry's perspective as far as  
17 what a revenue adequacy constraint would actually  
18 be, and how it would impact industry and their  
19 ability to earn adequate revenues, etc. And we  
20 also keep hearing about SAC, and every time I  
21 hear about SAC, I kind of have a Pavlovian  
22 negative response, I will admit.

1                   But SAC was part of Coal Rate  
2 Guidelines and constrained market pricing  
3 principals and along with SAC was revenue  
4 adequacy and something called management  
5 efficiency and they also had some kind of phasing  
6 constraint. So, it wasn't that it is only SAC,  
7 it's just, as I understand, that SAC is the one  
8 that ultimately was pursued by the parties. I  
9 think Western Coal Traffic League had a lot to do  
10 with helping figure out how the process came  
11 about.

12                   I do wonder is it just that we haven't  
13 gone down the revenue adequacy constraint path  
14 far enough to figure out what that methodology  
15 should be? It's hard to say that we shouldn't or  
16 can't do it when it's been talked about since  
17 1985. So while I appreciate the message from the  
18 industry saying don't go there, long before any  
19 of us got here, a previous agency decision said  
20 it was a constraint. So if you could just  
21 comment on how you would now just ignore it.

22                   MR. ATKINS: We're not asking you to

1 ignore what was in place in 1985. What we're  
2 saying is that worldwide regulators are  
3 discarding this type of approach and so I don't  
4 know what was going through the head of the ICC  
5 in 1985. There is a lot of information on the  
6 record about how even in the notice of proposed  
7 rulemaking, it doesn't look anything like the  
8 revenue IRC constraint that you're hearing talked  
9 about today.

10 But let's put aside what was or was  
11 not on the minds of the Agency in 1985. The  
12 economic theory has evolved. Professor  
13 Sappington spoke to you about there was this myth  
14 that regulators really believed that you were  
15 serving the public interest by putting a hard  
16 constraint on the overall revenues that a  
17 regulated entity could earn but what they  
18 experienced, the empirical evidence and the  
19 experience in other industries was it has really  
20 bad side effects. It discourages innovation, it  
21 discourages competition, it discourages  
22 productivity and so they moved away from that

1 approach to more progressive approaches that look  
2 a lot like the SAC model or the simplified SAC  
3 model.

4 So, we're here today urging you to  
5 abandon it not because of what was said in 1985  
6 but because of the lessons that other industries  
7 learned who were put under that type of  
8 constraint and we don't want to wait, have you  
9 place the constraint on the industry and then  
10 wait to see the negative consequences rear their  
11 ugly heads and then come to the Agency and say  
12 now it's time to get rid of it. We feel that you  
13 should learn from those prior mistakes and the  
14 evolution and the thinking and get rid of it now.

15 MR. SAPPINGTON: As I mentioned in my  
16 testimony, just to supplement what Mr. Atkins had  
17 to say, is that around the 1980 period in the  
18 telecommunications industry, for example, all 50  
19 states they have their own state regulators of  
20 telecommunication services. In all fifty states,  
21 they employed rate of return regulation and  
22 today, almost none use rate of return regulation

1 so there has been this fundamental shift in  
2 understanding of how regulation works and how it  
3 should be designed and so just as Mr. Atkins  
4 said, it's hard to understand exactly what the  
5 rationale was for those statements back in the  
6 Staggers Act but certainly academic thinking, the  
7 principals of regulation have changed  
8 dramatically since then and so perhaps what they  
9 had, even if they did intend to think about rate  
10 of return type regulation in this industry, that  
11 thought is no longer what would be well received  
12 by students of regulatory policy.

13 MS. BEGEMAN: But the statute hasn't  
14 changed to keep up with --

15 MR. ATKINS: Well the statute hasn't  
16 changed but there is nothing in the statute that  
17 directed you to, the agency to impose a system-  
18 wide constraint.

19 MS. BEGEMAN: No, but with respect to  
20 the concept of differential pricing.

21 MR. ATKINS: Right. The statute  
22 hasn't, clearly the statute hasn't changed but we

1 do think that you should avoid going down a path  
2 and using a discredited approach and you know, it  
3 bears mentioning again, using a discredited  
4 approach that rests on these flawed measurement  
5 errors just compounding the two together just  
6 doesn't seem like the right policy. If you have  
7 reservations about the SAC model, then focus our  
8 attentions on trying to grapple with those. I  
9 understand you've already done some, had some  
10 outside experts come in and try to help you  
11 improve the internal processes. Nobody is  
12 suggesting that there isn't room to improve upon  
13 it but what they want is for you to stay on solid  
14 economic foundation and not go back to using  
15 approaches that we already know what the  
16 consequences of imposing those on the industry  
17 are going to be.

18 MS. MILLER: Can I, you just used the  
19 term a system wide constraint.

20 MR. ATKINS: Yes.

21 MS. MILLER: And why do you call it a  
22 system wide constraint?

1                   MR. ATKINS: Okay. So, from my  
2 perspective, I see two categories of proposals  
3 that are before you today. You haven't actually  
4 heard the worst one yet that the Western Coal  
5 Traffic League started. The worst ones are the  
6 rebate proposals. So it's NIT League's proposal  
7 and it's the ACC's proposal where they are going  
8 to rebate to the twenty percent based on the  
9 overall financial health of the industry. That's  
10 an overall constraint that the revenues that are  
11 generated from the eighty percent are going to  
12 affect how much rebate you give back to the  
13 twenty percent.

14                   The fact that you're only giving back  
15 the twenty percent or ten percent or five  
16 percent, it doesn't matter how small the number  
17 of shippers are that you are returning the money  
18 to, you're trying directly the performance of the  
19 railroad in this competitive marketplace to what  
20 you will let them charge their so called captive  
21 traffic, that's a system wide constraint. That's  
22 a different approach than what Western Traffic



1 League, you heard about first thing in the  
2 morning.

3 They said up front they are not  
4 putting an overall constraint on the railroads.  
5 That approach has a whole different set of  
6 incentive problems. We can talk about them some  
7 more if you'd like to but that's not the one that  
8 we're referring to when we say you're going to  
9 impose a system wide rate cap on the industry.

10 MR. SAPPINGTON: So even if you're not  
11 regulating the prices in the competitive sector,  
12 you are regulating earnings there so in that  
13 sense you are regulating the entire industry  
14 rather just focusing it on the captive shippers.

15 MS. MILLER: But why do you say you're  
16 regulating earnings because you're not  
17 restricting earnings.

18 MR. SAPPINGTON: Well you would be, as  
19 I understand the proposal that's been made to  
20 rebate the earnings above adequate levels to  
21 reduce the prices in the regulated sector. That  
22 is, in my view, regulating earnings in the entire

1 sector which in my view, I think is a real recipe  
2 for disaster because you've got, at a minimum,  
3 eighty percent of the system functioning very  
4 well by essentially deregulating the industry  
5 which has led to these wonderful gains and now to  
6 think about going back and either directly or  
7 indirectly regulating all elements of the  
8 industry would just be a real disaster.

9 MR. ELLIOTT: A question for Mr.  
10 Eliasson. With respect to, I guess this is more  
11 of a railroad issue, the railroads constantly  
12 point to their ability to invest and their  
13 concern about that. Are the railroads, or I  
14 guess we'll use CSX as the example, capable of  
15 getting the money that they need to make the  
16 investments that they need to run the railroad  
17 now the way they want it? Are they able to do  
18 that and go out and get that money?

19 MR. ELIASSON: We are, and the reason  
20 we are is because of the fact that if you look at  
21 our ability to earn a good return on the  
22 incremental spending that we do right now so the

1 two and a half billion dollars that we are  
2 spending this year, we have the ability to earn a  
3 return above our costs of capital of that.

4 If you change that paradigm, if you  
5 say that you can only earn  $X+1$  then that will  
6 change and as a result, as we think about our  
7 capital budget and we look at that growth portion  
8 specifically to begin with, that growth portion  
9 that we are spending to improve our customer  
10 service and improve the customer access to our  
11 network. At that point, we have to see what that  
12 return is and if that return that you're  
13 subscribing would be less than what our other  
14 options would be which would be dividends or  
15 share of purchases, we then would be forced by  
16 our shareholders because they want to invest in  
17 where the highest return is to rethink that  
18 proposition which is why we say that it's a  
19 vicious cycle that you get into if it starts  
20 capping the returns on the railroad, because  
21 incentives are no longer there to do what we've  
22 done as you saw on the slide earlier where the

1 rates today are sixty cents on the dollar versus  
2 1980.

3 And the irony is that the three  
4 customer groups that generally are here to  
5 complain the most about what we do as an industry  
6 have raised the rate three times as much as we  
7 have and yet we're here trying to find an avenue  
8 to transfer earnings from us to them partly  
9 because there is an outlet for that discussion  
10 that otherwise wouldn't exist. So yes, if you  
11 cap the returns on incremental investments, we  
12 would go to a bad place. We're not there today  
13 and our investors are looking at the prospect of  
14 continuing to improve our returns and that's why  
15 we get the access to capital. If that changes,  
16 things will change in terms of the investment  
17 decisions that we're making.

18 MS. BEGEMAN: Do you mind if I ask a  
19 question?

20 MS. MILLER: Go ahead.

21 MS. BEGEMAN: For the Board's annual  
22 determination of revenue adequacy, which CSX has

1 not been on that list to be revenue adequate  
2 based on the Board's determination, does that  
3 mean anything to you when you read the Board's  
4 annual determination? Do you just glance at it  
5 or does it have any true meaning whether or not  
6 you're revenue adequate according to us?

7 MR. ELIASSON: In terms of the capital  
8 decisions that we make today within the framework  
9 that exists today, that is not as relevant. But  
10 the threat of actually having something happen,  
11 if we become it, does enter into our mind as we  
12 make investment decisions that are long-term in  
13 nature. But right now, we focus on, if I go out  
14 for 2016 and we allocate a capital budget of  
15 let's say 2.5 billion dollars, if we think that  
16 that return is not going to be there, we can't  
17 with good conscious, put as much money into the  
18 capital but specific to the revenues, right now,  
19 the way that we understand the rules of the game,  
20 it is not something that is in the forefront as  
21 we focus on, as we decide our investment choices.

22 MS. BEGEMAN: Thank you.

1 MR. ELLIOTT: I've asked this question  
2 before or it's been asked, but with respect to  
3 the TRB report and this is probably for the  
4 economists, there is a lot of strong criticism  
5 that we heard about the SAC test. There was  
6 another proposal with respect to rate comparison  
7 and I just wanted to hear your thoughts on their  
8 suggestions in that, what was a neutral study.

9 MR. ELIASSON: Maybe I can just first  
10 take kind of an

11 MR. ELLIOTT: Sure, I didn't mean to  
12 leave you out.

13 MR. ELIASSON: Well, I feel neglected.  
14 But, and I'm not an expert on it but I've heard  
15 this come up earlier today about comparison so  
16 maybe that's a way to address it. Having been in  
17 sales and marketing and having had DuPont and  
18 other people as my customers, being Vice  
19 President of Chemicals for a period of time, that  
20 makes me very, very concerned because we  
21 constantly try to get traffic off the highway  
22 system. We constantly try to grow our business

1 by taking our competitor's traffic. Okay?

2 Now, when we do that, if I go after a  
3 business that let's say has a \$1500 revenue per  
4 carload, because that is the rate that is  
5 required to get it onto my system, and that I  
6 have traffic over here that I'm charging \$2500  
7 because of efficiencies or because of the fact  
8 that the network is only populated by one  
9 customer, in that comparative analysis I'm going  
10 to be penalized for going after that \$1500  
11 carload and we are going to have incentives that  
12 then are perverse for us and from a public  
13 policy, an economic policy perspective, you're  
14 going to go down a path that I don't think we  
15 want to go down because I'd rather only keep  
16 fewer profitable customers and continue to shrink  
17 the way we've done in the previous 25 years  
18 because that's the only way I can get close to  
19 continuing to earn improved returns.

20 MS. MILLER: I don't see why  
21 necessarily, if I'm following the TRB proposal,  
22 that would happen. I mean, what they were really

1 recommending is that one, what you want are  
2 market based rates so this is another way to try  
3 to get an understanding of what a market based  
4 rate would be when you don't have a market, when  
5 you don't have a competitive market to set it and  
6 you don't come out and say this will be your  
7 rate.

8 What you do is say this rate appears  
9 to not meet a modeled rate out of the competitive  
10 market and then it opens up the opportunity for  
11 both sides to come in and talk about their rates.  
12 So it doesn't necessarily say what you'd end up  
13 with is the rate that came out of the model or a  
14 comparison but it would be what would trigger  
15 looking at that rate in more detail.

16 MR. ELIASSON: Differential pricing is  
17 fundamental to everything that we do. Each and  
18 every customer is located differently, has  
19 different cost characteristics too.

20 MS. MILLER: Sure.

21 MR. ELIASSON: So I'm trying to just  
22 say that if you are allowing, if you are going



1 down a path of comparative rates, which to some  
2 degree frankly is the reason why you have the CSX  
3 case in front of you that you have today which  
4 tell in our minds, market dominance should never  
5 have been assessed there because there are  
6 hundreds and thousands of trucks leaving that  
7 facility on a daily basis but because you do a  
8 rate comparison that said, that indicated that  
9 this is, warrants your further investigation.  
10 But if I go after traffic that has a lower cost  
11 profile to it and you compare that to my existing  
12 traffic, I am going to be at a disadvantage.

13 MR. ATKINS: I'm going to let my  
14 economist speak first and then I'll give you one  
15 or two thoughts.

16 MR. CORNELL: What Professor  
17 Schmalensee probably has in mind is that you  
18 could build a statistical model that looked at  
19 all of the competitive routes and then picked out  
20 characteristics.

21 MS. MILLER: Right. That's the way I  
22 understood it.

1 MR. CORNELL: And then you'd be able  
2 to predict by using those characteristics what  
3 this non-competitive route would have. My answer  
4 to that would be a bit like my answer to the  
5 issue with revenue adequacy. The proof is really  
6 in the pudding. He's kind of sketched this idea  
7 out.

8 MS. MILLER: Sure.

9 MR. CORNELL: What I would think you  
10 would have to do is ask him or some of his  
11 colleagues or maybe the Board and its staff if  
12 you were interested in that approach and maybe  
13 with help from the industry to see if it works,  
14 to really try to delve into it. Because at this  
15 level, the issue is going to be the one that  
16 Professor called and the CSX people talked about.  
17 Does the model really effectively tell you what  
18 this unique line should be priced at? Is it  
19 sufficiently comparable? That's a hard  
20 determination to make particularly when there's  
21 been no specific work done yet.

22 MR. SAPPINGTON: I think Professor

1       Cornell's characterization is exactly right that  
2       the proof would really be in the pudding here.  
3       In theory, this benchmarking idea makes perfect  
4       sense. But in theory so does the SAC test. In  
5       fact, I think SAC has more attributes than the  
6       benchmarking approach. And also the benchmarking  
7       approach has been tried in other industries, in  
8       the water industry in particular.

9               Again, people thought well look, we'll  
10       just see how one water supplier of public water  
11       systems, how one system is performing as compared  
12       to another one. We also have geographic  
13       monopolies because of the transport costs and  
14       water. So we'd say how costly it is for this  
15       firm to produce rather than the other and if we  
16       see one firm has higher costs, that must mean  
17       they are inefficient and so we shouldn't, we  
18       should punish them. But then you get into the  
19       hearing room and you get into very complex  
20       detailed discussions of exactly why one firm has  
21       higher costs than the other because of the  
22       characteristics of the environment in which they

1 are operating.

2 So I think it just changes the nature  
3 of the discussion but you really, getting at the  
4 same point, you're trying to replicate what  
5 prices would be charged in a competitive market.  
6 You just have two possible benchmarks, both of  
7 which have, in theory, potential attributes but I  
8 think in practice they are both going to be very  
9 difficult to implement perfectly.

10 MR. ATKINS: Commissioner Miller, if  
11 I could just offer you a couple of my  
12 observations about that report. I'm not sure if  
13 we're seeing it quite the same way or not but I  
14 think we might be. You can break that report  
15 into three components. The majority of the  
16 report talks about how there are better ways to  
17 assess whether or not you should even be able to  
18 get into the Board, then using 180 percent of  
19 ERCs.

20 MS. MILLER: Right.

21 MR. ATKINS: Okay? I'd characterize  
22 that as about 80 percent of their report where

1       they talk about how ERCs has got serious  
2       problems, 180 is an arbitrary number. I don't  
3       think there is a person in the room that would  
4       disagree with you. That was a Congressional  
5       compromise in 1980 and it's really not much that  
6       you can do about it. But it's an interesting  
7       part of their analysis where they would do this  
8       benchmark look to see how far out in the tail are  
9       you. There is also a part of it that says that  
10      you shouldn't do revenue adequacy, which  
11      obviously we don't disagree with.

12               MS. MILLER: Uh-huh, that's true.

13               MR. ATKINS: The middle part of it --

14               MS. MILLER: So you have to take the  
15      good with the bad, right?

16               MR. ATKINS: No, I'm sorry. I'm not  
17      just going to do that because the middle part of  
18      it is bare and the middle part of it is well  
19      okay, once I've decided, I've got a better way of  
20      you coming in the door. How are we going to  
21      resolve this? I'm going to put basically you in  
22      a room with an arbitrator. Both sides make

1 arguments and the arbitrator just picks a number.  
2 That's not a meaningful way to decide how,  
3 whether the rate is reasonable or not.

4 You have to have a standard. Whatever  
5 the standard is, you can't just say arbitration  
6 is the standard. Arbitration is a process. It's  
7 a simplified process. It's not the standard that  
8 you apply. What would you tell the arbitrator?  
9 If the arbitrator is sitting in a room, you say  
10 okay, the parties get to submit evidence about  
11 what the reasonable rate is. How does he pick,  
12 or her? It's just lacking the one, the heart of  
13 it. And if you look at their criticism of SAC,  
14 to be honest, that's also lacking.

15 It's remarkable that that report  
16 doesn't even mention any of the literature about  
17 the SAC test. It doesn't discuss Bombles  
18 (phonetic) work or Panzer's work or Willig's  
19 (phonetic) work. When you look at up front who  
20 they spoke to, they didn't speak to a single  
21 railroad or a single railroad expert. Now, and I  
22 think unfortunately when you don't talk to, I

1 think you can appreciate this, when you don't  
2 talk to everybody and you don't listen to  
3 everybody about a particular issue, you're likely  
4 to end up maybe going in the wrong direction and  
5 I just found that aspect of their report thin,  
6 lacking, and it just didn't seem to justify  
7 setting aside SAC which so many economists have  
8 said over the years is a robust way of trying to  
9 determine the maximum lawful rate.

10 MR. SAPPINGTON: I would agree  
11 entirely. I do believe they pointed out some  
12 potential flaws in, or problems in using the SAC  
13 test but they didn't, in my view, seem to fully  
14 appreciate the sound principles on which the SAC  
15 test is based. And again, in my view, the basic  
16 principal that you need to keep in mind when  
17 designing good regulatory policy, is that you're  
18 trying to replicate the discipline of a  
19 competitive market and that's precisely what the  
20 SAC test does. So, just because it is hard to  
21 implement or because it has some minor flaws,  
22 doesn't mean you throw it out. It means you try

1 to work with it and improve it but again, I think  
2 that is giving you overriding correct principal  
3 in which to base your regulatory policy.

4 MR. ATKINS: And Commissioner Miller,  
5 I know that they didn't propose a benchmark  
6 approach but all of the points that Fredrik made  
7 about how appallingly bad it would be and the  
8 disincentives it creates, keep those in mind as  
9 you listen today because one of the proposals  
10 from NIT league and ACC is once you're revenue  
11 adequate, they would propose a benchmark  
12 approach. So they would try to gauge the  
13 reasonableness of the rate based on the deal that  
14 CSXT cut in order to keep another traffic on the  
15 system and that guts demand based differential  
16 pricing.

17 If there is anything fundamental about  
18 the railroad industry, it's the need for them to  
19 engage in demand based differential pricing. You  
20 can't gauge the reasonableness of the rate for  
21 somebody who's got competitive alternatives and  
22 say that's the rate that you need to charge



1 everybody. Then you have no more demand-based  
2 differential pricing and there is no recovery of  
3 the fixed and common costs needed to support the  
4 network which is, I think, the basic point that  
5 CSXT was making.

6 So it doesn't necessarily apply to the  
7 TRB report because I don't think they were  
8 advocating a standard and that's the problem with  
9 it, there wasn't one. But keep it in mind as you  
10 hear about a benchmarking approach with some of  
11 your future panelists.

12 MR. ELLIOTT: Thank you very much.

13 MR. ATKINS: Thank you.

14 MR. ELLIOTT: Okay. Why don't we get  
15 started with the next panel?

16 MR. VON SALZEN: Okay, thank you.

17 Good afternoon Chairman Elliott, Vice Chairman  
18 Begeman, Ms. Miller. I'm Eric Von Salzen,  
19 outside counsel for Arkansas Electric Cooperative  
20 Corporation or AECC. I'm going to be discussing  
21 the legal context for evaluating the policy  
22 changes required to reflect the attainment of

1 revenue adequacy by the Class 1 railroad  
2 industry. The legal authority supporting that  
3 discussion are cited in AECC's previous written  
4 submissions. With me is Michael Nelson, AECC's  
5 Transportation Consultant, who will then discuss  
6 the economic context for the specific policies  
7 and practices the Board should adopt to recognize  
8 this new reality in the railroad industry.

9           As you know, and as the remarks you've  
10 heard today certainly demonstrate, there is a  
11 sharp division between the railroads on the one  
12 side and their customers on the other about the  
13 importance of the industries attainment of  
14 revenue adequacy. We think this is a big deal  
15 that calls for the Board to change its focus from  
16 helping the railroad industry to achieve  
17 financial health to pursuing other policy goals  
18 set by Congress. The railroads, in contrast,  
19 argue that there is no reason for the Board to  
20 change anything in response to their attainment  
21 of revenue adequacy and that you should continue  
22 with business as usual.

1                   The railroads are wrong. In the  
2                   Staggers Act, Congress directed the ICC and later  
3                   this Board, to make adequate and continuing  
4                   effort to assist rail carriers in attaining  
5                   revenue adequacy. That's what you and before  
6                   you, the ICC, have been doing for three and a  
7                   half decades and you have succeeded. As a result  
8                   of that success, the Board no longer has a  
9                   mandate to support further increases in rail  
10                  earnings. However, it does continue to have  
11                  responsibility for many other policy goals and  
12                  statutory requirements.

13                  One of these that has become very  
14                  important very rapidly in recent years stems from  
15                  the accrual of earnings by the Class 1 railroads  
16                  in excess of the revenue adequacy level.  
17                  Earnings for the Class 1 industry as a whole have  
18                  been over the revenue adequacy level since 2011  
19                  and the amount of excess earnings has increased  
20                  each year. Cumulative total for the period from  
21                  2011 through 2014 is over \$6 billion, which 2.5  
22                  billion accrued in 2014 alone.

1           The rail transportation policy makes  
2 clear that under circumstances like this, the  
3 Board is expected to take remedial action when  
4 revenues exceed the revenue adequacy level. That  
5 it is, as the rail transportation policy says,  
6 the policy of the United States government to  
7 maintain reasonable rates where there is an  
8 absence of effective competition and where rail  
9 rates provide revenues which exceed the amount  
10 necessary to maintain the rail system and to  
11 attract capital. That's exactly where we are  
12 today. Thus, the Board's job as prescribed as  
13 the rail transportation policy is to rectify that  
14 situation.

15           Your predecessor, the ICC, considered  
16 the situation that would arise when the rail  
17 industry earnings surpassed the revenue adequacy  
18 level as they now have. The commission  
19 interpreted the statute to require changes in  
20 regulatory policy and practice once revenue  
21 adequacy was attained. The ICC said carriers do  
22 not need greater than adequate revenues and in a

1 regulated setting, they are not entitled to any  
2 higher revenues.

3 The ICC's interpretation of the  
4 Staggers Act was affirmed by the Federal Court  
5 and it was ratified by Congress when Congress  
6 passed the ICC Termination Act of 1995. The  
7 principal of ratification means that when  
8 Congress reenacts a statute, it accrues and  
9 implicitly incorporates into the statute  
10 authoritative agency and judicial interpretations  
11 of it. Thus Congress has ratified the ICC's  
12 interpretation that what the Staggers Act  
13 requires is that when the railroads attain  
14 revenue adequacy, there is no longer any  
15 justification for further increases in  
16 differential pricing that would yield revenues  
17 above the revenue adequacy level.

