

Date: December 12, 2019

Case: Hearing on Railroad Revenue Adequacy



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SURFACE TRANSPORTATION BOARD

EP 761

HEARING ON REVENUE ADEQUACY

EP 722

RAILROAD REVENUE ADEQUACY

PUBLIC HEARING

Thursday, December 12, 2019

9:30 a.m.

James E. Webb Memorial Auditorium of the
National Aeronautics and Space Administration
300 E Street, S.W.
Washington, D.C.

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

2 (9:30 a.m.)

3 CHAIRMAN BEGEMAN: Good morning. Thank
4 you for joining us for the Board's hearing on
5 railroad revenue adequacy and the related
6 recommendations provided by the Board's Rate Reform
7 Task Force in its April report. My colleagues and I
8 have been making good use of the report, and I
9 commend the members of the Task Force for their work
10 on what was a very important and challenging
11 undertaking.

12 The Board held a hearing on issues related
13 to railroad revenue adequacy in July 2015, as part of
14 the EP 722 proceeding. Last year the Board issued
15 the decision clarifying that informal discussions
16 between the Agency and stakeholders were permitted in
17 that proceeding which was, and still is, in an
18 informal pre-rule stage -- informational pre-rule
19 stage.

20 We expected that the clarification would
21 spur stakeholder interest in discussing the complete
22 issues with us. Unfortunately, the interest didn't

1 materialize, at least as I envisioned it would. But
2 I'm very pleased that so many stakeholders are taking
3 the opportunity to participate in this hearing today
4 and tomorrow.

5 I thank the witnesses for their
6 participation, and their effort to prepare for this
7 hearing. We also received written comments from
8 several parties who will not be appearing. Based on
9 the submissions, I expect the hearing will be very
10 informative. I will briefly go over just a few
11 general hearing matters, and then turn to my
12 colleagues to share any opening remarks they may wish
13 to make.

14 So, during the course of the hearing today
15 and tomorrow. Let me start again. Please silence
16 your cell phones. We want to hear from every party
17 that has filed a notice of intent to participate,
18 and make sure there's an opportunity for questions to
19 be asked and answered.

20 To allow that to happen, the parties are
21 asked to stick to their allotted times. Each witness
22 is asked to step up to the lectern to provide your

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1 testimony. The lectern is equipped with lights and a
2 timer which will guide you regarding your time. Two
3 minutes before your time expires, a yellow light will
4 appear. When you see a red light, your time will
5 have expired and you will need to conclude your
6 remarks.

7 It's not my intent to cut-off a speaker,
8 but we do need to keep things moving, so that we can
9 hear from all the participants. The witness tables
10 are also equipped with microphones. It's my hope
11 that in responding to our questions, the panelists
12 will not only interact with us, but with one another.

13 A transcript of the entire hearing will be
14 placed on the Board's website within a few days of
15 the close of this hearing. For the benefit of the
16 recorder, please speak clearly into the microphone.
17 He is welcome to interject when he can't hear. He's
18 sort of helping control what we're doing, so let's
19 really give him our assistance to the extent we can.

20 We'll keep the record open until February
21 13th to allow for the filing of additional written
22 comments. We recognize that there are already

1 several upcoming filing deadlines between now and
2 then covering a variety of important matters, and we
3 want to accommodate filers who may be involved in a
4 number of those proceedings.

5 If you have slides or exhibits today that
6 haven't already been filed, please submit them
7 promptly to our Office of Proceedings in the EP 761
8 and EP 722 dockets by emailing them to milss@stb.com.

9 Whether we take a short break for lunch
10 today will depend on how we are doing on time. We
11 must conclude each day's session by 6 p.m. at NASA's
12 request. They're accommodating us and we are very
13 grateful and appreciative to their assistance, so we
14 want to be good stewards of their space while we're
15 in here.

16 As I said, please silence your phones.
17 And I'm now going to turn to