18 Now the railroads and some of their  
19 economists claim that the statute, as it has been  
20 authoritative interpreted and ratified, is  
21 outmoded and fails to reflect the latest thinking  
22 in regulatory theory. We think they are wrong

1 but this isn't the forum for parties to argue  
2 about whether the statute is outmoded. The Board  
3 applies the statute. It doesn't change it. If  
4 the railroads really think that the statute is  
5 outmoded and should be changed, they need to make  
6 their case to Congress. Raising this claim here  
7 is simply dilatory. Notice of this hearing, the  
8 Board identified several issues for discussion  
9 related to the coal rate guidelines.

10 What I've just said relates to the  
11 issue near the top of page 3 of your notes. By  
12 way of clarification, I want to stress that the  
13 ICC's language that you quoted about railroads  
14 seeking to obtain returns in excess of the cost  
15 of capital is from a footnote in the coal rate  
16 guidelines that addresses what the ICC apparently  
17 regarded as a possible exception to the general  
18 rule. But the general rule stated in the text of  
19 the guidelines is that carriers do not need  
20 revenues greater than the standard revenue  
21 adequacy and we believe that in a regulated  
22 setting they are not entitled to any higher

1 revenues. The ICC didn't explain why it dropped  
2 that footnote in about what a railroad would need  
3 to have to show to get revenues above the  
4 adequacy level after just having said the  
5 railroad isn't entitled to higher revenues than  
6 revenue adequacy. Perhaps the Commission just  
7 wanted to warn that if a railroad did seek to  
8 earn returns above the cost of capital would have  
9 a very heavy burden to bear to justify that. But  
10 the general rule is clear that a railroad is not  
11 entitled to revenues above the revenue adequacy  
12 level.

13 AECC has provided the board with a  
14 roster of specific actions to address the  
15 achievement of revenue adequacy and the rapid  
16 growth of excessive earnings including rate case  
17 reforms, enhanced availability of competitive  
18 access and a revenue adequacy constraint that  
19 would refund the shippers excess rail revenues.  
20 I want to stress that all of AECC's proposals are  
21 consistent with the ICC's recognition that  
22 railroads must be allowed to earn revenues that

1 provide a rate of return on net investment equal  
2 to the current cost of capital so that it fairly  
3 rewards the companies investors and ensures  
4 shippers that the carrier will be able to meet  
5 their service needs for the long term. AECC's  
6 proposals would not in any way threaten the  
7 ability of the railroad industry to attract and  
8 retain needed capital.

9           You've heard a lot of harsh rhetoric  
10 from the railroads today about how shippers want  
11 to turn the clock back to the 1970's, just want  
12 to pursue their own selfish interests and so  
13 forth. Our proposals are supported by the  
14 principals adopted by the ICC over thirty years  
15 ago, affirmed by the federal appellate court and  
16 ratified by Congress. We are proposing that the  
17 Board take appropriate and measured steps to  
18 reduce the harms to the public interest being  
19 caused by rail rates in excess of what the  
20 railroads need to attain adequate revenues. Mr.  
21 Nelson will now discuss the economic and public  
22 interest considerations that accompany the legal



1 issues that I've just been discussing.

2 MR. NELSON: Thank you, Eric. Good  
3 afternoon and welcome back Chairman Elliott.  
4 Good afternoon Vice Chairman Begeman and  
5 Commissioner Miller. This proceeding is of great  
6 personal and professional interest to me because,  
7 as I think I mentioned the last time I was here,  
8 as a graduate student in the late 1970's I took a  
9 lot of coursework in regulatory economics with  
10 Professor Ann Friedlaender of MIT. Her work was  
11 central to the economic theories and analyses  
12 upon which the Staggers Act reforms originally  
13 were based and in June of 1983, she was one of  
14 the signatories of the verified statements  
15 submitted by the group of economists that  
16 reviewed and endorsed the ICC's original plans  
17 for implementing CMP in the coal rate guidelines  
18 proceeding.

19 During the formative years of the  
20 Staggers Act reforms, I was well immersed in the  
21 economic theories and principals upon which those  
22 reforms were based and over the years I

1       periodically have described the economic and  
2       public interest considerations that have arisen  
3       in specific work proceedings. From that basis,  
4       I've had some thoughts as I was sitting back  
5       there about how to reconcile different things  
6       that have been said here today sort of through  
7       the lens of CMP and I've tried to incorporate  
8       some of them kind of on the fly in my prepared  
9       remarks. If I'm unsuccessful in that, I would  
10      welcome questions at the end and I specifically  
11      have a few thoughts related to the Vice  
12      Chairman's questions related to SAC. So we'll  
13      see if I run out of time first.

14                   Thirty-five years after the Staggers  
15      Act, the economic theories and principles upon  
16      which it was originally based continued to  
17      provide a useful framework and guidance for  
18      regulatory actions and this shouldn't come as a  
19      surprise as neither the statutes nor the relevant  
20      economic considerations have changed much in the  
21      interim. We've heard a lot about the benefits of  
22      competition from previous speakers today so I'm

1 not going to spend a lot of time on that.

2 In a competitive marketplace there are  
3 few worries about excessive earnings or poor  
4 service or long-term industry financial health  
5 because those issues tend to be addressed by the  
6 natural actions of market forces. It is  
7 important to note that competing firms typically  
8 face ongoing incentives to innovate in ways that  
9 enable them to offer more attractive products and  
10 services at lower costs. In the longer term,  
11 pushing down costs produces financial health and  
12 resiliency by broadening the markets the firm can  
13 profitably serve and its ability to generate  
14 profits even under adverse market conditions.  
15 Although the cost structure of railroads  
16 necessitates some amount of differential pricing,  
17 market forces can provide a very effective tool  
18 for ensuring quality service, reasonable rates  
19 and innovation that supports long-term industry  
20 health.

21 When listening to Mr. Hamberger's  
22 remarks earlier today, it seemed like he was

1 pretty much making the same point but it did  
2 contrast with remarks I recall from a few years  
3 ago where a Class 1 railroad executive testifying  
4 before the Board dismissed shipper expectations  
5 of substantial carrier investment, reduced rates  
6 and improved service as being an impossible  
7 combination to achieve. While his position made  
8 some intuitive sense, the railroads actually  
9 delivered that combination of positive features  
10 for the first fifteen years or so of operation  
11 under the Staggers Act, an accomplishment enabled  
12 by robust productivity improvement in that more  
13 competitive environment.

14 AECC has discussed in several filings  
15 and I believe it was corroborated in some data  
16 that Union Pacific submitted in this proceeding,  
17 that the break point between the strong early  
18 performance under the Staggers Act and the more  
19 recent pattern of adverse cost changes,  
20 productivity stagnation, large scale service  
21 problems and inflation adjusted rate increases,  
22 came with the reductions in market forces

1       stemming from the consummation of the large 3 to  
2       2 merges in the east and west and the  
3       implementation of the bottleneck rule.

4       Efficiency and productivity improvements driven  
5       by market forces are important to the long-term  
6       health and performance of the industry and should  
7       not be overlooked. The economic benefits of  
8       market forces were at the heart of the Staggers  
9       Act reforms and have not changed in the interim.

10               From an economic perspective, the  
11       Staggers Act anticipated that the rail industry,  
12       its customers and the economy as a whole would  
13       rely on such market forces to the greatest extent  
14       feasible. The main limitation on such reliance  
15       was the recognition of the difficult financial  
16       condition of at least portions of the rail  
17       industry and the resulting need for the ICC and  
18       SDB to give weight to improving the ability of  
19       the industry to attract and retain capital as  
20       needed to maintain, modernize and expand. This  
21       is reflected in Section 1070482. With all due  
22       respect to the economic arguments advanced by the

1 railroad parties, those arguments ask us to  
2 believe that the freedoms provided by the  
3 Staggers Act and thirty-five years to exercise  
4 them, have not been sufficient to enable the  
5 railroads to now attract and retain needed  
6 capital. I don't believe that is the case and  
7 the Board should not either. The Board has  
8 abundant evidence that proves the Staggers Act  
9 has not failed and that, if anything, the  
10 industry for a while has been ripe for the types  
11 of changes the Board is now considering. AECC  
12 has gone over this evidence in detail and this  
13 and other proceedings and here, I'll just touch  
14 on some of the major points.

15 The industry has vigorously exercised  
16 the freedoms provided in the act merging down to  
17 seven Class 1 railroads, abandoning or spinning  
18 off extensive trackage and implementing  
19 dramatically force reductions. The Board's own  
20 consultant, Christiensen Associates, found the  
21 Class 1 railroads all have been able to attract  
22 and retain optimal amounts of capital at least

1       since 1995. Christensen also found that even  
2       with the adverse costs and productivity impacts  
3       that resulted from the duopolies and the  
4       bottleneck rule, the Class 1 industry has been  
5       revenue adequate since 2001 under the Cap-M  
6       standard.

7               By the AAR's numbers, the railroads  
8       have invested 575 billion in their networks  
9       between 1980 and 2014 with the typical current  
10      annual build and maintain expenditure over 20  
11      billion per year and well over half of that  
12      representing capital spending on track and  
13      equipment.

14             Also, there are the massive premiums  
15      above the current market value of tangible assets  
16      that have been paid in recent merger and  
17      acquisition transactions. World-class investors  
18      like Warren Buffett, not to mention the large  
19      railroads themselves like NS and CSX have paid  
20      the large premiums that demonstrate the ability  
21      of the railroads to attract abundant capital.

22             Last, but certainly not least, are the

1 results of the Board's own methodology for  
2 determining revenue adequacy. To illustrate  
3 this, I've updated the chart I presented at the  
4 public hearing in Ex Parte 711. Is my chart here  
5 somewhere? It's pretty much a line going up so I  
6 don't think people need to see the details too  
7 much. The Board now has found that the Class 1  
8 industry as a whole was revenue adequate in 2011,  
9 2012 and 2013 and that the level of earnings in  
10 excess of the revenue adequacy level has  
11 increased each year.

12 Available information for 2014  
13 indicates that this pattern has continued with  
14 excess earnings exceeding two and a half billion  
15 as I think Eric mentioned and for reasons  
16 discussed in our recent reply filing in Docket  
17 No. EP558, even that number may be low. In any  
18 event, the excess earnings of the Class 1  
19 railroads and large, growing rapidly and show no  
20 sign of returning to the revenue adequacy level  
21 on their own. The cumulative excess earnings are  
22 now so large that AECC believes they provide an



1 answer to the Board's question regarding the  
2 proper duration of the measurement period for  
3 assessing revenue adequacy.

4 The large excess earnings in recent  
5 years mean that for almost any period of time the  
6 Board realistically might consider, the  
7 cumulative excess earnings will be positive.

8 It's true, if you go back the four years that was  
9 mentioned earlier, six years which is a little  
10 more than I think NBER would say is the length of  
11 an average business cycle, or even nine years  
12 which is the entire time that data is available  
13 since the original DCF method was set aside by  
14 the Board.

15 So the short answer is that it's kind  
16 of a moot point that no matter the number of  
17 years, the result is still likely to show excess  
18 earnings and the need for the Board to be  
19 prepared to undertake remedial action. ACC  
20 agrees generally with the idea that revenue  
21 adequacy is a long-term concept, but mainly in  
22 the sense that it is supposed to reflect the

1 ability of firms in the industry to attract and  
2 retain needed amounts of capital and ability that  
3 is not determined by a single accounting period.

4 AECC recognizes the administrative  
5 convenience of some amount of smoothing but that  
6 doesn't seem particularly relevant when the  
7 pattern is one of a sustained upward trend as we  
8 have here. AECC is also concerned that some of  
9 the longer periods under consideration may  
10 inhibit the Board in the exercise of its  
11 responsibilities under Sections 1070482 and  
12 10101, Section 6. If something really bad  
13 happened tomorrow and industry earnings went  
14 below the revenue adequacy level, it could take  
15 years before the Board, if it adopted a longer  
16 evaluation period, it could be years before the  
17 Board would have a basis for acting pursuant to  
18 Section 1070482 because the longer evaluation  
19 period would still show excess earnings.

20 So I guess our point that we're trying  
21 to make is that to the extent practical, the  
22 Board should be trying to push up to help the

1 industry when things are bad and push down to  
2 protect the economy from the substantial harms of  
3 excessive earnings when things are good for the  
4 railroads but too much averaging could undermine  
5 both of those roles.

6           Aside from the proper duration of the  
7 revenue adequacy measurement period, AECC  
8 believes it is important that the Board give  
9 careful consideration to the possible role of  
10 industry and regional level measurements of  
11 revenue adequacy. As discussed further in our  
12 opening comments, in a duopoly you are basically  
13 always going to have one carrier doing better  
14 than the other at any given point in time as a  
15 result of its management decisions.

16           Relying on regional or industry level  
17 measurements would have the effect of preserving  
18 the incentives for the individual carriers to  
19 still compete against the average and would  
20 address the incentive problems that several of  
21 the railroad parties have mentioned today that  
22 potentially could arise from attempting to cap

1 the earnings of individual carriers at their  
2 individual revenue adequacy level.

3           Regarding the Board's question about  
4 limitations on differential pricing for all  
5 captive shippers versus a subset most subject to  
6 market power, AECC has explained how the theory  
7 underlying CMP means generally the reductions in  
8 differential pricing should be concentrated in  
9 the shipments most likely to be subject to the  
10 exercise of rail market power and here I'd like  
11 to jump in with a little bit of sort of  
12 spontaneous CMP description that I think will  
13 address some of the economic discussion that has  
14 taken place already today.

15           We heard from the AAR panel references  
16 to regulation should be based on a competitive  
17 market standard and it should seek to minimize  
18 distortions. CMP does that but it doesn't use  
19 the standard that they seem to have in mind for  
20 the frame of reference for the distortions that  
21 they seem to have in mind. CMP starts with the  
22 textbook competitive market standard that price

1 is going to equal marginal costs and that is  
2 infeasible in the rail industry to actually  
3 achieve that and I think it was actually  
4 mentioned some in the prior panel that you have  
5 to have some amount of differential pricing if  
6 you're going to be able to pay all the bills in  
7 the fixed cost and earn a return on the capital  
8 because marginal cost pricing doesn't work due to  
9 the cost structure of the industry.

10 But the amount of deviation from  
11 marginal cost pricing that is allowed under the  
12 theory is permitted following Ramsey pricing  
13 principals. Ramsey pricing principals here  
14 refers to you try to have the largest variation  
15 from your ideal standard of a marginal cost  
16 price. You have the largest variation born by  
17 the traffic that is least elastic and least  
18 susceptible to changing the pattern of movement  
19 that would occur if the ideal marginal cost  
20 pricing occurred.

21 But the whole idea of Ramsey pricing  
22 and Ramsey pricing principals is to minimize the

1 disturbance of the pattern of resource allocation  
2 that you get from the competitive pricing  
3 standard. So the same principal that allows  
4 differential pricing to occur in the first place  
5 basically requires that as you compress  
6 differential pricing, because you only are  
7 supposed to allow the amount needed to enable the  
8 industry to reach a revenue adequate level and  
9 this goes back to the consensus statement of the  
10 economists.

11 If you read that, I think it's  
12 explicit in there that the sixteen of them signed  
13 their name to a document that said allowing  
14 earnings above the adequacy level would  
15 constitute abuse of market power. So, I believe  
16 that it appeared in the coal rate guidelines  
17 because that's what the CMP theory says and the  
18 economists all agreed on it. So, the compression  
19 through the rate structure would be applied  
20 generally at the higher end of the differential  
21 pricing that is in place and I know there has  
22 also been consternation or concern about the role

1 of non, prospectively competitive traffic in  
2 generation contribution that would then turn into  
3 supercompetitive earnings and be subject to some  
4 of the proposals including AECC's but the fact  
5 that that traffic would contribute to,  
6 potentially contribute to what we call  
7 supercompetitive or excess earnings and generate  
8 a need to apply downward pressure on the upper  
9 levels of differential pricing, that was  
10 something that was in the Christensen study so  
11 its, it may sound bad but it is what the theory  
12 says and it's the theory that allows differential  
13 pricing in the first place.

14 I think the railroads have tried to  
15 use as a frame of reference that they've gotten  
16 used to the idea of differential pricing and  
17 they've kind of gotten away from the idea that's  
18 very evident in the original theory that the  
19 amount of differential pricing is supposed to be  
20 minimized. It's not supposed to be business as  
21 usual. It's supposed to be only as much as is  
22 needed to accomplish that end.

1           On the Board's question regarding the  
2           connection between revenue adequacy and  
3           availability of competitive access remedies, AECC  
4           agrees with NIT League's presentation earlier  
5           basically that all of the forms of competitive  
6           access authorized by the statute have been  
7           available to the Board with or without the  
8           achievement of revenue adequacy.

9           From AECC's view, the Board has  
10          historically applied a policy toward competitive  
11          access that is so restrictive that basically no  
12          awards have of competitive access have been made  
13          within the past 30 years and to the extent that  
14          that policy reflects the Board's past support for  
15          the attainment of revenue adequacy, it may be a  
16          nexus for a policy change regarding competitive  
17          access that isn't specifically statutory but it's  
18          in the policy.

19          In consider competitive access, the  
20          Board should also take account that although  
21          competitive access may produce downward pressure  
22          on rates in some circumstances, it also promotes



1 increases in efficiency that tend to decrease  
2 costs particularly for train load and unit train  
3 traffic so then that effect on rail earnings may  
4 not be as large as some may fear. An  
5 illustration of this is provided in a study of  
6 the bottleneck rule presented to the Board by  
7 AECC which found the operating cost savings that  
8 potentially could be achieved by rescinding the  
9 bottleneck rule for trainload and unit train  
10 movements were comparable in magnitude to the  
11 rail industries claims regarding potential lost  
12 revenue.

13 Congress recognized that competitive  
14 access can be very beneficial to the industry and  
15 the public interest by promoting greater  
16 efficiency and lower cost operations. Congress  
17 also recognized that the adequacy of rail service  
18 may result not only from a carrier's financial  
19 health but also from market forces released by  
20 competitive access that can motivate carriers to  
21 deploy the resources needed to provide adequate  
22 service. The attainment of revenue adequacy

1 provides an opportunity for the Board to finally  
2 take steps to exercise its competitive access  
3 powers to realize the service and other benefits  
4 of market forces that have been largely held in  
5 abeyance for the past 35 years.

6 In removing or considering the removal  
7 or restrictions on competitive access, the Board  
8 would need to address the concerns expressed by  
9 some rail shippers including WCTL this morning,  
10 that the actual or hypothetical availability of  
11 competitive access could undermine rate case  
12 protections.

13 Mr. Van Salzen tells me it would be  
14 inconsistent with the statute if relaxed  
15 restrictions on competitive access made on the  
16 basis of the achievement of revenue adequacy  
17 nevertheless created opportunities for increased  
18 differential pricing by undermining the market  
19 dominance determination. The Board, therefore,  
20 should ensure that competition prospectively  
21 introduced by a competitive access is  
22 sufficiently effective in the meaning of Section

1 10707 that it will not permit rate increases if  
2 the rate case protections are removed.

3           Toward this end, AECC has been working  
4 on a specific proposal that potentially could be  
5 useful if the Board elects to pursue this issue.  
6 With the achievement of revenue adequacy, the  
7 Board should now be actively embracing, relying  
8 on and applying competitive market standards.  
9 This doesn't mean open access, rather it means  
10 things like acting decisively to curb excess  
11 earnings, removing artificial constraints on  
12 competitive access and forcing efficient  
13 management standards and accountability and  
14 things like that.

15           In the end, this is what remains in  
16 the statute after revenue adequacy is attained.  
17 It also is the path that addresses the legitimate  
18 needs of shippers in a competitive economy,  
19 protects the economy as a whole against the  
20 harmful effects of excess earnings, provides the  
21 Board with meaningful leverage over chronic rail  
22 service problems and ultimately is beneficial to

1 the cost structure and the long-term health of  
2 the railroads themselves. The red light is on so  
3 I don't want to go into my SAC stuff.

4 MR. ELLIOTT: Thank you. Mr. Cutler.

5 MR. WHITESIDE: Mr. Whiteside.

6 MR. ELLIOTT: Mr. Whiteside. I  
7 apologize.

8 MR. WHITESIDE: I am Terry Whiteside.  
9 I want to thank the Board, Chairman, Vice Chair  
10 and Commissioner Miller for inviting me out here  
11 for the cultural experience of the humongous heat  
12 and humidity. I come from a part of the country  
13 where we rarely wear deodorant and I assured Lucy  
14 Marvin this morning that I was wearing deodorant.

15 Thank you for the opportunity to  
16 appear here today on behalf of ARC's, seriously.  
17 And for the fifteen groups representing the  
18 shippers and producers of agricultural  
19 commodities mostly in the west. ARC's membership  
20 includes captive shippers and producers of  
21 agriculture commodities and other commodities  
22 including coal, sand and other minerals. Since

1 1987, ARC has been active in STB proceedings and  
2 focused primarily on the fairness of captive rail  
3 customers. We hope the day is coming when we  
4 will see a better balance between the railroad's  
5 revenue needs and effective regulatory recourse  
6 for captive shippers and farm producers.

7 The railroads argue that if status quo  
8 isn't broken, don't fix it. These arguments are  
9 understandable but they are false. Regulatory  
10 policy adopted when the railroad industry was  
11 fragmented and financially weak are no longer  
12 appropriate when the industry today is very  
13 concentrated and enjoying record revenues and  
14 profits. The railroads have surely benefited  
15 from the ICC and the STB policies that were first  
16 adopted in the past. Let's face it, that was the  
17 goal of those policies and they worked well for  
18 Class 1 railroads.

19 Now, however, it's time for a change.  
20 You don't keep giving blood transfusions after  
21 the patient has regained health. The captive  
22 shippers whose high rates restored the railroads

1 to financial strength need some relief. Simply  
2 stated, captive rail shippers and farm producers  
3 need more reasonable rates and should have less  
4 revenue extracted by the market dominant  
5 railroads that no longer need to collect  
6 excessive revenues from regulated freight.

7 Out west, the northern tier states, we  
8 have whole areas, whole industries and whole  
9 states that are completely captive. The ag  
10 shippers and the producers we speak for are  
11 particularly poor served by the regulatory status  
12 quo. SAC and simplified SAC are prohibitively  
13 expensive and the three benchmark rule is  
14 designed to help only the isolated shippers whose  
15 rates are out of line with those of nearby  
16 competitors in states where they are all out of  
17 line.

18 In addition, rail rates on wheat are  
19 generally paid by local grain elevators but borne  
20 by the farm producers and we've talked about that  
21 before. The farm producers bear it and the grain  
22 elevators pay it and the real question is

1 sometimes the very first thing that happens when  
2 we file a case is the railroads will say you  
3 don't have standing to even file even though you  
4 pay the freight. The three benchmark rule is  
5 designed really only to help those isolated  
6 shippers as I said. In addition, rail rates on  
7 wheat are generally paid by the local elevators.  
8 The elevators may be captive but they may not  
9 suffer from high rates.

10 I was up in Saskatchewan this week and  
11 one of the things that they were talking about  
12 was how they have just come to the conclusion  
13 that the elevators only care about the cross  
14 county differential. They don't care about what  
15 the rates are. Well that's the same things in  
16 the States. In addition, few farm producers and  
17 small elevators have the time or resources to  
18 fight the major railroads particularly under STB  
19 policies. They are generally seeing, I have  
20 McCarty Farms in mind, to favor the railroads.  
21 They're small businesses and they must focus on  
22 all the other requirements of earning a living

1 leaving little time for complex regulatory  
2 proceedings. That's why ARC has long supported  
3 arbitration. Final offer arbitration works well  
4 in Canada. We were pleased to see the support  
5 for final offer arbitration in recent TRB  
6 reports. The one modernizing freight rail  
7 regulation.

8 We'd also like to see further work  
9 done on arbitration through programs like NGFA  
10 but remember that NGFA's program, while the  
11 railroads have indicated they were coming there,  
12 really only affect the grain companies, not the  
13 farm producers who actually pay the freight.  
14 Arbitration under STB regulation and contrast has  
15 not been helpful. Railroads decline to arbitrate  
16 because it's voluntarily. Over rates, they  
17 prefer litigation, which they see and I think  
18 correctly, as favoring them. And even if the  
19 railroads agree to arbitrate, require an  
20 arbitrator to apply SAC or simplified SAC or  
21 three benchmark on an accelerated schedule would  
22 not really improve the shipper's prospects or



1       save them any money.

2                   What does all of this mean? It all  
3       adds up to no effective regulatory recourse for  
4       captive shippers and producers and no bargaining  
5       leverage for those who would prefer a negotiated  
6       solution. Every captive shipper and producer  
7       would prefer to negotiate a mutually exclusive  
8       compromise of disputes over rail rates and rail  
9       increases. Sounds like an impasse and it is an  
10      impasse. However, this proceeding could be a  
11      game changer. The Board can and should implement  
12      the revenue adequacy and management efficiency  
13      constraints promised 35 years ago when CMP was  
14      adopted.

15                   For us, the most important result of  
16      the revenue adequacy constraint would probably be  
17      to reduce the size and frequency of rail rate  
18      increases on captive traffic. For grain shippers  
19      and producers and other shippers who are only  
20      able to ship under tariff rates, rail rate  
21      increases are a significant problem. Contracts  
22      are not an option because the railroads don't

1 offer them.

2 In the future, captive shippers and  
3 producers asked to pay differentially higher rate  
4 increases than their non-captive counterparts.  
5 That would have to be a basis for resisting  
6 railroad pricing that threatened to exasperate  
7 the rates exceeding the competitive levels that  
8 the railroads say they support. Such shippers  
9 should also be able to negotiate compromise  
10 solutions. Something they rarely do today and  
11 they can't do.

12 This would be a major improvement for  
13 the small captive shippers. Particularly  
14 shippers and producers of ag commodities but we  
15 have a number of small shipments that are still  
16 captive. They may be big shippers but they are  
17 small shipments. There would be no significant  
18 reduction in revenues for revenue adequate  
19 railroads. Restricting future rate increases and  
20 STB rate complaint proceedings by allowing  
21 differentially higher increases only where there  
22 is a long-term revenue adequate railroad provides

1 justification which would not affect base rates  
2 that are differentially higher due to past  
3 pricing of captive and non-captive traffic.

4 To address this problem, ARC has  
5 proposed a two benchmark rule approach for  
6 revenue adequate railroads and have expanded the  
7 revenue VC comp benchmark for rate challenges  
8 involving railroads not yet found to be revenue  
9 adequate. Railroads criticize calls for any  
10 effective limits on differential pricing or  
11 captive traffic as inconsistent with their need  
12 to invest and is likely to produce more service  
13 meltdowns of the type experience in the west in  
14 recent years. In effect, they seek to be  
15 rewarded for poor performance by being assured  
16 that attainment of revenue adequacy will never  
17 affect their ability to price captive traffic the  
18 way they do today with little or no exposure to  
19 regulatory remedies.

20 This makes no sense to me. The  
21 revenue adequacy constraint would affect only  
22 captive traffic. Far less than half of the rail

1 customers probably in the five percent range  
2 would apply only in rate cases after market  
3 dominance was established and contract shippers  
4 could not invoke the constraint. Exempt shippers  
5 could do so only with such difficulty as to make  
6 the challenge unlikely and even shippers with  
7 potentially meritorious complaints rarely seek  
8 relief as shown by the small number of rate  
9 challenges filed at the Board.

10 For reasons discussed in our prior  
11 comments in this proceeding and several others,  
12 there is really no reason to expect a flood of  
13 complaints or any significant impact on revenues.  
14 Rather, after thirty-five years, captive shippers  
15 and producers would enjoy a well-deserved  
16 increase in the likelihood that rates on the  
17 captive traffic will be increased no more than  
18 need be for the railroads to attract necessary  
19 capital.

20 So, I thank you and I'll turn the  
21 microphone over to Mr. Cutler.

22 MR. CUTLER: Thank you, Terry. You

1 can hear me okay? Thirty-five years ago the ICC  
2 adopted constrained market pricing with its four  
3 constraints, SAC, revenue adequacy, management  
4 efficiency and phasing. Since then, CMP has been  
5 cited consistently by the ICC, the STB and the  
6 courts as the basis for regulation of maximum  
7 rail rates, reasonable rail rates. In 1996,  
8 pursuant to a congressional mandate, the Board  
9 attempted to address the fact that only one of  
10 the CMP constraints, SAC, was operative by  
11 leaving the vast majority of rail rates  
12 effectively unregulated. However, simplified SAC  
13 and three benchmarks, which were adopted to fill  
14 this regulatory gap, have proved to be of little  
15 use to captive rail customers unable to afford  
16 SAC.

17 I agree with Ray Atkins, there have  
18 been ups and downs in SAC but I think five  
19 million is still a pretty safe estimate of the  
20 cost of litigating a SAC case. I believe the  
21 railroads often spent more. I don't remember the  
22 most recent figure for simplified SAC but I think

1       it was at least a million dollars, maybe half a  
2       million for three benchmark cases.

3               Moreover, simplified SAC necessarily  
4       produces higher rates than SAC even though SAC  
5       rates should never be exceeded and with three  
6       benchmark in U.S. Magnesium, the "winning  
7       shipper" got relief only to the extent that rates  
8       could not exceed 350 percent of variable costs.  
9       That's not really much of a relief mechanism.

10              If there is a silver lining, it's that  
11       the barriers to regulatory recourse that made  
12       shipper protections more apparent than real and  
13       serve the railroads very well. They consolidated  
14       abandoned trackage, reduced work forces, made  
15       shippers absorb costs and burdens and raised  
16       rates with rates increasing more on captive than  
17       on non-captive traffic. As the recent TRB report  
18       found during the period of 2002 to 2013, rail  
19       rates on grain and oil seeds went up eighty  
20       percent for smaller shipments of less than eighty  
21       cars and seventy percent for larger shipments.  
22       More than for any other commodity except coal.

1 TRB also found that by 2013, rates  
2 where smaller volumes of grain were some thirty-  
3 five percent higher than for larger volumes of  
4 fifty cars or more. It should come as no  
5 surprise that the result is increasingly frequent  
6 findings that railroads are meeting and exceeding  
7 revenue adequacy even under the Board's extremely  
8 conservative standards.

9 To date, ICC and STB rail rate  
10 regulation has served the goal of increasing the  
11 major railroads financial strength very well.  
12 This is the good news of the last thirty-five  
13 years though the railroads are still not  
14 satisfied. Despite glowing reports to  
15 shareholders of their extraordinary  
16 profitability, they will not acknowledge that  
17 they have achieved revenue adequacy and demand  
18 that the Board adopt replacement cost accounting.  
19 Even that would not, in their view, provide any  
20 basis for any reduction in differential pricing  
21 of any captive traffic unless the shipper wins a  
22 SAC case.

1           As the beneficiaries of thirty-five  
2 years of preferential treatment under CMP, the  
3 railroads can't now claim with any legitimacy  
4 that CMP should be rewritten to eliminate the two  
5 constraints, revenue adequacy and management  
6 efficiency constraints that hold the most promise  
7 of helping all captive customers, not just those  
8 who can afford to bring a SAC case. None of the  
9 railroad's arguments for major surgery on CMP  
10 like this have merit.

11           Let's look first at the argument that  
12 it would be unlawful for the Board to implement  
13 the revenue adequacy constraint, i.e., that CMP  
14 is inconsistent with the Board's governing  
15 statute. This was not the railroad's position in  
16 the original judicial review of CMP. In  
17 Consolidated Rail Corp v. United States, 812 F  
18 2nd 1444, the third circuit concluded, "we are  
19 convinced that the ICC's basic approach on  
20 revenue adequacy is consistent with the 4R and  
21 Staggers Acts". In so holding, the court was  
22 agreeing with the position of the railroads which



1 would raise questions on appeal about  
2 implementation of SAC and management efficiency  
3 that the court found premature.

4 In 2001 when the DC circuit reviewed  
5 the STB's only application of the revenue  
6 adequacy constraint, the court rejected three  
7 arguments relevant to this proceeding. Those  
8 arguments were that the Board could not apply the  
9 revenue adequacy constraint, that it should have  
10 applied the SAC test and that it was required to  
11 use replacement cost accounting. This is the CF  
12 Industries v. STB decision by the DC circuit, 255  
13 F 3rd 816. The fact that the carrier was a  
14 pipeline rather than a railroad does not affect  
15 the court's holding of statutory compliance.

16 Mr. Sipe attempts to brush CF  
17 industries aside because the pipeline was raising  
18 rates across the board. Number one, that has  
19 nothing to do with the question of statutory  
20 compliance of CMP and the revenue adequacy  
21 constraint applied in that case. Number two, in  
22 the grain business, rate increases across the

1 board are very common. Exactly the kind of thing  
2 that the pipeline did in the CF Industries  
3 decision. In addition, I don't mean to suggest  
4 that the statute and case law don't include other  
5 guidance. The railroads say the statute doesn't  
6 support revenue adequacy but you have been  
7 directed to 10704 and to the rail transportation  
8 policy.

9           There is another factor that has not  
10 been mentioned earlier so far today and that is  
11 this, for thirty years now in proceeding like  
12 this after proceeding like this, not to mention  
13 in individual rate cases, but also the rulemaking  
14 proceedings that determine how these cases are  
15 litigated, a consistent refrain by the railroad  
16 industry is don't do what the shippers want  
17 because that will keep us from attaining revenue  
18 adequacy. Now, they can't have it both ways.  
19 They can't say that for thirty-five years every  
20 regulatory decision, in every regulatory  
21 decision, the benefit of the doubt has to go  
22 their way because of the Congress congressional

1 mandate that this Board promote the attainment of  
2 revenue adequacy and then say when we get there,  
3 oh, well, that was just a thermometer to check  
4 trends and it has nothing to do with regulation  
5 of the rates of captive traffic. The revenue  
6 adequacy constraint does not violate 49-10707 D2,  
7 which prohibits presumptions of market dominance  
8 or rate unreasonableness when RVC ratios are  
9 above 180. That's not what we're talking about  
10 here. We're talking about revenue adequacy not  
11 exceeding 180. And Section 10701 does not  
12 preclude requiring revenue adequate railroads to  
13 justify continued differentially higher rate  
14 increases on captive traffic.

15 In any event, the initial burden would  
16 be on the shipper to establish captivity, invoke  
17 the revenue adequacy constraint and show that the  
18 defendant railroad was violating it. They in  
19 defense of a challenged differentially higher  
20 rate increase, the railroad would have to show  
21 why the challenged increase should be permitted.  
22 It would make no sense to require a shipper to

1 bear the burden of showing with particularity,  
2 I'm quoting from that footnote in coal rate  
3 guidelines here, it would make no sense to  
4 require a shipper to bear the burden of showing  
5 with particularity a defendant railroad's need  
6 for differentially higher revenues, the harm it  
7 would suffer, if it could not collect them and  
8 why the captive shipper should provide them.  
9 Obviously the railroad needs to be the party that  
10 shows those things and if those are not the  
11 tests, how could a captive shipper challenge  
12 differentially higher rate increases?

13 SAC, SSAC and three benchmark were not  
14 designed for this task. In an analogous  
15 situation, the ICC decided in 1985, the same year  
16 it decided coal rate guidelines that in market  
17 dominance determinations shippers would have the  
18 burden of proof as to inter and intramodal  
19 competition and railroads would have the burden  
20 of proof as to product and geographic  
21 competition. That's product and geographic  
22 competition to ICC's second one. The Board

1 clearly has legal authority to implement the  
2 revenue adequacy constraint.

3 The real question is how the  
4 constraint should work. ARC can agree with WCTL  
5 that a four-year period is enough for revenue  
6 adequacy to be adjudged long-term.  
7 Parenthetically, we also support WCTL on the Cap-  
8 M issue that's going to be discussed more  
9 tomorrow. And as AECC points out, the 2010 Caves  
10 Christensen report found no problems with access  
11 by major railroads to adequate capital going back  
12 many years.

13 I also agree with Mr. Nelson's point  
14 that this problem will probably take care of  
15 itself. It's unlikely that long-term revenue  
16 adequacy determinations will be made, that any  
17 railroad will be adjudged by the Board to be  
18 long-term revenue adequate within the sense that  
19 we're talking about now this year or the next  
20 because there is no proposal on the table in this  
21 proceeding. There will have to be further  
22 proceedings, the Board will have to decide what

1 to do based on the comments we are discussing  
2 today. Probably another NPR will have to come  
3 out, probably more comments.

4 We're talking a couple of years at a  
5 minimum, I think, to implement any revenue  
6 adequacy constraint. During that time, we'll  
7 have more data and apparently we have three years  
8 of data showing a lot of railroads revenue  
9 adequate now. We'll have more Ex Parte 552  
10 series proceedings determinations come out  
11 parallel with your consideration of what to do  
12 about the revenue adequacy constraint. In our  
13 view, those future Ex Parte 552 series revenue  
14 adequacy determinations will just continue to  
15 show more good news about railroads attaining and  
16 exceeding revenue adequacy.

17 A more serious concern will be whether  
18 railroads might anticipate the implementation of  
19 a revenue adequacy constraint and respond by  
20 attempting to gain the Board's revenue adequacy  
21 calculations or possibly attempting to raise as  
22 many captive shippers rates as possible, as high

1 as possible prior to the time when differentially  
2 higher rate increases for captive customers might  
3 be constrained.

4 The Board should be vigilant in  
5 addressing any such actions. The question of how  
6 to implement the revenue adequacy constraint  
7 needs to be considered in two parts. The first  
8 part involves constraining future rate increases  
9 by revenue adequate railroads by disallowing  
10 differentially higher rate increases on captive  
11 traffic than on non-captive traffic absent  
12 exceptional circumstances. ARC, et al, and other  
13 shipper parties strongly support such a  
14 constraint consistent with the discussion in coal  
15 rate guidelines, 1 ICC 2nd 520, 534-36 and  
16 footnote 36. This is the WCTL version of a  
17 revenue adequacy constraint that's been discussed  
18 already today.

19 The revenue adequate railroad whose  
20 differentially higher rate increases is  
21 challenged by a captive shipper is violating this  
22 constraint should bear a heavy burden in

1 attempting to justify any exception. In most  
2 cases, the rule should be no more differentially  
3 higher increases in captive customer's rate once  
4 a railroad is long-term revenue adequate. The  
5 railroads can't seriously contend that this  
6 aspect of revenue adequacy constraint so long  
7 anticipated will significantly affect their  
8 revenues or their ability to invest in  
9 necessarily infrastructure improvements.

10 As for suggestions of service  
11 problems, if the revenue adequacy constraint  
12 finally becomes applicable, can anyone really  
13 imagine any justification if a railroad were  
14 required to impose non-differential rate  
15 increases on captive and non-captive shippers and  
16 attempted to retaliate against the captive  
17 shipper with service cut-backs? Such conduct  
18 would seem to invite an unreasonable practice  
19 complaint or other vigorous regulatory responses.

20 Revenue adequate railroads should be  
21 more likely, not less likely, to provide good  
22 service even if revenue adequacy doesn't



1       guarantee honest, economical and efficient  
2       management. Unregulated monopolies can be guilty  
3       of service failures and may be more likely to  
4       fall short of meeting customer needs given the  
5       absence of disincentives.

6               It's not clear how the management  
7       efficiency constraint would apply to revenue  
8       adequate railroads. That constraint has been  
9       interpreted to serve only to offset the amount by  
10      which a railroad falls short of revenue adequacy.  
11      In other words, under certain interpretations,  
12      the management efficiency constraint would go  
13      away once revenue adequacy were attained. Maybe  
14      there could be a use for it in situations like  
15      the one I'm talking about or like the situation  
16      with the recent service problems out west.  
17      However, the Board has other tools available to  
18      address poor service and more differential  
19      pricing of captive traffic should rarely, if  
20      ever, be seen as an appropriate remedy for that.

21              It must also be remembered that  
22      revenue adequacy based constraint on future

1 differential rate increases would affect  
2 relatively little traffic. It wouldn't apply to  
3 rate increases on captive traffic that match  
4 increases on non-captive traffic. Many railroads  
5 claim that they engage in such pricing. Only  
6 long-term revenue adequate railroads would be  
7 subject to the constraint. Most of their  
8 customers couldn't invoke it. According to the  
9 most recent STB data, only 40 percent of railroad  
10 revenues came from shippers paying rates  
11 exceeding 180 percent of variable costs. This  
12 has been discussed earlier. I won't go into all  
13 the details again.

14           One other point, many shippers pay  
15 rates at or only slightly above one hundred  
16 eighty percent of variable costs or they ship in  
17 low volumes. For these shippers, rate litigation  
18 is uneconomical especially since rates cannot be  
19 ordered below 180 percent of variable cost.  
20 Other shippers wouldn't be able to show  
21 qualitative market dominance or wouldn't want to  
22 shoulder the necessary litigation burdens despite

1       having grounds for relief. Accordingly, railroad  
2       claims being driven below railroad adequacy due  
3       to rate cases seeking to limit future  
4       differential rate increases are not credible.  
5       This is especially true in light of evidence by  
6       railroads of their increasing ability, which  
7       comes as no surprise to captive shippers to raise  
8       rates on non-regulated traffic.

9               AAR witness accounts say revenues from  
10      regulated shipments have been flat while revenues  
11      from competitive traffic, I'm quoting here, "have  
12      generated an additional 2.5 billion in  
13      contribution of the variable costs". Half of the  
14      overall increase from 2008 to 2012. Remarkably,  
15      some railroads argue that this is a bad thing as  
16      if captive customers should make  
17      disproportionally high contributions to railroad  
18      revenues forever. But in its October 30, 2006  
19      decision in Ex Parte 657 sub 1, major issues in  
20      rail rate cases, which was affirmed by the DC  
21      circuit, the Board cited that "important  
22      principal that a railroad should recover as much

1 of its cost as possible from each shipper before  
2 charging differentially higher rates to captive  
3 customers", STB decision 12.

4 At a minimum then, the Board should  
5 implement a revenue adequacy constraint that  
6 protects captive shippers against unjustifiable  
7 differentially higher rate increases by long-term  
8 revenue rail adequate railroads. There is,  
9 however, more to the issue. Specially, the  
10 revenue adequacy constraint should also constrain  
11 continued differential pricing of captive traffic  
12 that occurs through means other than  
13 differentially higher rate increases.

14 In coal rate guidelines, the revenue  
15 adequacy constraint was characterized as follows,  
16 in other words, captive shippers should not be  
17 required to continue to pay differentially higher  
18 rates than other shippers when some or all of  
19 that differential is no longer necessary to  
20 ensure a financially sound carrier capable of  
21 meeting its current and future service needs.

22 Now, a constraint like a western coal

1 traffic league constraint, which we also support,  
2 would prevent only future differentially higher  
3 rate increases which would prevent only future  
4 differentially higher rate increases on captive  
5 traffic by revenue adequate railroads, would help  
6 prevent further differential pricing of captive  
7 traffic from exacerbating the current competitive  
8 disadvantages born by captive customers vis-a-vis  
9 non-captive customers. However, it wouldn't  
10 remedy those current competitive disadvantages.  
11 Those are built into the base rates.

12 Put another way, captive customers  
13 would continue to pay differentially higher base  
14 rates than other shippers even after the  
15 attainment of long-term revenue adequacy made  
16 some or all of that differential unnecessary for  
17 the railroad. To this extent, a limited revenue  
18 adequacy constraint affecting only future rate  
19 increases would fall short of constraining rail  
20 rates as called for in coal rate guidelines. The  
21 railroads may argue that the Board should not  
22 risk driving railroads below revenue adequacy.

1           Many shippers would agree but too many  
2 rate cases and too many prescriptions of  
3 reductions in rail rates on captive traffic are  
4 hardly a pressing concern today. Over regulation  
5 of rail rates hasn't been a problem since the  
6 1970's. Why should the Board refuse to allow  
7 challenges to differentially higher base rates on  
8 captive traffic if the railroad could eliminate  
9 the differentials, charge similar rates to  
10 similarly situated captive and non-captive  
11 customers and still earn revenues well above  
12 levels found adequate by the Board. Earlier  
13 today, Mr. Hamberger said that price controls are  
14 universally objected to by economists because the  
15 introduce marketplace distortions. Well  
16 differential pricing also introduces marketplace  
17 distortions. Something needs to be done about  
18 excessive differential pricing of rail rates and  
19 it's a lot easier to grapple with the issue of  
20 how to deal with those after a railroad attains  
21 long-term revenue adequacy.

22           The railroads have argued that the

1 goal of STB rate regulation should be rates on  
2 captive traffic that mimic rates charged in the  
3 competitive marketplace. Professor Kalt said, I  
4 believe I'm quoting here, "the goal is to push  
5 prices to levels they would have if there were  
6 competition". A revenue adequacy constraint that  
7 only applies to reduce most differentially higher  
8 future increases in rates on captive traffic  
9 cannot achieve this goal. To achieve this goal,  
10 we need revenue adequacy constraint that goes  
11 farther and also enables captive shippers bringing  
12 rate challenges to seek reductions and  
13 differentially higher base rates when some or all  
14 of the differential is no longer needed because a  
15 railroad's revenues significant exceed long-term  
16 revenue adequacy.

17 Now, a lot of the discussion this  
18 morning seems to assume that revenue adequacy  
19 meant the railroad was barely at revenue adequacy  
20 and was therefore in danger with any loss of  
21 revenues of dropping below that line. That's not  
22 the reality. The reality more and more is that

1       railroads are significantly above revenue  
2       adequacy and the question becomes whether, to  
3       what extent the Board should continue to promote  
4       the, well the statute talks about the attainment  
5       of revenue adequacy. The statute doesn't say  
6       it's the responsibility of the Board to promote  
7       railroads achieving more than revenue adequacy.

8               Now, let's assume there needs to be  
9       some wiggle room here to be on the safe side. At  
10      some point, the amount by which railroad revenues  
11      exceed revenue adequacy calls for some action and  
12      that's the point, I think, at which this second  
13      aspect of the revenue adequacy constraint  
14      deserves your attention. There would still be a  
15      bias in the railroad's favor. As noted above,  
16      relatively few captive shippers are able to seek  
17      relief and many who could file rate cases with  
18      some hope of success will never take that step.

19             In addition, the jurisdictional  
20      threshold of one hundred eighty percent of  
21      variable costs means that significant  
22      differential pricing for railroads is built in



1 and will always be beyond the reach of regulatory  
2 remedies. However, this fact is not a reason to  
3 avoid fuller implementation of the revenue  
4 adequacy constraint. On the contrary, it's a  
5 reason to discount the railroad's alarmist claims  
6 of financial disaster if there is any change in  
7 the status quo.

8 Various shipper groups have put  
9 forward various ways of implementing the revenue  
10 adequacy constraint. In the rail transportation  
11 of grain rate regulation review proceeding,  
12 Arcadell (phonetic) made proposals to deal with  
13 these issues which we reiterated in our comments  
14 in this proceeding. Basically we recommended a  
15 two benchmark approach that eliminates the  
16 problematic RBC comp benchmark. As we ready it,  
17 the RBC comp benchmark is designed to preserve  
18 demand based differential pricing. We're not  
19 sure that that makes a lot of sense once  
20 railroads have achieved long-term revenue  
21 adequacy. The other problem we have with the RBC  
22 comp benchmark is it seems to be a way of

1 preserving, protecting from regulation entire  
2 rate structures where the same rates are being  
3 charged, for example, to wheat shippers across  
4 Montana. But, having spoken to those issues at  
5 the Board's recent hearing on June 10th, I don't  
6 want to spend a lot of time repeating ourselves  
7 at this hearing. I would say that, I like Vice  
8 Chairman Begeman's point that the how of this  
9 part of the revenue adequacy constraint might  
10 need to be developed over time as SAC was. One  
11 way to allow that to happen would be to, for the  
12 Board to say that the second part of the revenue  
13 adequacy constraint, the idea of constraining  
14 base rates, now the variables have said that,  
15 have called this a rebate. Their idea is that  
16 you would take every dollar they make in the  
17 future and give it to captive customers.

18 That's actually not what we have in  
19 mind. What we have in mind is getting at the  
20 differential between captive and non-captive  
21 shippers so that those rates are, there is less  
22 of a competitive disadvantage for the captive

1 customers. To the extent that that differential  
2 is gone, the railroads are free to keep every  
3 dollar they can make and God bless them. We want  
4 the railroads to succeed and make lots of money.  
5 We just think the time has come for them to give  
6 the captive shippers who for 35 years have been  
7 helping them achieve revenue adequacy, a little  
8 relief.

9           It may take a while for the way, the  
10 means of doing that to work itself out but if it  
11 were, if shippers were allowed to bring those  
12 cases, those issues could be worked out case by  
13 case as shippers develop approaches to dealing  
14 with a base rate, the differential pricing in  
15 past base rates issue. You also have limitations  
16 issues that would preserve much of the  
17 differential pricing the railroads have enjoyed  
18 over the years. The Board can and should pursue  
19 a revenue adequacy constraint that does two  
20 things. First, writing in future rate increases  
21 and second, offering the possibility of  
22 challenges to excessive differential pricing and

1 base rates by railroads whose rates are now and  
2 will continue to be above revenue adequacy over  
3 the long term. SSAC and three benchmark, due too  
4 little to restrict differential pricing by  
5 revenue adequate railroads for the vast majority  
6 of captive shippers.

7 Finally, the Board asked whether this  
8 problem might be alleviated through expanded  
9 competitive access remedies. The answer is yes  
10 but only if expanded access through switching or  
11 otherwise actually produces effective competition  
12 as opposed to the appearance of competition. If  
13 that happens, no rate case would be filed. The  
14 railroads would have the Board believe that a  
15 shipper with access to two railroads should never  
16 be able to show qualitative market dominance no  
17 matter how high its rates. The statute in case  
18 law show why such claims are false.

19 At CF Industries decision upholding  
20 the Board's application of the revenue adequacy  
21 constraint, the DC circuit listed a number of  
22 agency and court decisions holding that for rates

1       above 180 percent of variable cost, the statutory  
2       test of captivity is the absence of effective  
3       competition. Effective competition doesn't mean  
4       having access to two railroads. Effective  
5       competition is competition that keeps rates  
6       reasonable. ARC, et al, supports action in EP-  
7       711 to improve access remedies that have long  
8       been provided in the statute. However, such  
9       remedies, even if made available will not obviate  
10      the need for other regulatory remedies including  
11      rate remedies under CMP. Many captive shippers  
12      are simply too far from any second railroad,  
13      especially in Montana and other large western  
14      states for excess remedies to produce effective  
15      competition. Even if a second railroad were able  
16      to provide alternative service subject to a  
17      reasonable access fee, the result would not be  
18      effective competition if the two railroads  
19      elected not to compete on price or if they both  
20      charged excessive rates.

21                   Railroads like to cite contestable  
22      market theory under which the possibility of a

1 new entrant might keep an incumbent from charging  
2 too much. Like access remedies, contestable  
3 market principals can work. But they can also be  
4 used in an attempt to shield abuses of market  
5 power from regulatory remedies. In EP-705,  
6 competition of the railroad industry, we learned  
7 of situations in which a shipper captive to one  
8 railroad built out to another at great expense  
9 only to find that the second railroad was  
10 unwilling to compete with the first.

11 The balance between STB promotion of  
12 railroad revenue adequacy and protection against  
13 excessive rates for captive shippers needs to be  
14 adjusted to meet the changing realities. While  
15 new access remedies are a step in the right  
16 direction, they are not a substitute for  
17 implementation of an effective revenue adequacy  
18 constraint.

19 I see my red light is on Mr. Chairman.  
20 I have three sentences if I could add before we  
21 go to the questions? First, there was some talk  
22 of S-808 and the importance of railroads being

1     able to invest in infrastructure. We support  
2     that. We need railroads to invest in their  
3     infrastructure and we agree with the importance  
4     of railroads being revenue adequate. No one is  
5     arguing about that. We are not trying to put a  
6     hard cap on revenues, we're just looking to help  
7     captive shippers a little bit. But I'd also like  
8     to say that I believe, through legislative  
9     history of S-808, says that Congress does not  
10    intend to change how revenue adequacy works at  
11    the STB. So I don't think that legislative  
12    effort should be grounds for not going forward  
13    with this proceeding.

14                 In addition, Professor Kalt said that  
15    there shouldn't be regulation of railroads as  
16    monopolies because the activity to public  
17    interests that gives rise to that need for  
18    regulation is withholding service as a way to  
19    drive up costs. And he says the railroads don't  
20    do that. Well, okay, to the extent that they  
21    don't, assuming they don't, I don't buy the  
22    principal. Comcast doesn't withhold service from

1 people, Pepco doesn't withhold service from  
2 people.

3 That can't be the only test of whether  
4 the, that's not the only way in which rates get  
5 driven up. Withholding service to drive up rates  
6 isn't the only way for a monopoly to drive up  
7 rates. They could do it directly. When people  
8 have no choice but to buy whatever is on offer  
9 and to pay whatever is being demanded, that's the  
10 easy way to drive up rates. Withholding service  
11 doesn't have to be part of the analysis.

12 Third, the cult apartment building  
13 analogy, I don't think we're looking to  
14 reinstitute a version of rent control for the  
15 railroad industry. On the other hand, we all  
16 know that developers all over America are being  
17 asked to build in their high priced apartment  
18 buildings a handful of units that teachers and  
19 cops and nurses can afford to buy. I think if  
20 you want to look for an analogy in the apartment  
21 world, the analogy would be the railroads being  
22 able to charge whatever they like for the mass of



1       their customers who are non-captive shippers but  
2       having some constraints on their ability to  
3       continue differentially pricing the small amount  
4       of traffic they have that's captive. Thank you  
5       and we'll try to answer your questions.

6               MR. ELLIOTT: Thank you.

7               MS. BEGEMAN: Mr. Nelson, I'll give  
8       you an option of when you would like to answer  
9       this question, but I know that you said that you  
10      had given some thought to some comments that I  
11      made about SAC or it sparked some ideas that you  
12      wanted to share. The hour is getting late and we  
13      do have another panel, and I know you're on  
14      tomorrow morning's panel so if you would like to  
15      wait and tell me then, but I don't want you to  
16      not have the opportunity.

17              MR. NELSON: If the Board would prefer  
18      that I wait, that's fine or I can try to make a  
19      quick hit at it right now, either way.

20              MS. BEGEMAN: Why don't you try to  
21      make it quick.

22              MR. NELSON: At the time SAC was

1 created, it's important to remember that the  
2 industry had had a lengthy period of not being  
3 able to attract and retain needed capital so that  
4 frequently you would have a case where the  
5 incumbent carrier in a rate challenge arguably  
6 did not have a physical plant that was anywhere  
7 near optimal for the actual mix of traffic that  
8 was being moved. SAC was not

9 MS. MILLER: Mr. Nelson, could you get  
10 closer to the mic?

11 MR. NELSON: Oh, sorry. SAC  
12 originally was not intended to be an overall  
13 earnings test but rather a test of cross subsidy  
14 so that when there was a revenue inadequate  
15 railroad, it would still provide a place to draw  
16 a line where you'd stop the differential pricing  
17 but it would be on cross subsidy grounds, not on  
18 overall earnings grounds.

19 It's not an earnings test. It has an  
20 earnings test in it but the earnings test is  
21 applied to the hypothetical new entrant that  
22 would serve only the part of the system that's

1 needed to move the issued traffic and I think it  
2 involved an assumption that a new plant and  
3 equipment would be needed because of the presence  
4 of the actual plant wasn't optimal or anywhere  
5 near optimal.

6           There were impaired assets that  
7 wouldn't be economical to ever replace. So, it  
8 was conceived as a way to deal realistically with  
9 the situation that existed with the capital stock  
10 at the time so that the shipper could get the  
11 benefit of the efficiencies that the railroad  
12 eventually would implement as the railroads  
13 became better able to attract and retain capital.

14           One of our proposals in rate cases is,  
15 with the attainment of revenue adequacy, the  
16 Board should consider sort of going the opposite  
17 direction from what the railroads are talking  
18 about because now if they are revenue adequate,  
19 it's reasonable to assume that they are making  
20 the optimal decisions on the physical plant so  
21 that the mix that they have of new and  
22 depreciated, used equipment is approximately what

1 a shipper would want to be able to rely on in a  
2 challenge and there is no reason to presume, as  
3 there was back at the time SAC was created, there  
4 is no reason to presume that the plant that is  
5 there is not reasonably efficient to handle the  
6 traffic. Does that sort of get at what you were  
7 asking?

8 MS. BEGEMAN: No. And I don't know  
9 that I was asking, I was really just sort of  
10 commenting about some of my frustrations with the  
11 process and I may not have been as articulate as  
12 I could or should be, or maybe I really shouldn't  
13 be articulate about the matter. As Deb  
14 described, we understand on one level why SAC is  
15 considered the gold standard, and approved by the  
16 courts. The economists think highly of it. But  
17 to see it in practice, not even so much from the  
18 two parties perspective but internally, I just  
19 feel that there is more subjectivity to the calls  
20 than I would like to see, and if there were a way  
21 to --

22 MR. NELSON: And I think --

1 MS. BEGEMAN: -- and I think, I know  
2 that the Chairman contracted with folks to try to  
3 look at the process. Maybe there is a way that  
4 we can improve it. I'm going to remain hopeful.  
5 SAC isn't going to go away any time soon.

6 MR. NELSON: I think from ...

7 MS. MILLER: Mr. Nelson, could I ask  
8 you a follow-up question?

9 MR. NELSON: Sure.

10 MS. MILLER: So, when you were  
11 describing then saying that SAC at that time  
12 originally the railroads didn't really have a  
13 physical plant adequate to serve the shippers  
14 needs, are you saying that that drove a lot of  
15 the development of the SAC process and that SAC  
16 was appropriate under that circumstance but not  
17 appropriate today?

18 MR. NELSON: No. I'm saying the  
19 reliance of SAC on sort of replacement costs or  
20 an assumption that all new capital stock would be  
21 ...

22 MS. MILLER: Oh, that's where that

1 concept came from.

2 MR. NELSON: Yes, I believe that's  
3 where that came from and why that may no longer  
4 even be necessarily an appropriate assumption  
5 going forward and I think the rail parties, at  
6 least from my perspective they've kind of  
7 overstated the transfer ability of SAC as a cross  
8 subsidy test to make it into an overall earnings  
9 test that has to rely on replacement costs. That  
10 just seems like a reach to me.

11 MS. BEGEMAN: Mr. Cutler, one of the  
12 things that you said towards the end jumped out  
13 at me. You said you're really just trying to  
14 help the captive shippers a little bit.

15 MR. CUTLER: Right.

16 MS. BEGEMAN: So that comment  
17 contrasts with what the rail industry witnesses  
18 are saying about what the shippers are seeking.  
19 It's night and day.

20 MR. CUTLER: I know. I think some of  
21 it may be talking past each other. I think  
22 that's a lot of that going on in this proceeding.

1       Some of it is, I mentioned at the grain rate  
2       hearing that it was remarkable to see the TRB  
3       study talk about fairness to shippers. I don't  
4       usually see economists talk about fairness. It's  
5       just, nothing against economists but it's just  
6       not to be quantifiable or on their radar screens.  
7       But, the captive shippers have had a lot to do  
8       with the railroads getting where they are today.

9               Now, the railroads are charging more  
10       compensatory prices to non-captive shippers as  
11       well but let's face it, those differentials  
12       between captive rate and non-captive rates have  
13       been substantial and persistent, have persisted  
14       for many years. My question, which is that of  
15       many other shippers is to what extent is it still  
16       justifiable to have similarly situated shippers,  
17       one of which has truck competition and the other  
18       which doesn't who may be competing with each  
19       other and have the poor schmo with no truck  
20       competition, no access to trucks for his freight,  
21       paying substantially higher rates than all the  
22       more fortunately situated shippers of the same

1 commodity who have truck transportation.

2           Isn't it time, once the railroads are  
3 making not just revenue adequacy but more than  
4 revenue adequacy, more than they need to invest,  
5 to expand, to do all the things that they want to  
6 do and that we want them to do. Isn't the ideal,  
7 we keep hearing this from the railroads, if the  
8 ideal is to push the rates to what they would be  
9 if there were competition, doesn't that mean  
10 weaning the railroads off of differentially  
11 pricing captive freight. Not to just give  
12 captive shippers free transportation or cheap  
13 transportation but to give them the same kind of  
14 rates that the rest of the industry therein gets  
15 by virtue of having more competition available to  
16 them. That's what I'm getting at. And if you  
17 can accomplish that result without hurting the  
18 ability of the railroads to invest, or keep their  
19 shareholders happy or expand, and I think the  
20 railroad's future is extremely bright, the  
21 trucking industry is their principal competitor  
22 and the trucking industry has got all sorts of



1 problems with driver shortages, regulatory issues  
2 and so forth.

3 I think the railroads are going to  
4 continue to grow. I think they are going to  
5 continue make money. They are going to continue  
6 to have plenty of money to invest. Why, in such  
7 a future, where the railroad is just not at but  
8 well above revenue adequacy, what's the rationale  
9 for preserving these competitive disadvantages on  
10 shippers who have less, have fewer competitive  
11 options.

12 Now, the railroads are right, the idea  
13 of going into this new territory raises difficult  
14 questions of implementation. It will take a lot  
15 of time to figure out how to do this well but if  
16 the railroads really are consistently well above,  
17 and some of them are, out west particularly, BNSF  
18 and UP particularly, if they are consistently  
19 fourteen, fifteen plus percent with the cost of  
20 capital at ten percent or more, why not, if the  
21 ideal is push the rates to where they would be if  
22 there were competition. Why not do that? Why

1 settle for only not making things worse through  
2 the WCTL approach to revenue adequacy that's  
3 limited only to not letting differential pricing  
4 get more differential in the future once a  
5 railroad becomes revenue adequate. Why not  
6 proceed to the second aspect of that issue. Now,  
7 when I first started working this proceeding, I  
8 kind of was where WCTL is but the more I read  
9 coal rate guidelines and the more I focused on  
10 those principals that we quoted, the more I  
11 thought well wait a minute, of course, we should  
12 have WCTL type revenue adequacy constraint.  
13 Everybody should be able to agree on that one but  
14 don't these words suggest the need for more than  
15 that and doesn't fairness suggest the need for  
16 more than that? That's what led to sort of the  
17 second phase of revenue adequacy, of our approach  
18 to revenue adequacy constraints.

19 MS. BEGEMAN: Thank you.

20 MS. MILLER: So I'm curious if any of  
21 you would like to comment on this issue of  
22 replacement costs, what the impact of that would

1 be, what your interpretation or definition is of  
2 the term replacement costs?

3 MR. CUTLER: Not us Commissioner  
4 Miller. We haven't done the analysis to be able  
5 to speak intelligently to that one, I'm sorry.

6 MS. MILLER: Okay.

7 MR. NELSON: I'm hoping to touch on  
8 that tomorrow if that's all right.

9 MS. MILLER: Sure, that's fine. And  
10 then Mr. Cutler, you've said several times that  
11 the railroads are significantly above revenue  
12 adequacy. Are you basing that conclusion on the  
13 figures published by the Board?

14 MR. CUTLER: Yes. And I'm  
15 anticipating that the trend line is going to  
16 continue. Obviously if things change, if there  
17 is some sort of disaster and those numbers  
18 change.

19 MS. MILLER: Even looking at coal,  
20 you're still that bullish?

21 MR. CUTLER: Well, in the west, yes.  
22 In the west I am. Now BNSF is hauling a lot of

1 coal, export coal, Terry could you?

2 MR. WHITESIDE: Not yet, but they're  
3 working on it. I will say this that the farm  
4 producers when I've sat down and explained  
5 replacement costs to them have decided that that  
6 would be a great revenue model for the farms.

7 MR. CUTLER: Of course the other thing  
8 that's happening out west is sand and oil.  
9 That's a dramatically growing business and  
10 intermodal. I go back long enough to when  
11 intermodal rail was a lost leader and shipper  
12 counsel like me were complaining that these rates  
13 weren't even at variable cost and there should be  
14 an adjustment, a regulatory adjustment to reflect  
15 that fact. But intermodal is growing by leaps  
16 and bounds and a lot of the intermodalist Asian  
17 freight, carried by UP and BNSF from the west  
18 coast. So I continue to think the future is very  
19 bright for the railroad industry.

20 MS. MILLER: And then finally, would  
21 any of you want to comment, you certainly  
22 addressed this but I'm wondering if you would

1 want to comment. What we heard from the railroad  
2 representatives that testified today is that the  
3 concept of railroads obtaining revenue adequacy  
4 doesn't mean anything should change about the  
5 regulatory structure.

6 MR. CUTLER: Oh yes, well, two things.  
7 We disagree with that for reasons I just  
8 explained, I think, in the discussion with Vice  
9 Chairman Begeman. I guess Ray Atkins put the  
10 question the most baldly is that he effectively  
11 admits the revenue adequacy constraint is there.  
12 He doesn't really go into the history or the fact  
13 that the railroads have been talking about the  
14 importance of revenue adequacy for 30 years and  
15 have been getting the benefit of the doubt in STB  
16 proceedings for thirty years but he just comes  
17 right out and says yes, it's there but thinking,  
18 the economic thinking has changed and people like  
19 him say it's a bad idea. So you should abandon  
20 the railroad-adequacy constraint. That leaves  
21 SAC, that leaves SAC, simplified SAC and three  
22 benchmark, and those are not working. We need

1 something, I mean one of you said it would be  
2 nice if there were a black box that does what SAC  
3 is supposed to do and does it fairly and in a way  
4 everybody can accept as sound. Now, once again I  
5 go back to the days when SAC case after SAC when  
6 the shipper won, and these were Utility Coal  
7 cases came in at less than one hundred eighty  
8 percent of variable cost. The most recent SAC  
9 case didn't come in at one hundred eighty percent  
10 of cost or one hundred eighty percent of variable  
11 cost or less. I think it was two hundred forty  
12 or something with Western Fuels case, but let's  
13 think about the final offer arbitration that  
14 Canada has. Terry tells me that grain rates in  
15 Canada are below one hundred eighty percent  
16 earned cost.

17 When the Staggers Act was initially  
18 enacted, that one hundred percent compromise was  
19 actually, I think it was one hundred sixty  
20 percent, and then one hundred sixty-five and it  
21 gradually grew over several years to one hundred  
22 eighty and then stayed at one hundred eighty.

1 That builds in a lot of differential pricing. At  
2 that time the analysis by Congress was that if  
3 every shipment could produce one hundred fifty  
4 percent of variable cost the railroads would be  
5 revenue adequate, and frankly, I hadn't thought  
6 about it before, but that aspect of the  
7 legislative history of the Staggers Act may be  
8 relevant to this proceeding.

9 MR. VON SALZEN: If I could just add,  
10 and I agree with all of that, but, you know,  
11 there are hard questions in this proceeding. I'm  
12 awfully glad that I don't sit up where you are  
13 and have to decide them. All I have to do is  
14 make arguments about one side or the other. But  
15 there's one question that's very easy and that's  
16 the question of whether the railroads are right,  
17 that now you should just continue to do what  
18 you've always done. Now look, the statute  
19 required you, and before you the ICC, to make an  
20 adequate and continuing effort to assist the rail  
21 carriers in attaining revenue adequacy. That was  
22 one of the things that you were required to do.

1 I don't think the railroads have been in here  
2 over the last thirty-five years complaining that  
3 you weren't doing that, so I have to exercise the  
4 assumption that that's what you've been doing.

5 And if that's what you've been doing and now  
6 you've succeeded, you're like the builder who's  
7 got a contract to build a ten-story office  
8 building or an apartment if we want to go back to  
9 that analogy. When he gets to the tenth floor he  
10 stops. He doesn't keep building. In your case,  
11 it's not that you're going to stop with the  
12 railroad industry, but you're going to stop  
13 helping them attain revenue adequacy because  
14 you've already done that. And then the heart ---  
15 and exceeded. Right. So then the hard question  
16 is where do you go from here? We've tried to,  
17 more in our written presentations, I think that  
18 we've been able to do orally here, we've tried to  
19 suggest courses of action that you could take  
20 that would improve that situation. And I think  
21 all of the shipper parties that have been in this  
22 proceeding today and probably the ones who will



1       come in tomorrow, whether you agree with their  
2       proposals or not they've been making good-faith  
3       proposals to deal with a real issue. And it's  
4       the railroad and their officers and their  
5       economists who have been coming in here and  
6       saying you don't have to do anything, business as  
7       usual, don't change anything. Ignore the fact  
8       that after 35 years we've achieved revenue  
9       adequacy, and that's a statutory goal that's been  
10      achieved. That's the thing that I would urge you  
11      to reject in your deliberations about this  
12      matter.

13               MR. ELLIOTT: Mr. Whiteside, I had a  
14      question. I was here for the last hearing but I  
15      wasn't sitting up here. As far as the farmers,  
16      I've talked to you many times about their  
17      concerns. If they have brought a case that we  
18      could make simple enough that would work for  
19      them, what kind of money are we talking about  
20      here for the kind of farmers that you're looking  
21      out for? Are we talking millions? Are we  
22      talking hundreds of thousands, and if so, what do

1 we need to do to simplify the cases so that they  
2 can actually bring them?

3 MR. WHITESIDE: Per farm? Is that  
4 what you're asking?

5 MR. ELLIOTT: Yeah.

6 MR. WHITESIDE: Farms vary in size.

7 MR. ELLIOTT: Sure.

8 MR. WHITESIDE: And we have large,  
9 very large farms in parts of the Northern Plains.  
10 They get smaller but more productive as you go  
11 south down into Kansas and Nebraska. But I think  
12 the ones that we've been dealing with in Montana  
13 and Idaho, we'd be talking about somewhere, if we  
14 could bring the rates down probably not 180,  
15 maybe 200, 220, they'd be talking about 40 or  
16 50,000 a farm, maybe 80,000. I say that and then  
17 I'm going to have them call me and say, no, it  
18 will be 120,000, but I think generally the farm  
19 production is such that if they had reasonable  
20 freight rates by today's standards we'd be  
21 talking about 80 or 90,000 a farm.

22 MS. MILLER: Annual number?

1 MR. WHITESIDE: Per year, per year,  
2 yes, ma'am.

3 MR. ELLIOTT: And then if the rates  
4 are relatively similar across the board for these  
5 farmers, I take it that it would be much easier  
6 for them to group together to bring a case?

7 MR. WHITESIDE: Yes, very much. I  
8 would almost require that.

9 MR. ELLIOTT: Okay.

10 MR. WHITESIDE: Whether we did it  
11 through an AG or whether we did it through an  
12 association, we've really talked very little  
13 about that, but there has been talk of the AG  
14 might want to bring it.

15 MR. ELLIOTT: Okay.

16 MR. WHITESIDE: And then Montana, what  
17 Idaho would do we don't know yet. So it would be  
18 one of those kind of things if we could get a  
19 reasonable chance and be able to combine them  
20 that would be heaven sent for them. And, you  
21 know, we're not talking about constant  
22 litigation. What we're talking about is the

1 possibility of maybe working with them to  
2 negotiate some more practical rates. The one  
3 thing I will say about the Burlington Northern  
4 and I said it in the last hearing, is they have  
5 been much more open since the process that you  
6 all started with data. They've been much more  
7 open with the shippers trying to work with them.  
8 And I think it was kind of a wake-up call for  
9 them. By the way I was up in Saskatchewan  
10 yesterday or two days ago when -- they have the  
11 same problems up there that we were having down  
12 here with that Canadian Railroad just not being  
13 responsive to anything that the government wanted  
14 them to do. So it was interesting when I found  
15 that out. Not that you probably needed to hear  
16 that.

17 MR. ELLIOTT: Any further questions?

18 MR. WHITESIDE: Thank you very much.

19 MR. VON SALZEN: Thank you.

20 MR. CUTLER: Thank you.

21 MR. ELLIOTT: We can have the next  
22 panel come up. It's going to be a couple of

1 minutes.

2 OFF THE RECORD

3 ON THE RECORD

4 MR. ELLIOTT: Okay. Why don't we  
5 finish up with Panel VI?

6 MR. MCINTOSH: Mr. Chairman and  
7 members of the Transportation Board, I am pleased  
8 to be here this afternoon to represent Olin  
9 Corporation and to provide comments as you  
10 explore the Board's methodology and questions  
11 around determining railroad revenue adequacy.  
12 And the revenue adequacy component used in  
13 judging the reasonableness of rail freight rates.

14 I have served as a corporate officer  
15 for Olin for sixteen years, and have nearly forty  
16 years of experience in the chemical industry.  
17 Olin Corporation is located in Clayton, Missouri,  
18 and consists today of three business segments.  
19 Winchester Ammunition, a leader in small caliber  
20 ammunition, providing ammunition to both the  
21 state and federal law enforcement to the U.S.  
22 military. The Chlor Alkali Products business, a

1 leading producer of bulk chlorine caustic bleach  
2 and other commodity chemicals in North America.  
3 MKA Steel, a distribution company. One of the  
4 largest distribution companies which is engaged  
5 solely in distributing products that are made by  
6 the typical chloric lime manufacturing process.

7 Olin is a publicly-traded company that  
8 has been listed on the stock exchange since 1917.  
9 Today I am testifying on behalf of the Chlor  
10 Alkali Products business, which is headquartered  
11 in Cleveland, Tennessee, and is one of the two  
12 chemical businesses that I have P&L  
13 responsibility for. That business has ten  
14 different manufacturing locations in North  
15 America, including locations in New York,  
16 Georgia, Tennessee, Alabama, Nevada, Louisiana,  
17 California, Washington state and Quebec. We were  
18 one of the first commercial suppliers of chlorine  
19 in the United States, and we've been involved in  
20 that industry for over a hundred years.

21 Olin has always shipped the vast  
22 majority of its commodity chemical products via

1 rail from the manufacturing sites that I  
2 previously mentioned. So rail transportation is  
3 essential to the success and viability of our  
4 business. The ability to obtain reasonable  
5 freight rates is vital, a vital component of that  
6 and so Olin sincerely appreciates the Board's  
7 effort to address revenue adequacy and rate  
8 reasonableness in today's hearing, and hopes  
9 changes will be made to the Board's current  
10 methodology. As I get through my comments I hope  
11 to provide you some sense of why that's so  
12 important to us.

13 As Olin has previously expressed in  
14 its comments to the Board in this matter, there  
15 is a clear disconnect between current methodology  
16 and determining revenue adequacy in the current  
17 financial state of the rail industry. And I know  
18 you've heard that before. It's been noted by the  
19 Senate Committee on commerce and science in  
20 reports and assessments of the industry dating  
21 back to November of 2013. In that report it said  
22 that the performance of the Class I railroads is

1 at its strongest since the passage of the  
2 Staggers Act. A simple review of stock prices  
3 and corporate activity clearly supports the  
4 undeniable financial success of the rail  
5 industry. However, despite this profitability  
6 the four Class I railroads have chosen to use the  
7 revenue to pay dollars to shareholders, to pay  
8 dividends and to invest in their system.

9 As part of a public company I don't  
10 dispute the necessity of investing and paying  
11 dividends and rewarding shareholders. I am just  
12 pointing out what we perceive to be an imbalance  
13 in the actual results that they report and some  
14 of the commentary that is made in hearings such  
15 as this, and also in one-on-one negotiating  
16 sessions with the railroads. In spite of those  
17 successes the Board's methodologies for  
18 determining the achievement of revenue adequacy  
19 and the reasonableness of rail rates has not  
20 changed. In essence, while the railroads have  
21 enjoyed that success, the enemy is for captive  
22 shippers like Olin to challenge the



1       reasonableness of freight rates remain unchanged.

2               Every one of the locations that I have  
3       mentioned that are a part of our chemical  
4       business is, in fact, a captive location, subject  
5       to the total lack of competition in all outbound  
6       rail shipments. As noted by the Board, all large  
7       rate-reasonable cases to date, nearly all, have  
8       relied upon the stand-alone cost constraint.

9       Olin has availed themselves of that, and I'll  
10      discuss our results and why they are  
11      particularly, I think, germane to these issues of  
12      this hearing in just a minute.

13             Unfortunately, for captive shippers  
14      like Olin the stand-alone cost constraint on rail  
15      rates has proven completely ineffective. For us,  
16      our experience is that's due to the expanse, the  
17      time requirements and the complexity associated  
18      with using the stand-alone rate case to try to  
19      achieve, you know, a rate relief in our current  
20      business environment. The inefficiencies of the  
21      stand-alone cost process have made rate cases  
22      almost completely inaccessible to shippers. In

1 all of the years that Olin has been a rail  
2 shipper, we have availed ourselves of a rate case  
3 one time. And I said, I'll mention that in more  
4 details in a minute. The result of this is that  
5 captive shippers like Olin, and as a point of  
6 reference, 85 percent of all chemicals  
7 manufacturing locations in North America, are  
8 captive to one rail supplier. So the result of  
9 this that captive shippers lack any meaningful  
10 counter-balance to the railroad's strong pricing.

11 So as a result, we, really, as a  
12 shipper, only have two alternatives, and neither  
13 one of them are good. We have the alternative of  
14 accepting the tariff premium that the railroads  
15 force upon us, or we can challenge freight rates  
16 under the stand-alone cost constraint system.  
17 Recognizing the cost and expense of challenging  
18 it, as I mentioned, Olin and other shippers have  
19 just avoided going to that route for challenge  
20 because it requires such a significant commitment  
21 with such extremely uncertain outcomes. Despite  
22 all of the risks associated with it, even when

1       you take on an action to try to achieve some  
2       relief, shippers really have a very limited up-  
3       side. If you win then your reward is that you  
4       get to pay reasonable freight rates for some  
5       period of time in the future. Railroads on the  
6       other hand have no down-side consequence to  
7       losing a rate case as all they're doing is  
8       returning money to the shipper that they were  
9       never actually entitled to in the first place.  
10      And considering that in order to have standing to  
11      come to the STB, shippers must pay a tariff price  
12      throughout a rate case proceeding, which can last  
13      years. The railroads are actually incentivized  
14      to prolong rate cases as long as possible.

15               Given this set of facts, it's not  
16      surprising that railroads and railroad groups  
17      oppose suggested changes to the stand-alone cost  
18      system. Let me stop here and mention briefly our  
19      experience with the stand-alone rate case. As I  
20      mentioned we've only done this once in our  
21      hundred plus years, or in the years in which the  
22      opportunity or the ability to do so in front of

1 the STB has existed.

2 We initiated in July a rate case on a  
3 single rate after we had seen a seven hundred  
4 percent escalation in that rate over the prior  
5 fifteen-year period, and at the time that we  
6 filed, pre the tariff rate that we have been  
7 paying since, the R/VC for that rate and for that  
8 route was over four hundred fifty percent. To  
9 date after four plus years we have spent twenty-  
10 five million dollars trying to secure reasonable  
11 rates. Nearly twenty of that twenty-five has  
12 been the incremental tariff rate that we have  
13 paid in order to have standing, to prosecute or  
14 file a rate case and follow it through to its  
15 conclusion.

16 The balance of that five to six  
17 million dollars has been the cost associated with  
18 the true rate case. From our perspective it's  
19 not fair. It's not simple, and it's not viable  
20 for the intent that we believe that the Board  
21 wants it to have. If it's not changed, if  
22 there's no other viable alternative, quite

1       frankly, I don't believe we'll file another rate  
2       case, because I don't believe I will be able to  
3       explain to our corporation that there is a reason  
4       to go through that process again.

5               In addition to the inefficiencies of  
6       the stand-alone cost system or cost constraint,  
7       we believe that there's no economic justification  
8       for the approach, especially as the railroads now  
9       are enjoying what we believe to be revenue  
10      adequacy. There have been, and the information  
11      that we have provided is part of our comments to  
12      papers, been several analyses of failures of the  
13      stand-alone cost constraint on the basis of  
14      economic theory. Dr. Gerald Faulhaber was quoted  
15      in the concerned shipper filings in September.  
16      Dr. Faulhaber was one of the original developers  
17      of the stand-alone cost constraint. He clearly  
18      argues that in today's environment there's no  
19      justification for it.

20             In addressing the shortcomings of the  
21      application of the stand-alone cost constraint  
22      and rate reasonableness cases, all the stresses

1 we hope the Board will avoid as it looks towards  
2 options, something that isn't simple. We believe  
3 that the complexity that the current process  
4 requires you to force creates so much opportunity  
5 or so little opportunity to prevail. And we  
6 would hope to see, if there is any change in the  
7 opportunities to try to prove rate reasonableness  
8 position that the Board would avoid creating what  
9 we have heard described as a full employment bill  
10 for economists. I can say that because it's late  
11 in the day and none of them are here --- that the  
12 stand-alone cost constraint has done.

13 We've also quoted works of Dr. Pittman  
14 of the Department of Justice, and we have  
15 consistently supported revenue to variable cost  
16 as a alternative to the current stand-alone cost  
17 constraint system. In our comments Olin cited a  
18 number of past filings and sources from others  
19 that have accepted or advocated for this  
20 approach. So it's not a new concept. Again, we  
21 believe the simplicity of it would provide a much  
22 more practical means of protecting captive

1 shippers. We believe that it would incentivize  
2 both the shipper and the railroad to fix problems  
3 before they became so significant and extreme  
4 that it required, you know, the Board's  
5 intervention or participation in the resolution.  
6 And we believe that it would provide a more fair  
7 and more equitable opportunity for a shipper to  
8 be heard and to have a vehicle to get a more  
9 reasonable rate.

10           The Board has undertaken this  
11 proceeding, we believe wisely to examine the  
12 revenue adequacy constraint on Ramsey pricing in  
13 rate cases, which was adopted by the ICC.  
14 Because this revenue to variable cost ceiling  
15 could be implemented or may be implemented as a  
16 result of this proceeding, we would suggest that  
17 we believe it's not necessary for the Board to  
18 implement a formal rule-making proceeding. We  
19 believe that the 722 proceeding could provide  
20 clarity to this process of enforcing a new  
21 revenue adequacy constraint, and we strongly  
22 request the Board implement a R/VC ceiling-based

1 process. Again, we believe the profits of the  
2 railroads show that they have demonstrated and  
3 exceeded revenue adequacy, and we believe as a  
4 result of that there is a need to change the  
5 methodologies for captive shippers like Olin to  
6 be able to enforce some revenue adequacy  
7 constraint when matched up against the rail rates  
8 that we currently pay. Thank you for the  
9 opportunity to speak.

10 MS. FASELER: Hi. Good afternoon.  
11 I'm Jacqueline Faseler, DOW's Global Director of  
12 Supply Chain Sustainability, and I want to first  
13 of all thank the Board for initiating this very  
14 timely and important proceeding. I am here today  
15 to encourage the Board to develop a clear set of  
16 standards for applying a revenue-adequacy  
17 constraint in a timely and cost-effective manner.  
18 This proceeding, along with the Board's Ex Parte  
19 711 proceeding on competitive switching is  
20 critical to the global competitiveness of  
21 American manufacturing. DOW's appearance at  
22 public hearings in both proceedings is a



1       testament to their importance to the American  
2       chemical industry, which employs nearly 800,000  
3       Americans.

4               For every one of those jobs an  
5       additional six jobs are created in the U.S.  
6       economy. The American chemical industry is  
7       highly dependent upon reliable and economic rail  
8       transportation to maintain its own  
9       competitiveness on the global stage. Both EP 711  
10      and this proceeding can further this goal by  
11      enhancing competition among rail carriers, and  
12      offering meaningful remedies to protect captive  
13      shippers from unreasonable rail rates.

14             DOW operates a fleet of more than  
15      20,000 rail cars for the transport of over  
16      110,000 rail shipments annually. DOW's largest  
17      plants at Freeport, Texas, Plaquemine, Louisiana  
18      and Taft, Louisiana represent over 58 percent of  
19      DOWs origin rail shipments and are captive to the  
20      same railroad. In addition, 80 percent of DOWs  
21      shipments are captive at the destination.  
22      Because the American chemical industry pays rail

1 rates at captive locations that are twenty to  
2 thirty percent higher than at competitive  
3 locations, the level of captivity is a very  
4 important factor in its overall competitiveness.  
5 DOW previously testified in the EP 711 proceeding  
6 based on its Canadian Rail inter-switching  
7 experience that competitive switching effectively  
8 enhances rail competition to achieve commercial  
9 negotiations that improve service, routing  
10 options and rates, but even the most liberal  
11 application of the competitive-switching proposal  
12 on EP 711 will benefit only two of DOWs large  
13 captive Gulf Coast facilities.

14 DOWs largest and most significant  
15 growth facility in Freeport, Texas, would remain  
16 captive, even after the adoption of competitive  
17 switching, and would continue to depend upon the  
18 Board's rate regulation procedures to ensure  
19 reasonable rail rates. The Board's existing  
20 stand-alone cost or SAC procedures for  
21 determining rate reasonableness are uneconomical  
22 and ineffective for the vast majority of carload

1 shippers like DOW. Those procedures which were  
2 designed originally for unit-trained coal  
3 shipments require a shipper to commit several  
4 million dollars over three to five years of  
5 litigation, which does not even account for the  
6 millions of additional dollars spent on high  
7 tariff rates.

8           Unlike coal shippers, who have an  
9 enormous concentration of volume between a single  
10 origin and destination, carload shippers have  
11 hundreds of origin-destination pairs, and the  
12 only way a carload shipper like DOW can justify a  
13 SAC case economically is to combine scores of  
14 lanes into a single case of even greater  
15 magnitude and complexity than a coal case. This  
16 greater complexity increases the cost of a  
17 carload SAC case to a much higher level. This  
18 proceeding offers the prospect of a meaningful  
19 alternative to SAC to determine reasonable rail  
20 rates. The economic principle underlying rail  
21 rate regulation for the past thirty years has  
22 been that railroads must be able to charge

1 captive shippers differentially higher rates than  
2 competitive shippers in order to recover total  
3 cost. The regulatory problem to be solved has  
4 been how much more captive shippers should pay  
5 than competitive shippers?

6 In the same decision that adopted SAC,  
7 this agent's predecessor, the ICC, identified  
8 revenue adequacy as the logical first constraint  
9 on a carrier's pricing, and declared that a  
10 captive shipper should not be required to pay  
11 more than is necessary for the carriers involved  
12 to earn adequate revenues. But the ICC never  
13 specified a set of standards for applying the  
14 revenue-adequacy constraint because no rail  
15 carrier was even close to earning its cost of  
16 capital at that time. Thirty years later that  
17 time has come. UP and NS have been earning their  
18 cost of capital, and Berkshire Hathaway's  
19 acquisition of BNSF means that it has access to  
20 capital. CSX is close to earning its cost of  
21 capital for the first time.

22 I conclude my testimony by strongly

1 urging the Board to use this proceeding to  
2 provide clear guidelines to all stakeholders on  
3 the standards and procedures that it will apply  
4 to determine reasonable rates under the revenue-  
5 adequacy constraint. I also renew DOW's previous  
6 entreaties that the Board adopt new competitive-  
7 switching rules. Competitive switching would  
8 enable DOW to rely upon competition as its  
9 preferred remedy was available, while the  
10 revenue-adequacy constraint could provide  
11 meaningful regulatory protections against  
12 unreasonable rates where DOW remains captive.

13 Thank you.

14 MR. JOHNSTON: Good afternoon. I'm  
15 Eddie Johnston with the Chemours Company, an  
16 independent, publicly-traded company that was  
17 spun off recently from DuPont. Thank you again  
18 for holding this hearing. I'm appearing now to  
19 emphasize the importance of this proceeding based  
20 upon my company's experience with the rate  
21 regulatory process. As you are aware, DuPont  
22 filed a rate case against Norfolk Southern in

1       2010. Most of the traffic covered by that  
2       complaint is now part of Chemours, who was  
3       recently substituted for DuPont in the case.

4               My remarks today do not concern the  
5       substance of that case, which is still pending  
6       before the Board on petitions for  
7       reconsideration. At the time we filed the rate  
8       complaint the Board had determined NS to be  
9       revenue adequate in five of the preceding six  
10      years. More recently the Board has determined NS  
11      to be revenue adequate for eight out of 10 years,  
12      from 2004 to 2013. NS's prolonged period of  
13      revenue adequacy, even in 2010, prompted us to  
14      give serious consideration to challenging the NS  
15      rates under the revenue-adequacy constraint. We  
16      were aware of the significant time and cost  
17      associated with the SAC case. Would revenue  
18      adequacy prove any different?

19              We finally rejected the revenue-  
20      adequacy approach because it was a step into the  
21      unknown. The principle was clearly there, but  
22      without an accepted, practical way to apply it

1 the costs and the risks were unknowable and they  
2 still are. In the absence of accepted standards  
3 and procedures we would have to develop our own  
4 and then defend them against a relentless attack  
5 from NS, not to mention their opposition to the  
6 very concept of a revenue-adequacy constraint  
7 that they've articulated to you this afternoon.

8 We even considered challenging the NS  
9 rates under both the SAC and revenue-adequacy  
10 constraints, but ultimately chose the familiar  
11 standards and procedures of the SAC. Designing a  
12 SAC case around 138 movements has proven to be a  
13 Herculean task, even more challenging, more  
14 costly and more complex than expected. Even  
15 though the Board ultimately concluded that NS  
16 possessed market dominance over one hundred  
17 thirty-two of the one hundred thirty-eight  
18 movements, and despite an average revenue-to-  
19 variable cost ratio for those movements of five  
20 hundred twenty-nine percent, with ratios ranging  
21 as high as eight hundred ninety-eight percent,  
22 the Board still determined that these rates

1 published by a carrier that has earned its cost  
2 of capital for eight of the past ten years were  
3 not unreasonable. Indeed the SAC analysis would  
4 not have found DuPont's rates to be unreasonable  
5 until their R/VC ratios exceeded 6,105 percent.  
6 SAC simply does not work for shippers like  
7 Chemours.

8 I understand why the railroads regard  
9 SAC as the gold standard. It puts gold in their  
10 coffers at the expense of captive shippers, but  
11 such a result cannot be reconciled with this  
12 agency's declaration and coal rate guidelines  
13 that rates not be designed to earn greater  
14 revenues than needed to achieve and maintain  
15 revenue adequacy. DuPont could not challenge the  
16 NS rates under this revenue-adequacy constraint  
17 because there was no way to do it. Unless and  
18 until this agency adopts a clear set of standards  
19 and procedures neither Chemours nor any other  
20 similarly situated shipper will be able to use  
21 the promised revenue-adequacy constraint.

22 The uncertainty of applying this



1 revenue-adequacy constraint creates  
2 unpredictability in rate case outcomes, which in  
3 turn hinders negotiated solutions. Since all  
4 Class I railroads have approached or attained  
5 revenue-adequate status it is imperative that the  
6 Board develop standards and procedures for  
7 applying the revenue-adequacy constraint.

8 In summary, SAC does not work for most  
9 shippers, the nation's manufacturers and farmers  
10 alike. A revenue-adequacy constraint could work  
11 better, but without an accepted, practical way to  
12 apply the constraint the promise of coal rate  
13 guidelines continues to go unfulfilled.

14 Therefore, I urge you to use this proceeding to  
15 fulfill this need as expeditiously as you can.

16 Thank you.

17 MS. BEGEMAN: Thank you all for your  
18 testimony this late in the day. You mentioned  
19 you have one plant, I think, in Quebec?

20 MR. MCINTOSH: Yes, ma'am.

21 MS. BEGEMAN: Do you utilize the  
22 switching ability in Canada?

1 MR. MCINTOSH: No. We don't. No. We  
2 don't. We don't have an inter-change point or a  
3 switching point with a competitor close enough,  
4 or that makes sense for us based on the ultimate  
5 destination.

6 MS. BEGEMAN: All right. You don't  
7 have any experience there that you can share?

8 MR. MCINTOSH: No. We don't have any  
9 experience, but we have commented that we would  
10 be very supportive of something, because as we  
11 look at our United States footprint and our  
12 locations in North America we would be able to  
13 use that as, you know, at least an attempt to  
14 gain some competitive position or some  
15 competitive improvement from where we are today.

16 MS. BEGEMAN: And Mr. Johnston, and my  
17 memory may be too fuzzy on this, but I certainly  
18 can appreciate your comments that the unknown of  
19 what the revenue-adequacy constraint has meant,  
20 at least until now, even still now, but this has  
21 made you hesitant to actually bring a case under  
22 that constraint.

1 MR. JOHNSTON: Yes.

2 MS. BEGEMAN: Although I thought a few  
3 years ago you did bring a case that was settled.

4 MR. JOHNSTON: We did bring a case  
5 that was settled, but that would have proceeded  
6 as a SAC case had the case been settled.

7 MS. BEGEMAN: Oh, it was a SAC case.  
8 It wasn't a revenue-adequacy case?

9 MR. JOHNSTON: No.

10 MS. BEGEMAN: Thank you for correcting  
11 my impression.

12 MS. MILLER: So Mr. Johnston, did you  
13 say that after your case against Norfolk Southern  
14 was unsuccessful, the, you know, in doing  
15 analysis, that the R/VC ratio for you to have  
16 been successful would have had to have been over  
17 6,000?

18 MR. JOHNSTON: There was actually a  
19 range. Six thousand was the low end of that  
20 range. The upper end of the range was I believe  
21 25,000 percent.

22 MS. MILLER: Wow.

1 MR. JOHNSTON: Wow. Yes.

2 MS. MILLER: And Mr. McIntosh, you  
3 said that you estimate that to bring the SAC case  
4 it costs twenty-five million, twenty million of  
5 it really converting to the tariff. So can one  
6 conclude that the difference in what you paid  
7 under your contract rate and what you paid under  
8 a tariff rate was twenty million dollars?

9 MR. MCINTOSH: Yes, ma'am. That's  
10 correct.

11 MS. MILLER: And then over what period  
12 of time?

13 MR. MCINTOSH: Well it's been four  
14 years, a little over four years.

15 MS. MILLER: And so is that  
16 informative in terms of the sort of differences  
17 one ends up paying if you're captive and if  
18 you're unable to negotiate a contract, or did you  
19 have a sense about that?

20 MR. MCINTOSH: Two comments in that  
21 regard. We struggled to find a rate case that we  
22 could actually bring under SAC, bring forward

1 under SAC, because most of our contracts are  
2 bundled contracts. The railroads take position  
3 when you say, I'm going to challenge this rate,  
4 they say, well then you're going to tariff across  
5 this whole portfolio of routes that are part of  
6 this bundled contract. This happened to one that  
7 we did bring forward. It happened to be a stand-  
8 alone route that wasn't subject to, you know, the  
9 additional burden of having other routes ---

10 MS. MILLER: It wasn't bundled.

11 MR. MCINTOSH: -- moved to tariff.

12 That's correct. But I would say yes, this is  
13 indicative of the kind of tariff premium that we  
14 would pay. In our portfolio of, you know,  
15 freight relationships with the various Class I's  
16 we deal with, this would be indicative of what  
17 the tariff premium would be for us.

18 MS. MILLER: And would any of you, do  
19 you have anything to say about this issue of  
20 replacement cost? Is that anything you have  
21 either opinions or observations about?

22 MR. MCINTOSH: No, ma'am. I don't.

1 We have not analyzed it from that perspective.

2 MS. MILLER: Okay.

3 MS. FASELER: Yeah. DOWs a member of  
4 ACC, and tomorrow they're coming forward with the  
5 Concerned Shippers Association and they'll be  
6 talking more about that.

7 MS. MILLER: Okay.

8 MR. MCINTOSH: I think that's a  
9 question for the economists, and as I told you  
10 earlier, I'm not one.

11 MS. MILLER: They've all gone home.

12 MR. ELLIOTT: One question, I don't  
13 know if this panel is the appropriate panel.  
14 First of all I'd like to thank you very much for  
15 just coming and giving your real world  
16 experience. It's very helpful, and obviously we  
17 can hear the frustration in your voices. One of  
18 the frustrating things that you mentioned, Mr.  
19 McIntosh, was the twenty million dollars that you  
20 pay while this case is proceeding, and this may  
21 be more of a question for a lawyer, but I do see  
22 a lawyer nearby. Is there a way that the Board

1 can eliminate that premium that you're aware of?  
2 I know that there are some legal arguments that  
3 that may not be possible, but maybe Mr. Moreno  
4 should answer it unless --- I know that it's a  
5 hard thing for you. And I've heard that many  
6 times.

7 MR. MORENO: I'm not sure statutorily  
8 that there is a way, because the statute gives  
9 the railroads the pricing discretion unless and  
10 until you declare the rate to be unreasonable.

11 MR. ELLIOTT: Sure.

12 MR. MORENO: But it does emphasize the  
13 need for a more expeditious decision, because the  
14 quicker the decision comes out, the shorter time  
15 frame we're paying this rate premium.

16 MR. ELLIOTT: Thank you. That was my  
17 understanding.

18 MS. MILLER: Are you still having to  
19 pay the tariff rate, I mean, you know, now that  
20 you've sort of gotten into this position, can you  
21 get back into your contract rate or are you ---

22 MR. MCINTOSH: We have, we're

1 still paying tariff rate. You know, we have, the  
2 case is still under petition for reconsideration,  
3 and at the point in time at which it's finally  
4 decided, then, you know, we will be in a position  
5 of having unsuccessfully tried to file a rate  
6 case, having paid a tariff premium for four  
7 years, and quite frankly, when we go back to  
8 negotiate with the railroads I'm not sure from  
9 which position of strength we're going to have  
10 any ability to reduce the current rate we're  
11 paying for that, and I'll leave it at that.

12 MR. ELLIOTT: Thank you very much for  
13 coming today. Thank you all for participating  
14 today. We will be adjourned until tomorrow. We  
15 will reconvene at 9:30, so looking forward to the  
16 testimony tomorrow. Thank you very much.



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C E R T I F I C A T E

This is to certify that the foregoing transcript

In the matter of: Railroad Revenue Adequacy

Before: Surface Transportation Board

Date: 07-22-15

Place: Washington, DC

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BEFORE THE  
SURFACE TRANSPORTATION BOARD

DOCKET NO. EP 722  
RAILROAD REVENUE ADEQUACY

DOCKET NO. EP 664 (Sub-No. 2)

PETITION OF THE WESTERN COAL TRAFFIC LEAGUE TO INSTITUTE A  
RULEMAKING PROCEEDING TO ABOLISH THE USE OF THE MULTI-STAGE  
DISCOUNTED CASH FLOW MODEL IN DETERMINING THE RAILROAD  
INDUSTRY'S COST OF EQUITY CAPITAL

CONSUMERS UNITED FOR RAIL EQUITY  
WRITTEN SUBMISSION FOR PUBLIC HEARING



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Dated: July 21, 2015



Pursuant to the Surface Transportation Board's (STB) notice served May 8, 2015, Consumers United for Rail Equity (CURE) respectfully submits the following written statement for consideration in conjunction with the public hearing scheduled for July 22-23, 2015 in STB Docket Nos. EP 722 and EP 664 (Sub-No. 2).

CURE is a coalition of freight rail shippers. Through a growing coalition of industries and associations, CURE is working to educate the public on the impacts to consumers from railroad practices.

CURE is committed in helping to promote rail competition. To that end, CURE is particularly concerned that the promotion of effective rail competition and implementation of effective rate regulation has been impeded by the unfounded perception that the railroad industry has not achieved revenue adequacy on a long-term basis.

One of the goals of the **Staggers Rail Act of 1980** (P.L. 96-448) was to restore financial stability to the U.S. rail system. By all accounts, this goal has been achieved, as demonstrated by the industry's continued high levels of capital investment and shareholder returns including dividends, buybacks, and stock appreciation. In passing the **Staggers Act** 35 years ago, Congress recognized that when the rail industry achieved revenue adequacy, a more careful and thorough review of railroad rates would be appropriate.

CURE has long been concerned that the STB's annual determinations of the "revenue adequacy" for Class I carriers does not reflect the true health of the industry and its members. Further, CURE believes that the carriers' falsely perceived lack of adequate revenues has served to shield the railroads' exercise of their monopoly pricing power from STB scrutiny and prevented shippers from obtaining appropriate relief. For that reason, CURE continues to support elimination of the statutory requirement for the annual determinations.

As long as the annual requirement remains, however, the determinations should be accurate and reflect the true state of the industry. At a minimum, this should include use of an accurate cost of capital. Other evidence of financial health should be reviewed, and a comparison of return on net investment to the overall cost of capital should not preclude the consideration of additional evidence that shows that the industry and its members meet the other criteria specified in the statute for measuring revenue adequacy.

CURE strongly believes that there should be a meaningful revenue adequacy constraint on rates for captive shippers, especially for small shippers that otherwise do not have an effective path to rate relief. The Stand-Alone Cost test works only for the largest shippers, apparently only those with unit-train movements, and is very expensive to pursue. The Simplified Stand-Alone Cost test is also very expensive, offers reduced rate relief, and has been invoked only once. The Three-Benchmark approach offers limited rate relief, is not inexpensive by any means, may be ratcheted up by comparison to inflated rates paid by other shippers, faces considerable uncertainty, and has not attracted significant shipper interest.

For most shippers, the STB simply has not provided an effective means to prevent rate abuse. This should change, especially as the carriers have achieved revenue adequacy.

CURE strongly opposes railroad efforts to evaluate revenue adequacy on the basis of replacement costs. Replacement costing is inconsistent with the statutory definition of revenue adequacy in 49 USC 10704(a)(2) and the requirement for the STB to conform to generally accepted accounting principles to the maximum extent practicable in 49 USC 11141 and 11161. The use of net book value to review the adequacy of revenues is consistent with these provisions, whereas the use of replacement costs is not.

Net book value is the norm in rate regulation, and replacement costing is seldom, if ever, utilized, and for good reason, including the following: (1) replacement costing is inherently difficult to administer since values are likely to fluctuate; (2) brand new assets have higher productivity and lower operating costs, which would need to be offset against the higher capital costs; (3) ongoing renewal of assets eliminates the basis for including depreciation and also reduces the firm's risk profile; and (4) a substantial portion of the assets would not need to be replaced because replacement assets could be configured more efficiently and/or significant volumes would exit the system because the rates would not cover the costs.

In contrast, the use of standard, generally accepted accounting principles and the inclusion of capital expenditures within the asset base, at such time as the expenditures are actually made, gives the railroads ample incentives to maintain and expand capacity. Railroads are allowed to recover investments **WHEN** they are made. Railroad assets are long-lived, and there is no basis for allowing a railroad to recover costs in the years or the decades **BEFORE** investments are made – especially when there is no requirement or certainty that the funds will be invested, rather than used for dividends, buybacks, or executive compensation.

If replacement costs were utilized, it would be necessary to utilize real cost of capital to avoid a double count of inflation.

The replacement cost issue has been examined repeatedly, including by the Railroad Accounting Principles Board, and the use of replacement cost methodologies has always soundly been rejected. Given the financial strength of the railroads today, including publicly available information indicating that the railroad industry is revenue adequate, there is no plausible basis for the STB to adopt a replacement cost approach to evaluate revenue adequacy or limit the availability of rate relief.

Respectfully submitted,



David Sauer

President

CURE

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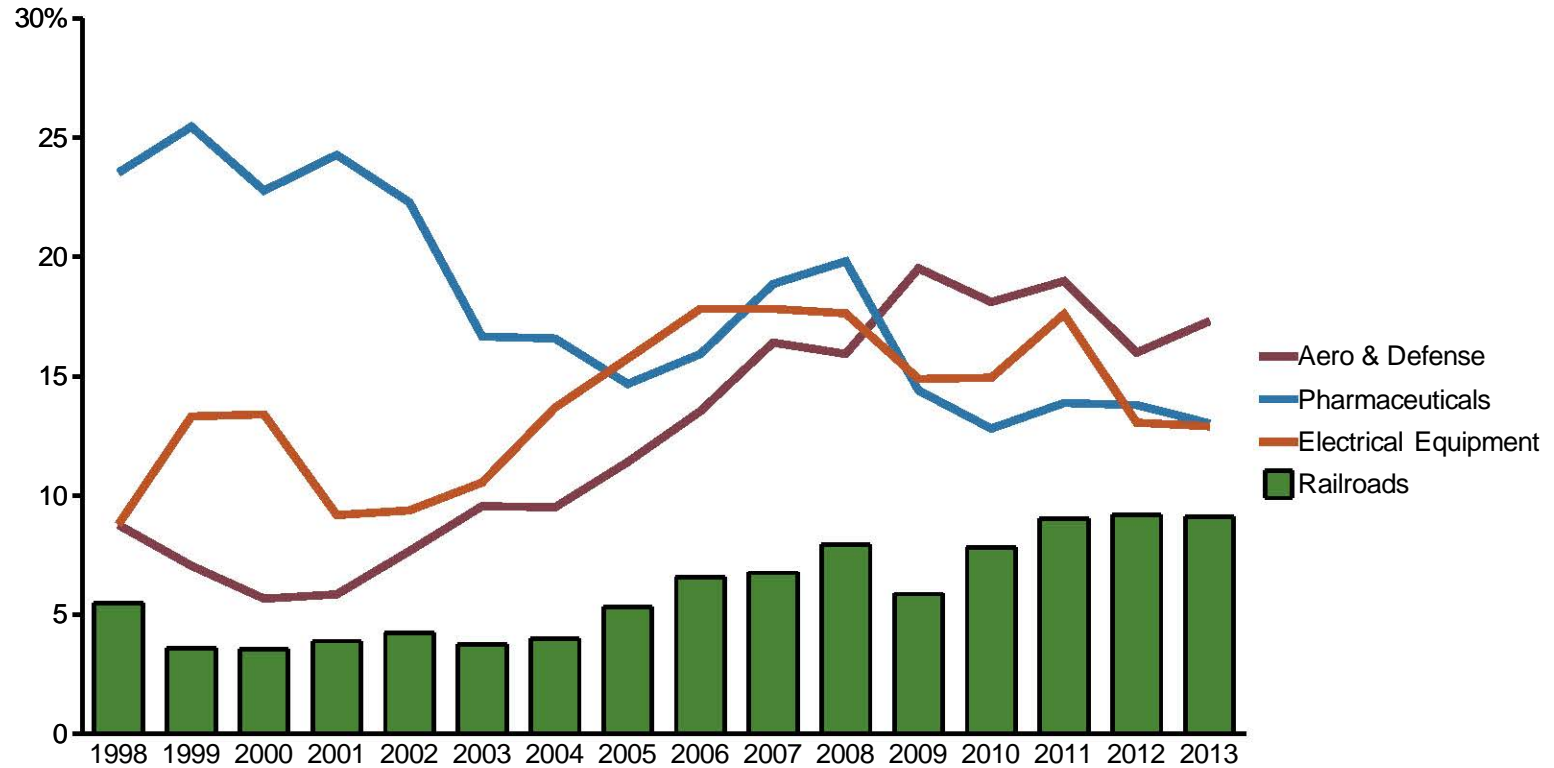
# Testimony of Roger Brinner

## On Behalf of the Association of American Railroads

EP 722 – Railroad Revenue Adequacy  
July 22, 2015

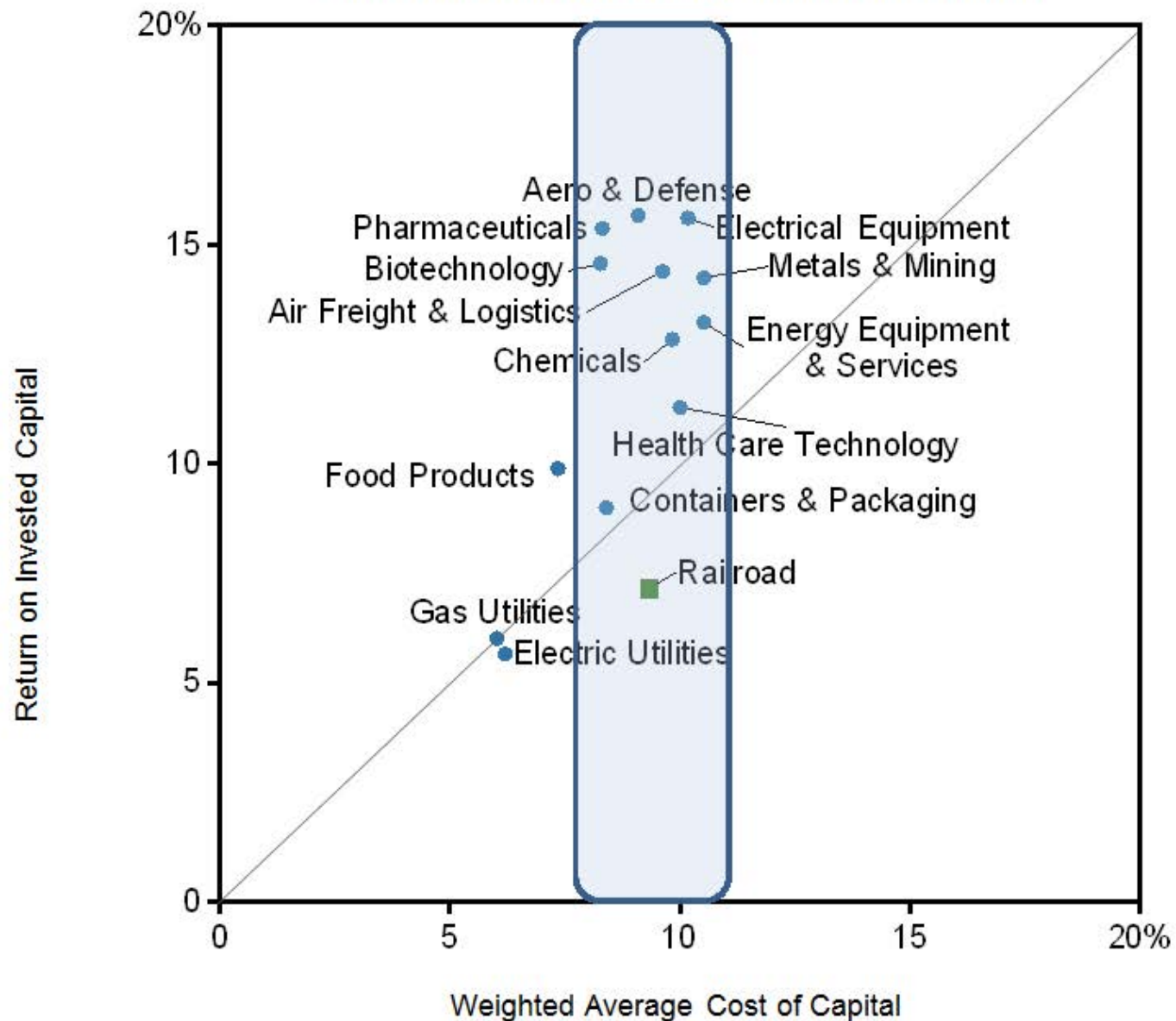
7

ROIC by Industry, 1998-2013,  
Bloomberg Calculations Assembled by Parthenon



Source: Parthenon using Bloomberg data

**Weighted Average Cost of Capital and ROIC by Industry, 10 Year Average (2004-2013),  
Bloomberg calculations assembled by Parthenon**





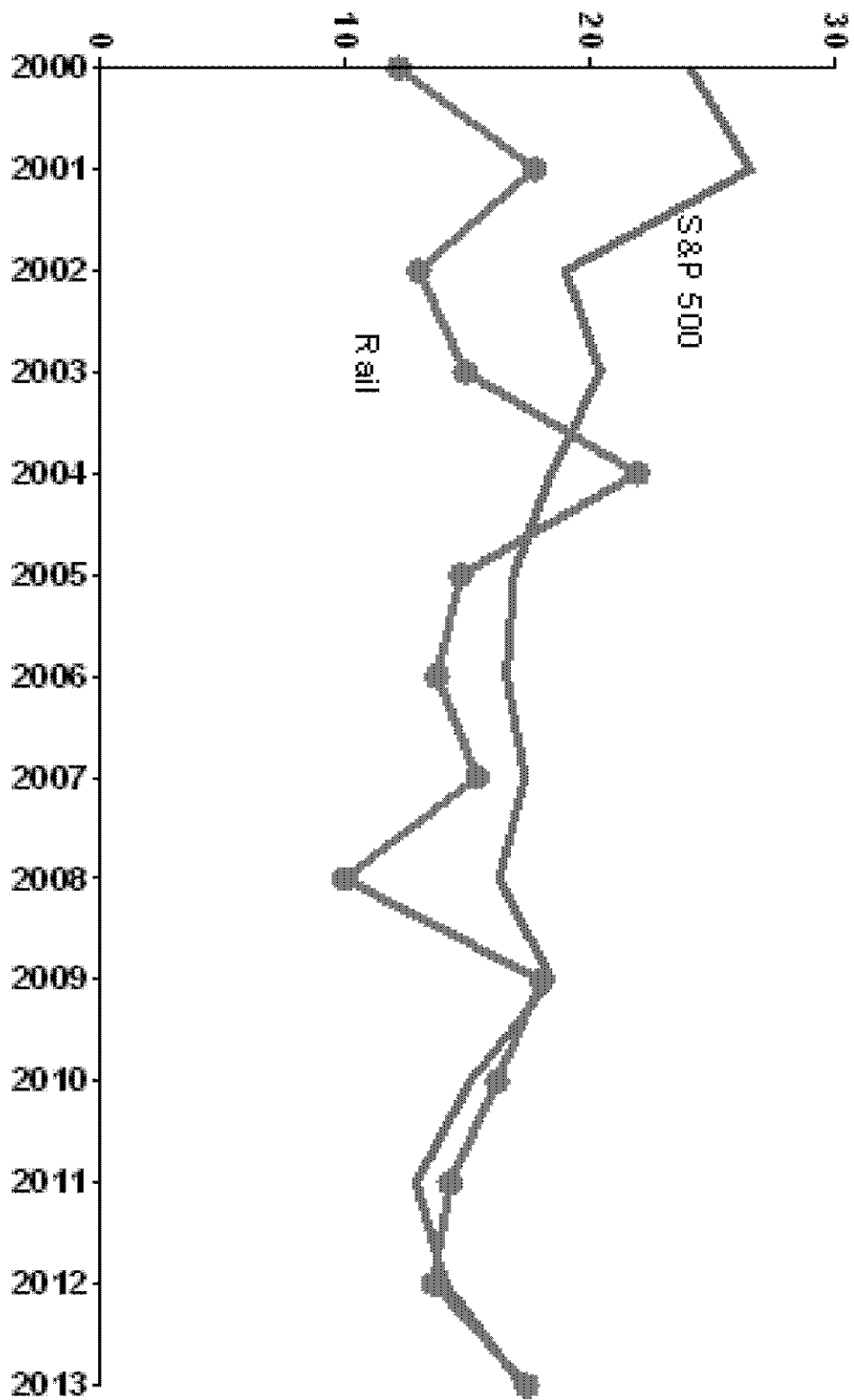
**CEO/CFO's Potential Project Investments  
(Hypothetical Data)**

<b>Project ROIC Rank</b>	<b>Project Investment (\$M)</b>	<b>Project ROIC</b>	<b>Cumulative Investment (\$M)</b>	<b>Cumulative ROIC</b>
1	\$0.70	23%	\$0.70	23%
2	\$0.50	21%	\$1.20	22%
3	\$1.00	19%	\$2.20	21%
4	\$0.40	16%	\$2.60	20%
5	\$0.80	14%	\$3.40	19%
6	\$0.60	11%	\$4.00	17%
7	\$1.10	8%	\$5.10	15%
8	\$0.20	6%	\$5.30	15%
9	\$0.70	3%	\$6.00	14%
10	\$0.80	2%	\$6.80	12%

CEO/CFO Hurdle Rate  
(equal to or exceeds  
corporate WACC) = 11%

## Price / Earnings Ratios

463



Source: Bloomberg



**Fredrik Eliasson, EVP CFO**  
**Ex Parte 722**  
July 22, 2015



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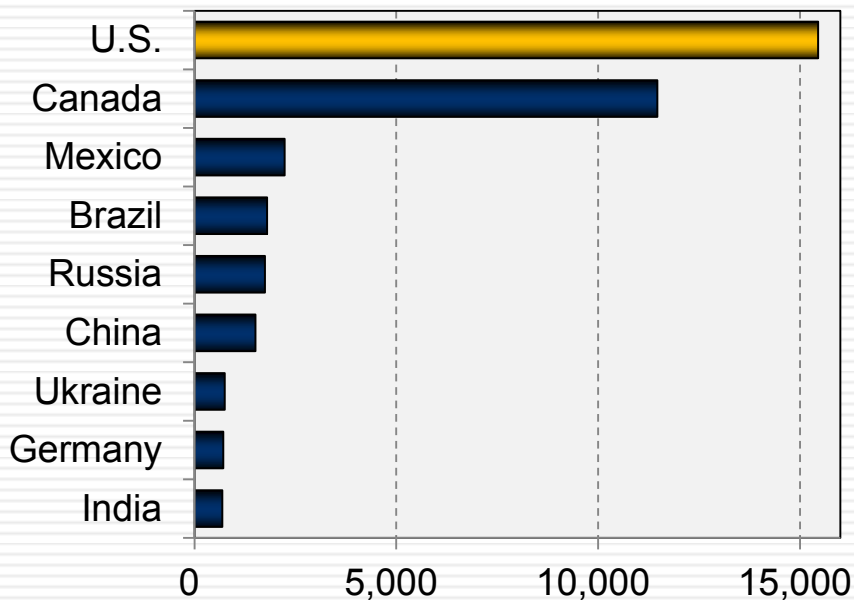
# Four pillars of any revenue adequacy policy:

- Measure Progress – Don't Constrain it
- Address Replacement Cost Imperative
- Promote Differential Pricing
- Ensure Free Market Results to Foster Investment

These pillars are essential to sound regulatory policy

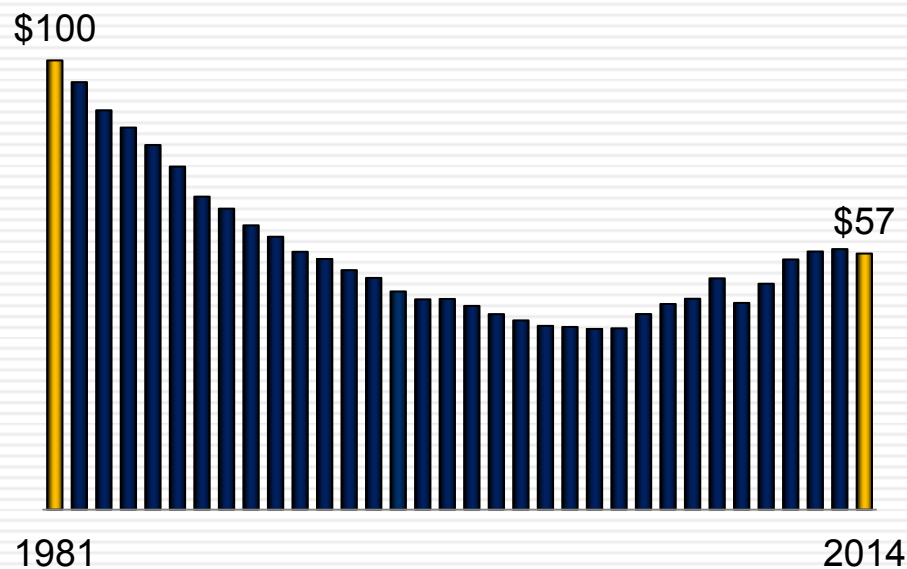
# Success of the Staggers Act since 1980

Global Railroad  
Employee Productivity<sup>2</sup>  
*Tkm+Pkm per Employee*



Globally, U.S. rails are most efficient

U.S. Freight Railroad  
Inflation-Adjusted Rates<sup>1</sup>  
*Indexed: 1981 = \$100*



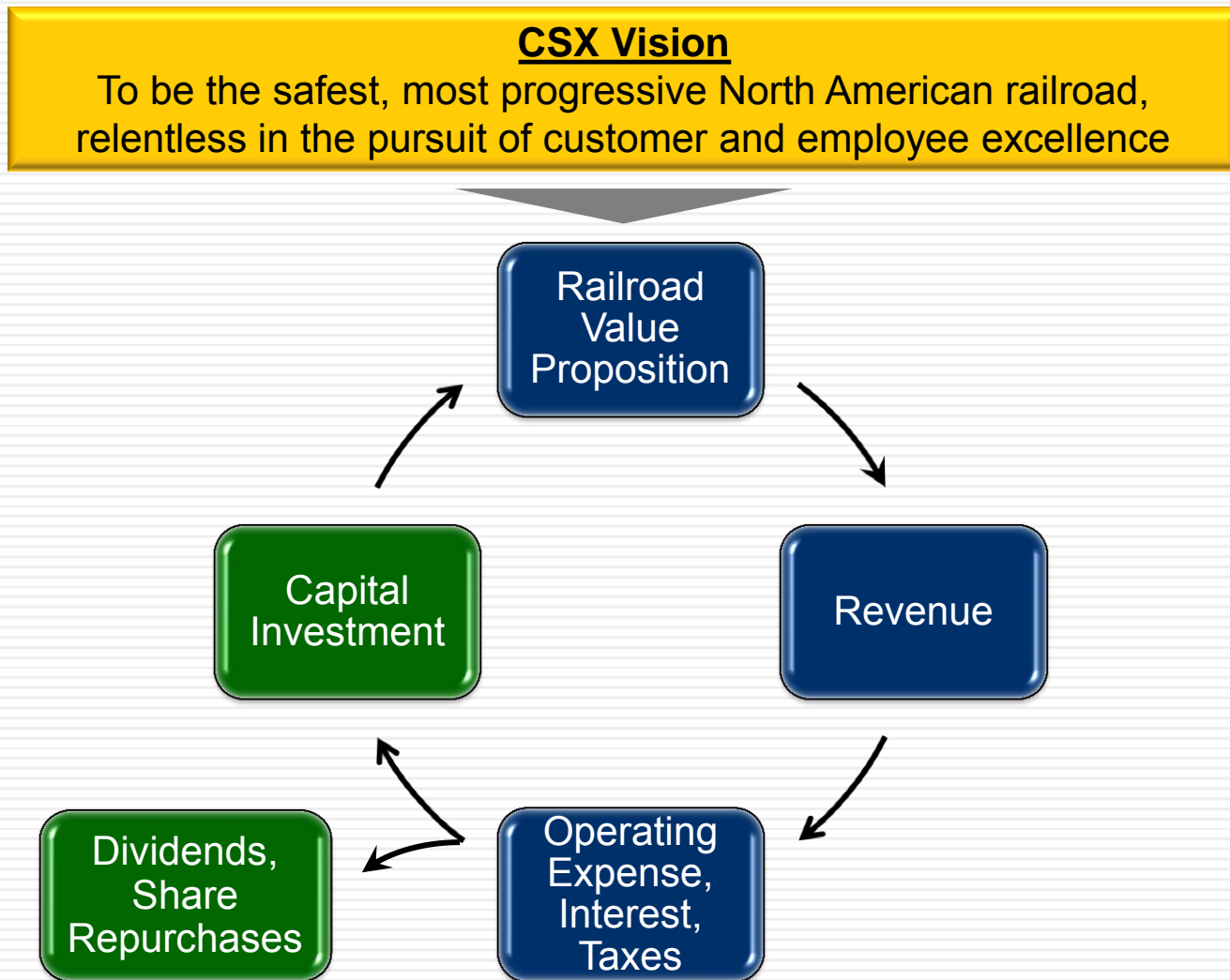
2014 rail rates 43% lower than 1981

(1) Source: Association of American Railroads, 2015

(2) Source: World Bank Railways Database, 2007

Tkm = Ton-km, refers to freight; Pkm = Passenger km, refers to passenger rail

# Value creation for shareholders and U.S. economy

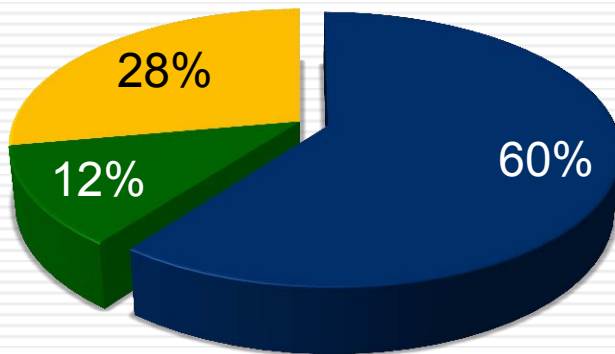


# Balanced approach to cash deployment

## CSX Cash Deployment

*2005-14 Average*

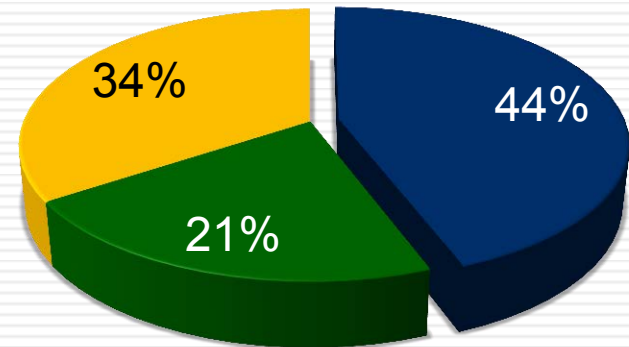
- Capital Investment
- Dividends
- Share Repurchases



## S&P 500 Cash Deployment<sup>1</sup>

*2005-14 Average*

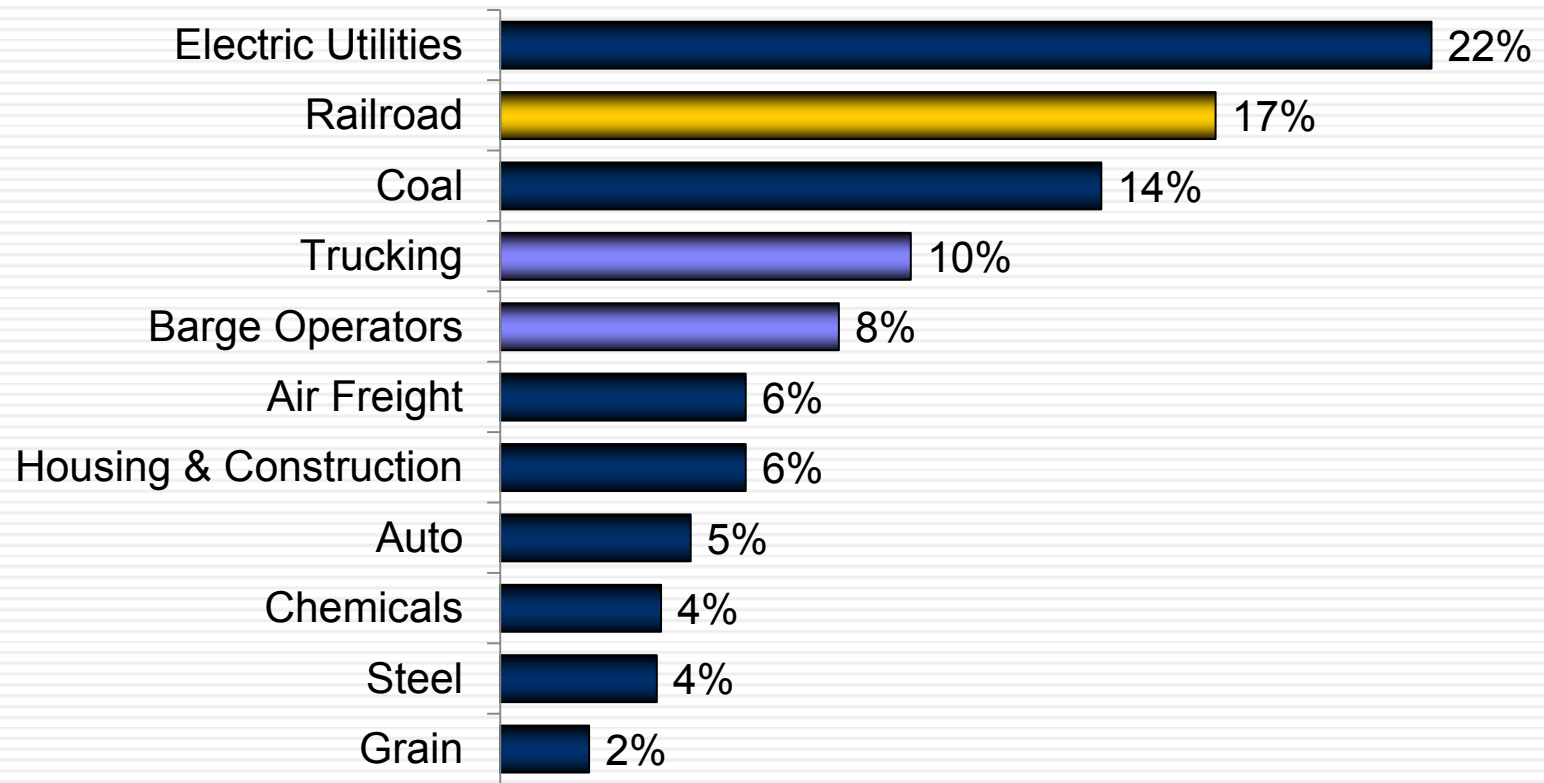
- Capital Investment
- Dividends
- Share Repurchases



(1) Source: Capital IQ, as prepared by Morgan Stanley, July 2015

# U.S. rail industry requires higher capital investment

## U.S. Industry Comparison: Capital Investment<sup>1</sup> *10-yr median Capital Expenditure / Sales*

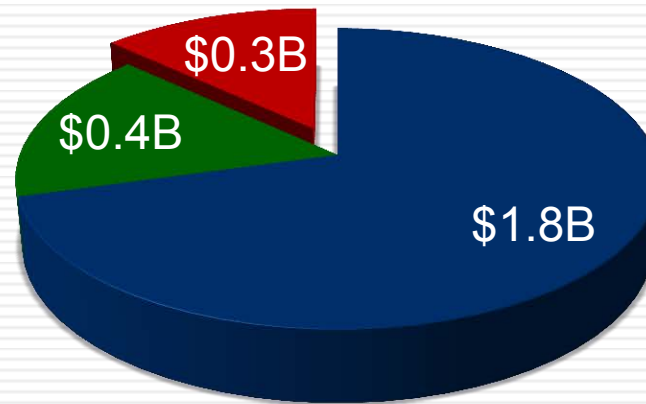


(1) Source: Credit Suisse analysis, June 2015; 10 year median from 2005-14

# Capital investment of \$2.5 billion in 2015

## CSX 2015 Capital Investment Total = \$2.5 billion<sup>1</sup>

- Infrastructure & Equipment Replacement
- Growth & Productivity Investments
- PTC & Regulatory



80%+ of capital investment in replacement and PTC

(1) Planned 2015 capital investment; actual results may differ

# Asset replacement costs are 3-4 times book value

## Track



Per Track Mile<sup>1</sup>

Depreciated Cost: \$0.4M

3x

Replacement Cost: \$1.1M

## Locomotives



Per Locomotive

Depreciated Cost: \$0.6M

4x

Replacement Cost: \$2.2M

## Freight Cars



Per Freight Car

Depreciated Cost: \$31K

3x

Replacement Cost: \$100K

# Major infrastructure costs ~40 times book value

## Bay St. Louis Bridge



Year in Service: 1967

Depreciated Cost: \$2 million

38x

Replacement Cost: \$75+ million

## Virginia Avenue Tunnel



Year in Service: Late 19<sup>th</sup> Century

Depreciated Cost: \$6 million

42x

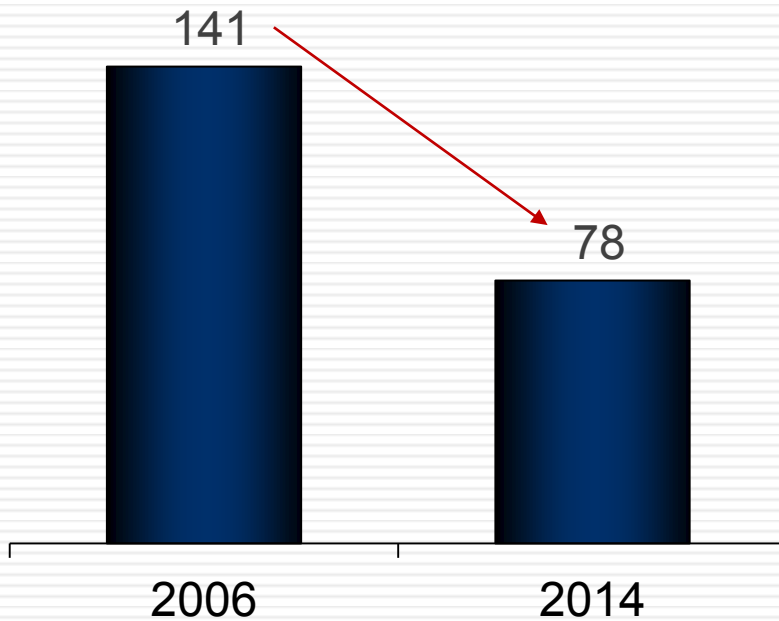
Replacement Cost: \$250+ million



# Investments aligned to evolving business mix

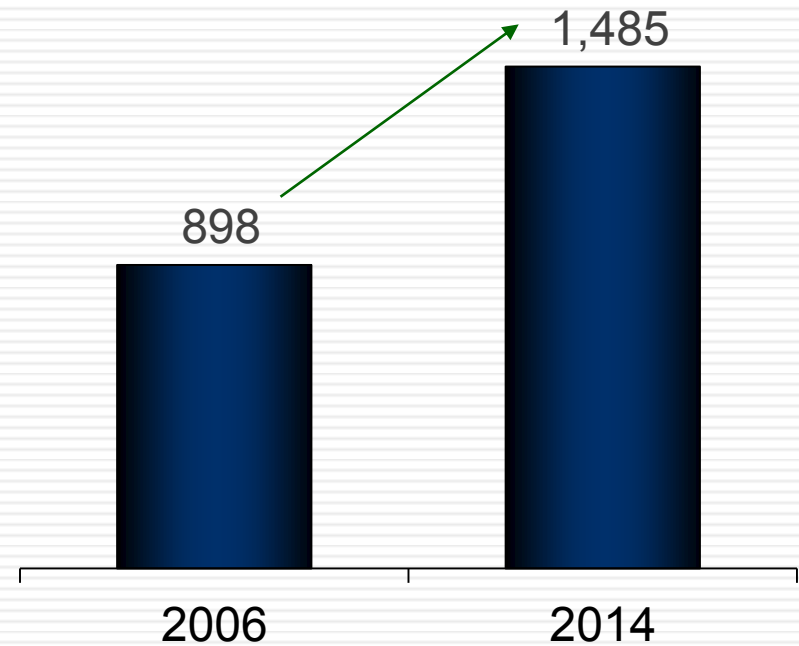
Utility Coal Volume  
*Tonnage in Millions*

(45%) Decrease



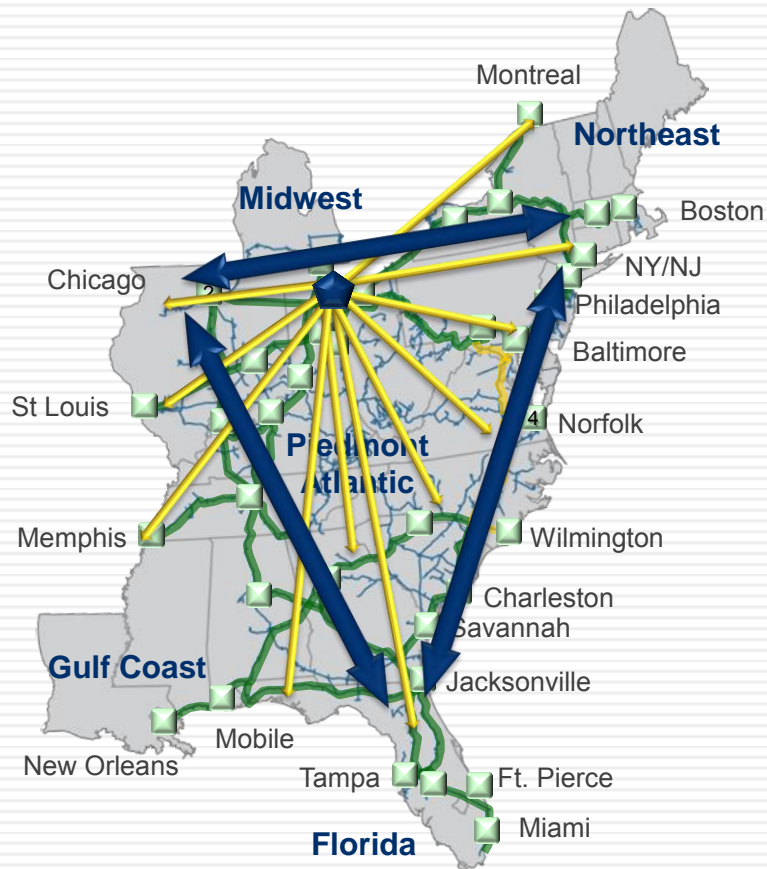
Domestic Intermodal Volume  
*Carloads in Thousands*

65% Increase



# Growth investments create public benefits

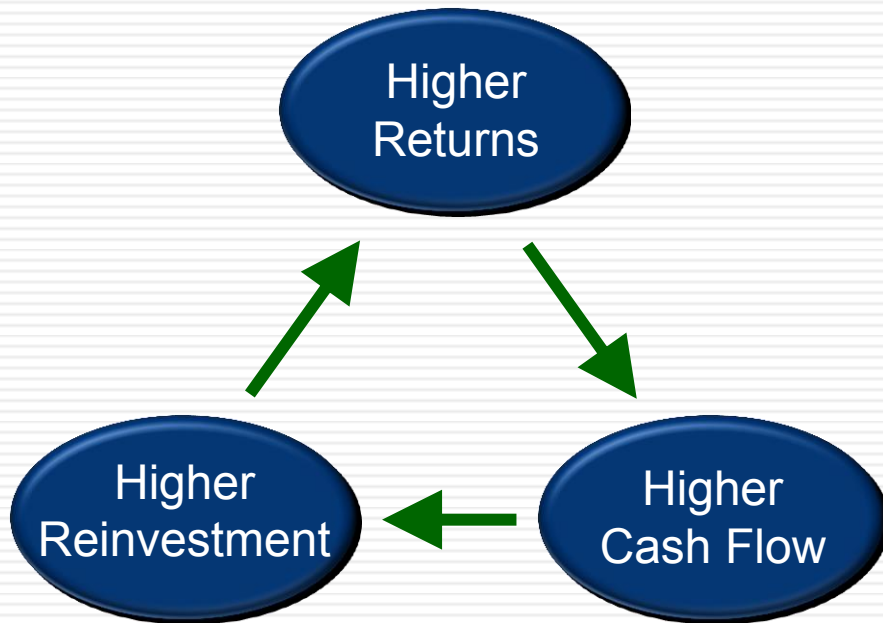
## NW Ohio Intermodal Terminal



**\$200M+ investment in new terminal**

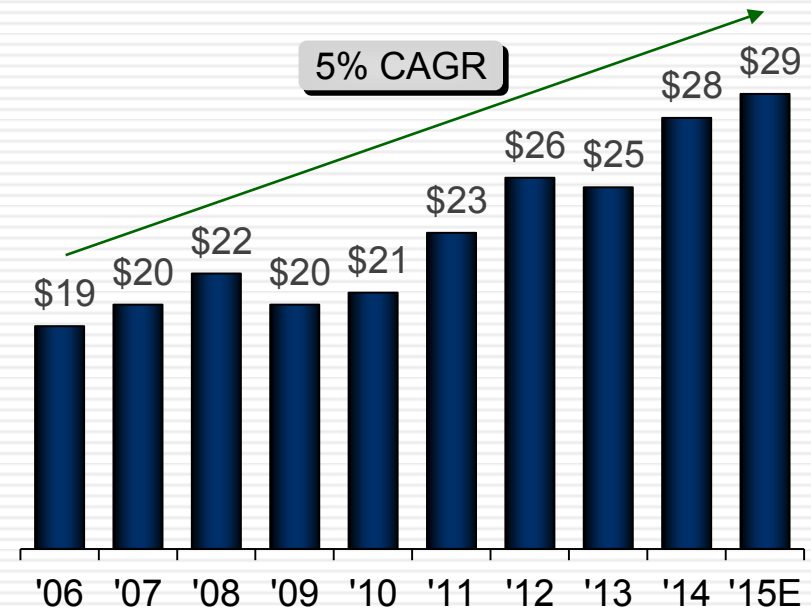
# Higher returns create investment opportunities

## “Virtuous” Investment Framework



## Class I Railroad Spend on Infrastructure & Equipment<sup>1</sup>

*Dollars in Billions*

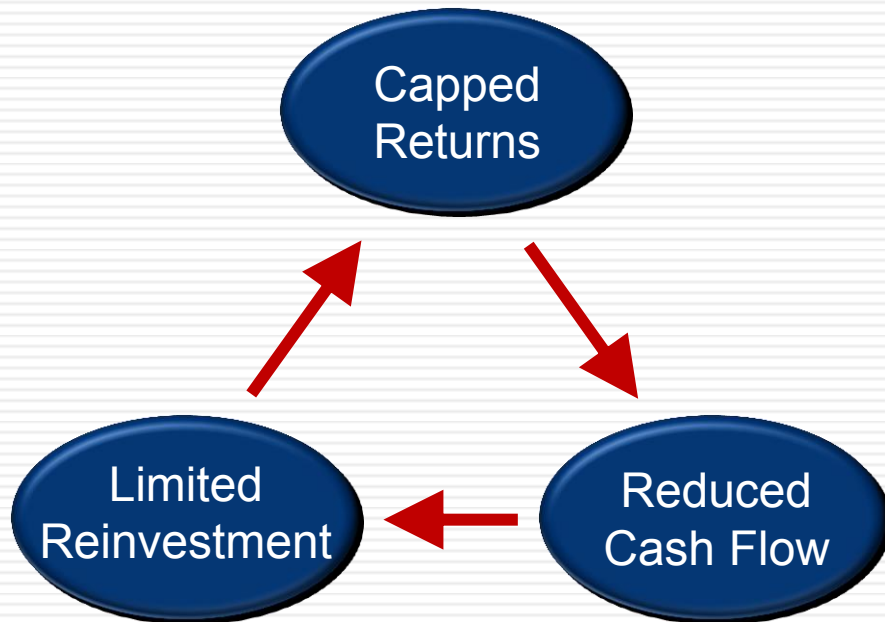


Returns above cost of capital needed to reinvest and grow business

(1) Capital investment plus maintenance expense; source: Association of American Railroads, 2015

# Constrained returns **lessen** public benefits

## “Vicious” Investment Framework



## Impact of Constrained Return

**Less** investment

**Less** efficiency

**Less** reliable service

**Less** resources

Constrained returns would drive under-investment and limit growth

# Summary: Four pillars of revenue adequacy

- Measure Progress – Don't Constrain it
- Address Replacement Cost Imperative
- Promote Differential Pricing
- Ensure Free Market Results to Foster Investment

These pillars are essential to sound regulatory policy





**Fredrik Eliasson, EVP CFO**  
**Ex Parte 722**  
July 22, 2015





# **STB EP 722—RAILROAD REVENUE ADEQUACY**

## **TESTIMONY OF THE NATIONAL INDUSTRIAL TRANSPORTATION LEAGUE**

**KARYN A. BOOTH**  
Karyn.Booth@ThompsonHine.com

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## 49 USC § 11102(c)(1)

### Use of Terminal Facilities

The Board may require rail carriers to enter into reciprocal switching agreements where it finds such agreements to be practicable and in the public interest, or where such agreements are necessary to provide competitive rail service. . . . (emphasis added)



## 49 USC § 10101(a)(6) Rail Transportation Policy

In regulating the railroad industry, it is the policy of the United States Government—

(6) to maintain reasonable rates where there is an absence of effective competition and where rail rates provide revenues which exceed the amount necessary to maintain the rail system and to attract capital. . . .  
(emphasis added)

## **49 USC § 10704(a)(2)**

### **Rates, Classifications, Rules, and Practices Prescribed by Board**

(2) The Board shall maintain and revise as necessary standards and procedures for establishing revenue levels for rail carriers providing transportation subject to its jurisdiction under this part that are adequate. . . . to cover total operating expenses, including depreciation and obsolescence, plus a reasonable and economic profit or return (or both) on capital employed in the business. The Board shall make an adequate and continuing effort to assist those carriers in attaining revenue levels prescribed under this paragraph.....



## 49 CFR § 1144.2(b)(3) Prescription

When prescription of a through route, a through rate, or reciprocal switching is necessary to remedy or prevent an act contrary to the competitive standards of this section, the overall revenue inadequacy of the defendant railroad(s) will not be a basis for denying the prescription.

## Transportation Research Board Report Modernizing Freight Rail Regulation

“A possible starting point for STB in assessing the impact of reciprocal switching is to allow its use in a more limited setting. For example, it could be used as an optional remedy for rates that have already been ruled unreasonable and thereby offer an alternative to a prescribed rate.” (Page 112)  
(emphasis added)

# Questions(?)

**Karyn A. Booth**

**[Karyn.Booth@ThompsonHine.com](mailto:Karyn.Booth@ThompsonHine.com)**

**202.263.4108**





# Ex Parte 722 – Railroad Revenue Adequacy

## Presentation for Norfolk Southern

238896

**David Sappington**  
University of Florida

**Bradford Cornell**  
California Institute of Technology

**Raymond Atkins**  
Sidley Austin

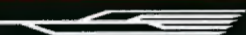
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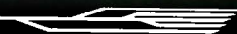
# Professor David Sappington

University of Florida



**NS NORFOLK  
SOUTHERN**  
*One line, infinite possibilities.*

- Principles of Sound Regulatory Policy Design
- The Board's Present Policy Implements Those Principles
- Explicit Earnings Regulation Has Many Drawbacks Because It Does Not Implement Those Principles





- **Asymmetric Earnings Regulation is Particularly Pernicious**
- **Regulators are Abandoning Stringent Earnings Regulation**
- **The Board is on the Frontier of Innovative Policy Design**

# Dispelling a Common Myth

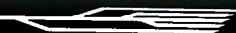
- **MYTH**—Regulators protect consumers by precluding regulated firms from securing more than “adequate” earnings.
- **TRUTH**—All parties gain when suppliers are motivated by the prospect of financial reward.



# Conclusions

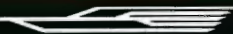
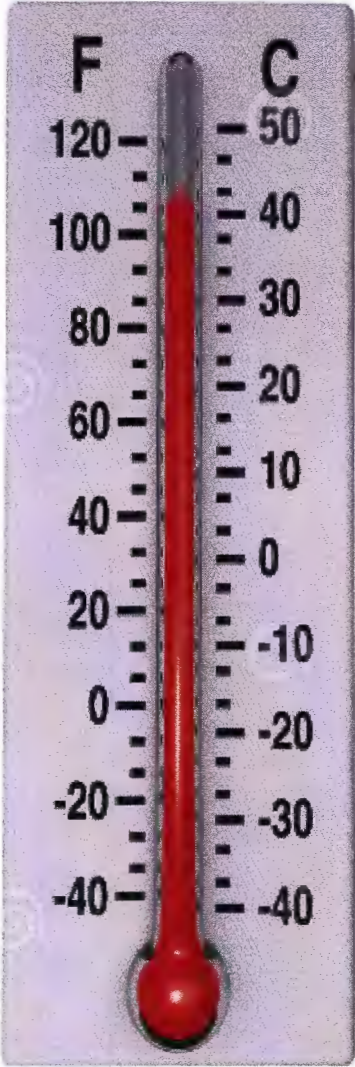
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- Retain current progressive policy that embodies the key principles of sound regulatory design.
- Resist pressure to return to largely discredited regulatory policies of the past.



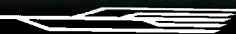
# Professor Bradford Cornell

## California Institute of Technology



# Deficiencies in Annual Measurement of Revenue Adequacy

- Fails to measure returns over the lifetime of rail assets.
- Treatment of deferred taxes.
- Comparison of an economic measure with an accounting measure.
- Inappropriate for evaluating individual rates.





## Exhibit 1a

Illustration of ROI from a Single Asset in each Year of its Life  
Calculated using Straight-Line Depreciation

	<i>A</i>	<i>B</i>	<i>C = A - B</i>	<i>D = PrevD - PrevB</i>	<i>E = C / D</i>
Year	Cash Flows (1000.00)	Straight-Line Depreciation	Net Income	Book Value (Beg. of Period)	ROI
1	\$117.46	\$50.00	\$67.46	\$1,000.00	6.75%
2	117.46	50.00	67.46	950.00	7.10%
3	117.46	50.00	67.46	900.00	7.50%
4	117.46	50.00	67.46	850.00	7.94%
5	117.46	50.00	67.46	800.00	8.43%
6	117.46	50.00	67.46	750.00	8.99%
7	117.46	50.00	67.46	700.00	9.64%
8	117.46	50.00	67.46	650.00	10.38%
9	117.46	50.00	67.46	600.00	11.24%
10	117.46	50.00	67.46	550.00	12.27%
11	117.46	50.00	67.46	500.00	13.49%
12	117.46	50.00	67.46	450.00	14.99%
13	117.46	50.00	67.46	400.00	16.87%
14	117.46	50.00	67.46	350.00	19.27%
15	117.46	50.00	67.46	300.00	22.49%
16	117.46	50.00	67.46	250.00	26.98%
17	117.46	50.00	67.46	200.00	33.73%
18	117.46	50.00	67.46	150.00	44.97%
19	117.46	50.00	67.46	100.00	67.46%
20	117.46	50.00	67.46	50.00	134.92%

## Exhibit 1b

Illustration of ROI from a Single Asset in each Year of its Life  
Calculated using Economic Depreciation

	<i>A</i>	<i>B</i>	<i>C = A - B</i>	<i>D = PrevD - PrevB</i>	<i>E = C / D</i>
Year	Cash Flows (1000.00)	Economic Depreciation [1]	Net Income	Book Value (Beg. of Period)	ROI
1	\$117.46	\$17.46	\$100.00	\$1,000.00	10.00%
2	117.46	19.21	98.25	982.54	10.00%
3	117.46	21.13	96.33	963.33	10.00%
4	117.46	23.24	94.22	942.21	10.00%
5	117.46	25.56	91.90	918.97	10.00%
6	117.46	28.12	89.34	893.41	10.00%
7	117.46	30.93	86.53	865.29	10.00%
8	117.46	34.02	83.44	834.36	10.00%
9	117.46	37.43	80.03	800.33	10.00%
10	117.46	41.17	76.29	762.91	10.00%
11	117.46	45.29	72.17	721.74	10.00%
12	117.46	49.81	67.65	676.45	10.00%
13	117.46	54.80	62.66	626.64	10.00%
14	117.46	60.28	57.18	571.84	10.00%
15	117.46	66.30	51.16	511.57	10.00%
16	117.46	72.93	44.53	445.26	10.00%
17	117.46	80.23	37.23	372.33	10.00%
18	117.46	88.25	29.21	292.10	10.00%
19	117.46	97.07	20.39	203.85	10.00%
20	117.46	106.78	10.68	106.78	10.00%



## Exhibit 2a

Illustration of ROI for a Single Year from a Set of Twenty Assets of Different Vintages  
Calculated using Straight-Line Depreciation

	<i>A</i>	<i>B</i>	<i>C = A - B</i>	<i>D = PrevD - PrevB</i>	<i>E = C/D</i>
Asset Age (Beg. Of Period)	Cash Flows	Straight-Line Depreciation	Net Income	Book Value (Beg. of Period)	ROI
	(1000.00)				
1	\$117.46	\$50.00	\$67.46	\$1,000.00	6.75%
2	117.46	50.00	67.46	950.00	7.10%
3	117.46	50.00	67.46	900.00	7.50%
4	117.46	50.00	67.46	850.00	7.94%
5	117.46	50.00	67.46	800.00	8.43%
6	117.46	50.00	67.46	750.00	8.99%
7	117.46	50.00	67.46	700.00	9.64%
8	117.46	50.00	67.46	650.00	10.38%
9	117.46	50.00	67.46	600.00	11.24%
10	117.46	50.00	67.46	550.00	12.27%
11	117.46	50.00	67.46	500.00	13.49%
12	117.46	50.00	67.46	450.00	14.99%
13	117.46	50.00	67.46	400.00	16.87%
14	117.46	50.00	67.46	350.00	19.27%
15	117.46	50.00	67.46	300.00	22.49%
16	117.46	50.00	67.46	250.00	26.98%
17	117.46	50.00	67.46	200.00	33.73%
18	117.46	50.00	67.46	150.00	44.97%
19	117.46	50.00	67.46	100.00	67.46%
20	117.46	50.00	67.46	50.00	134.92%
Current Year Total for All Assets			\$1,349.20	\$10,500.00	12.85%

## Exhibit 2b

Illustration of ROI for a Single Year from a Set of Twenty Assets of Different Vintages  
Calculated using Economic Depreciation

	<i>A</i>	<i>B</i>	<i>C = A - B</i>	<i>D = PrevD - PrevB</i>	<i>E = C / D</i>
Asset Vintage (Beg. Of Period)	Cash Flows (1000.00)	Economic Depreciation [1]	Net Income	Book Value (Beg. of Period)	ROI
1	\$117.46	\$17.46	\$100.00	\$1,000.00	10.0%
2	117.46	19.21	98.25	982.54	10.0%
3	117.46	21.13	96.33	963.33	10.0%
4	117.46	23.24	94.22	942.21	10.0%
5	117.46	25.56	91.90	918.97	10.0%
6	117.46	28.12	89.34	893.41	10.0%
7	117.46	30.93	86.53	865.29	10.0%
8	117.46	34.02	83.44	834.36	10.0%
9	117.46	37.43	80.03	800.33	10.0%
10	117.46	41.17	76.29	762.91	10.0%
11	117.46	45.29	72.17	721.74	10.0%
12	117.46	49.81	67.65	676.45	10.0%
13	117.46	54.80	62.66	626.64	10.0%
14	117.46	60.28	57.18	571.84	10.0%
15	117.46	66.30	51.16	511.57	10.0%
16	117.46	72.93	44.53	445.26	10.0%
17	117.46	80.23	37.23	372.33	10.0%
18	117.46	88.25	29.21	292.10	10.0%
19	117.46	97.07	20.39	203.85	10.0%
20	117.46	106.78	10.68	106.78	10.0%
Current Year Total for All Assets			\$1,349.20	\$13,491.90	10.0%





# Raymond Atkins

SIDLEY AUSTIN LLP

# Recap

---

- A system-wide revenue adequacy constraint is a discredited form of regulation that is fraught with perils.
- These perils are made exponentially worse by serious measurement errors.
- You do not need to travel down this path.

“... CMP, with its SAC constraint, is the preferred and most accurate procedure available for determining the reasonableness of rates in markets where the rail carrier enjoys market dominance.”

D.C. Circuit 1993 & 2006

*Burlington N. R.R. Co. v. ICC*, 985 F.2d 589, 596 (D.C. Cir. 1993)  
*BNSF Ry. Co. v. STB*, 453 F.3d 473, 481 (D.C. Cir. 2006)



“As railroads enjoy increasing market power with rising demand for their services the SAC test (in either its full or simplified form) would provide a **critical restraint** on their pricing of captive traffic, without deterring railroads from making the investments in their rail networks that are needed to meet rising demand.”

STB 2012

*Rate Regulation Reforms*, STB Docket Ex Parte No. 715, at 10 (served July 25, 2012) (emphasis added)

“The very purpose of the SAC test is to determine what [the railroad] needs to charge to earn ‘adequate’ revenues on the portion of its system that is included in the system of the SARR.”

STB 2005

*Xcel v. BNSF Ry. Co.*, STB Docket NOR 42057, at 6 (served Jan. 19, 2005)



---

“The Board is on solid ground here.”

D.C. Circuit 2006

*BNSF Ry. Co. v. STB*, 453 F.3d at 480 (D.C. Cir. 2006)

“[T]he RSAM figure merely provides a test of ‘system-wide revenue need’ and therefore ‘provides **no guidance** on the rates Xcel should be charged for the particular facilities and services Xcel uses.’”

D.C. Circuit 2006

*BNSF Ry. Co. v. STB*, 453 F.3d at 481 (D.C. Cir. 2006)  
(quoting STB/DOJ brief) (emphasis added)

# Norfolk Southern Network 20,000 miles



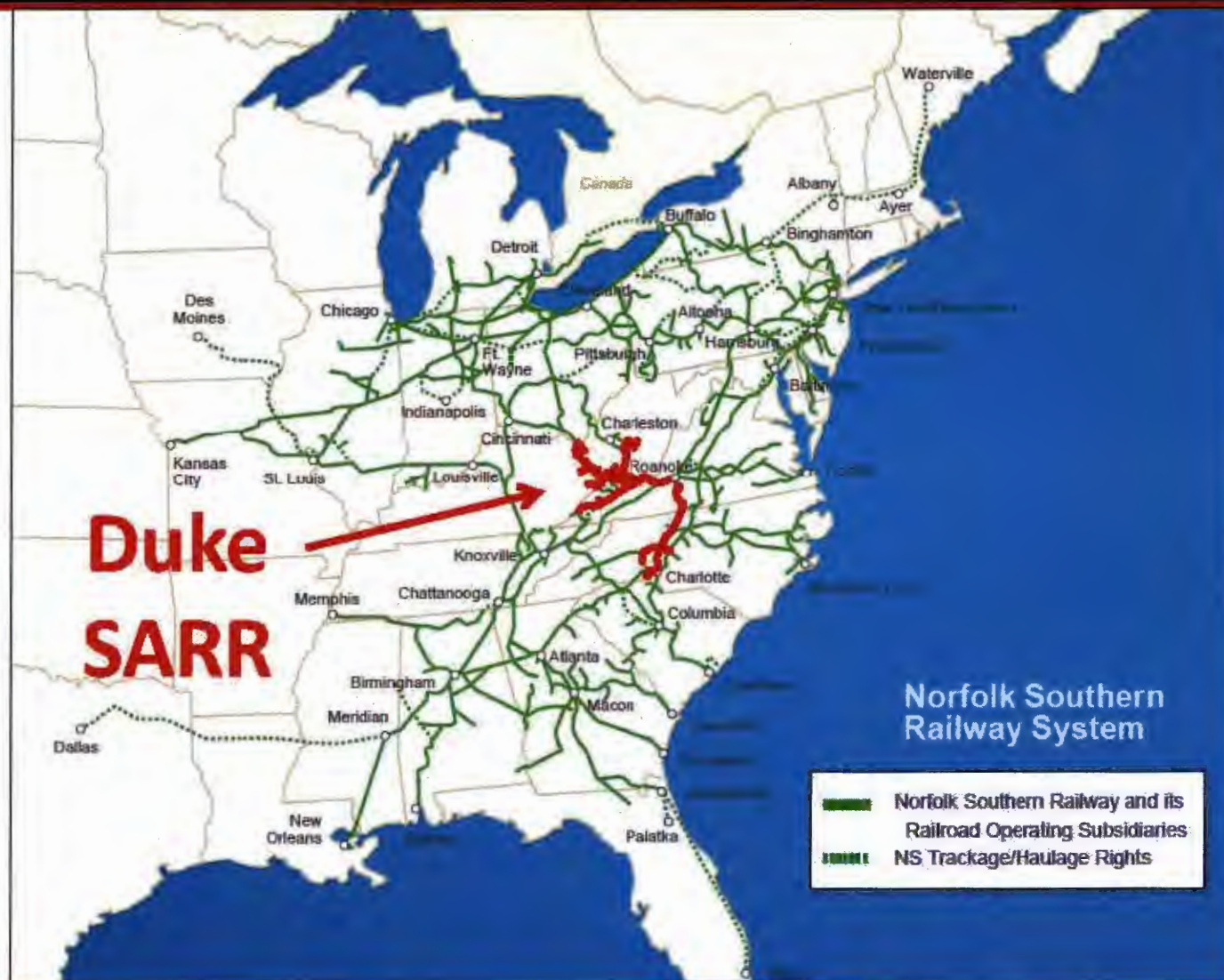


# SunBelt v. NS - NOR 42130 580 miles



# Duke v. NS - NOR 42069

## 1,100 miles





# DuPont v. NS - NOR 42125 7,200 miles



# Shipper Responses?

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- Dismiss concerns about incentive problems that plague rate-of-return style regulation
- Dismiss concerns about cross-subsidies
- Dismiss the measurement errors



# Subsidized Rent Control?

“A more appropriate comparison . . . would be to methods employed by government agencies charged with responsibility for setting affordable subsidized rents, or administering rent control policies, for the benefit of those who would be subject to economic hardship if forced to pay ‘what the market will bear’ for a portion of a limited housing stock. In those instances, ‘current market values’ are eschewed in favor of a public policy emphasizing reasonable rental rates.”

Joint Reply Comments of WCTL, Consumers Energy Co., and S. Miss. Elec. Power Assoc., STB Docket Ex Parte 722, at 15 (Nov. 4, 2014) (emphasis added)

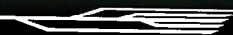


## Economists' Statement in Support of Staggers Act (Feb. 25, 1985)

“The appropriate standard for determining the adequacy of railroad revenues is a rate or return equal to the current cost of capital on the **replacement value** of all rail assets that are required to meet the demands for railroad service, regardless of the source of funds used in investing in those assets.”

Nobel Laureate Kenneth Arrow  
Nobel Laureate James Tobin  
(and 54 other leading economists)

Attachment D, Reply Comments of NS, STB Docket Ex Parte 722, (Nov. 4, 2014)



**NS** NORFOLK  
SOUTHERN  
One line. infinite possibilities.

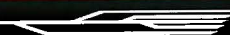
# SAC Is Not Broken

- Full-SAC is well designed for cases where there are millions of dollars in dispute.
- Simplified-SAC
  - Fast.
  - Simple. **NO HYPOTHETICAL RAILROAD**
  - Discovery burden on railroads.
  - Unlimited relief.
- But that is not the relief shippers are looking for.



# Multiple Independent Reasons To Abandon The Revenue Adequacy Constraint

- Regulators discarding rate-of-return regulation
- Stifle innovation
- Discourage investment
- SAC and Simplified-SAC are targeted “revenue adequacy” tests
- Massive measurement error
- Cost of capital should not be a ceiling
- Internal cross-subsidies
- “No Guidance” as to reasonableness of a particular rate



TO BE PLACED ON THE PUBLIC RECORD

238898  
238899

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BEFORE THE  
SURFACE TRANSPORTATION BOARD

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July 22, 2015  
Part of  
Public Record

Ex Parte No. 722

RAILROAD REVENUE ADEQUACY

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Ex Parte No. 664 (Sub-No. 2)

PETITION OF THE WESTERN COAL TRAFFIC LEAGUE TO INSTITUTE A  
RULEMAKING PROCEEDING TO ABOLISH THE USE OF THE MULTI-STAGE  
DISCOUNTED CASH FLOW MODEL IN DETERMINING THE RAILROAD INDUSTRY'S  
COST OF EQUITY CAPITAL

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WRITTEN TESTIMONY  
ON BEHALF OF OLIN CORPORATION  
BY JOHN L. MCINTOSH, SENIOR VICE PRESIDENT OF CHEMICALS

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# **1. INTRODUCTION TO OLIN CORPORATION**

Chairman Elliott and members of the Surface Transportation Board (the "Board"), I am pleased to be here today on behalf of Olin Corporation ("Olin") as you explore the Board's methodology for determining railroad revenue adequacy and the revenue adequacy component used in judging the reasonableness of rail freight rates. I have served as a corporate officer for Olin for 16 years, and have nearly 40 years of experience in the chemical manufacturing industry.

Olin Corporation is headquartered in Clayton, Missouri and consists of three segments: Winchester Ammunition, a leader in small caliber ammunition production and a supplier to U.S.

law enforcement and military; Chlor Alkali Products, a leading producer of bulk chlorine, caustic soda, bleach and other chemicals in North America; and K.A. Steel, one of the largest distributors of chemical products manufactured by chlor alkali producers. Olin is a publicly traded company that has been listed on the NYSE since 1917. Today, I am testifying on behalf of Olin's Chlor Alkali Products business, which is headquartered in Cleveland, Tennessee and includes ten different locations throughout North America, including locations in New York, Georgia, Tennessee, Alabama, Nevada, Louisiana, California, Washington state and Quebec, Canada. Olin was the first commercial supplier of chlorine in the United States and has been involved in the chlor alkali industry for over one hundred years.

Olin ships the vast majority of its chlor alkali products via rail from its various manufacturing locations in North America, so rail transportation is absolutely essential to Olin. The ability to obtain reasonable freight rates is vital to Olin's business, so Olin appreciates the Board's effort to address revenue adequacy and rate reasonableness issues in today's hearing and hopes that meaningful changes will be made to the Board's current methodology.

## **2. FINANCIAL SUCCESS OF RAILROADS AND FAILURE OF STAND ALONE COST CONSTRAINT**

As Olin has previously expressed in its Comments to the Board in this matter, there is a clear disconnect between the Board's current methodology in determining the railroad's revenue adequacy and the current actual financial state of the rail industry. As noted by the Senate Committee on Commerce, Science, and Transportation in November of 2013, the financial performance of the Class I Railroads "is at its strongest since the passage of the Staggers Act." A simple review of the major railroads' stock prices and corporate activity clearly supports the undeniable financial success of the rail industry. Despite their extreme profitability, the big four class I railroads have chosen to pay billions of dollars to its shareholders through stock

repurchases and dividends instead of investing in the expansion of the railroad system to meet increasing demand.

In spite of the railroads' financial success, the Board's methodologies for determining the achievement of revenue adequacy and the reasonableness of rail rates have remained unchanged. In essence, while the railroads have enjoyed terrific financial success, the avenues for captive shippers like Olin to challenge the reasonableness of freight rates have remained unchanged. As noted by the Board, "Nearly all large rate reasonableness cases to date have relied upon the stand-alone cost constraint."

Unfortunately for captive shippers like Olin, the stand-alone cost constraint on rail rates has proven to be almost completely ineffective due to its prohibitive expense, lengthy time requirements, and unnecessary complexity. In fact, the inefficiencies of the stand alone cost constraint process have made rate cases almost completely inaccessible to shippers. The result of this is that shippers lack a meaningful counterbalance to the railroads' strong pricing power over captive shippers. As a result, captive shippers are faced with two bad alternatives: they can simply accept the "tariff premium" forced upon them by railroads, or they can challenge freight rates under the stand alone cost constraint. Recognizing that these rate challenges cost many millions of dollars and take years to resolve, Olin and similarly situated captive shippers are required to go "all in" with extremely uncertain outcomes. Despite the inherent and costly risks associated with rate cases, shippers have very limited upside. If a shipper manages to win a rate case, its only reward is that it can pay reasonable freight rates to railroads. Railroads, on the other hand, have no downside consequences in losing a rate case, as they are simply returning shipper money to which they were never actually entitled. And, considering that shippers must continue to pay tariff premium prices throughout a rate case, the railroads are actually

incentivized to prolong rate cases as long as possible. Given this, it is not surprising that railroads and railroad groups adamantly oppose any suggested changes to the stand alone cost system.

In addition to the obvious inefficiencies of the stand alone cost constraint, there is no economic justification for this approach either, especially for railroads enjoying such extreme profitability. For a detailed analysis of the failures of the stand alone cost constraint on the basis of economic theory, I would like to draw the Board's attention to the Verified Statement of Dr. Gerald R. Faulhaber, which was attached to the initial comments of the Concerned Shipper Associations on September 5, 2014. Dr. Faulhaber is one of the original developers of the stand alone cost constraint, yet he clearly argues that in today's economic environment, there is no economic justification for the use of the stand alone cost constraint.

### 3. **REVENUE-TO-VARIABLE COST RATIO CEILING**

In addressing the various shortcomings of the Board's application of the stand alone cost constraint in rate reasonableness cases, Olin stresses that the Board should avoid the same pitfalls that have rendered the stand alone cost constraint so ineffective for captive shippers. The Board should avoid creating another "full employment bill for economists" as the stand alone cost constraint has been called and should focus on creating a simple and efficient alternative for reviewing rate cases.

Following the works of Dr. Russell Pittman of the U.S. Department of Justice, Olin has consistently supported the implementation of a ceiling on the railroads' revenue-to-variable cost ratio that may be charged by railroads to captive shippers. In its Comments, Olin cited to a number of past filings and sources that have advocated for this approach, so this is not a new

concept. Nonetheless, due to the relative simplicity of the revenue-to-variable cost ceiling, it would provide a much more practical means of protection for captive shippers against the railroads' pricing power in lieu of the unworkable stand alone cost constraint. As a result, captive shippers like Olin would finally obtain a meaningful counterbalance to the railroads' pricing power. The increased efficiency of the revenue-to-variable cost ceiling and relative predictability due to the inherent simplicity of this approach would cause rail rates for captive shippers to be self-policing because a shipper's threat to implement a rate case would almost immediately become viable (as opposed to the empty threat of commencing a long and arduous rate case under the Board's current framework). This, in turn, would incentivize railroads to enter into private contracts with captive shippers or otherwise provide for reasonable rates under tariff. As a result, not only will a captive shipper's rate case become much more efficient for the Board, but fewer rate cases will be necessary because railroads will have additional incentive to enter into private contracts with captive shippers.

The Board has wisely undertaken this proceeding to examine the revenue adequacy constraint on Ramsey pricing in rate cases, which was adopted by the Interstate Commerce Commission in 1985. Because the revenue-to-variable cost ceiling may be implemented as a result of this 722 proceeding, Olin respectfully submits that it is not necessary for the Board to implement a formal rulemaking proceeding. Olin's understanding of the Board's mission in implementing this 722 proceeding is simply to provide some clarity to the process of enforcing the revenue adequacy constraint. Therefore, Olin strongly advises the board against implementing a burdensome rulemaking process.



#### 4. CONCLUSION

The recent extreme profits of the major railroads show that they have far exceeded revenue adequacy, yet the Board's methodology in judging the reasonableness of rail freight rates and in determining whether railroads have achieved revenue adequacy has remained unchanged and ineffective for shippers like Olin. Olin, therefore, agrees with the Board that it is necessary to implement new methodologies for enforcing the revenue adequacy constraint on rail rates. Olin respectfully urges the Board to implement a clear, simple and efficient procedure for reviewing rate cases under this revenue adequacy constraint so that shippers may gain a meaningful counterbalance to the railroads' strong pricing power over captive shippers.

Respectfully submitted for and on behalf of Olin Corporation by:

/s/ John L. McIntosh  
John L. McIntosh, Senior Vice President of  
Chemicals



**Testimony of Edward R. Hamberger**  
**EP 722, *Railroad Revenue Adequacy***  
**July 22, 2015**

238915

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## Key National Policies at Risk

- ▣ Improving rail service
- ▣ Increasing exports
- ▣ Achieving energy independence
- ▣ Enhancing rail safety
- ▣ Increasing freight railroads' share of freight traffic
- ▣ Improving on-time performance for Amtrak and ensuring reliable service for commuters
- ▣ Increasing the resiliency of the national freight network

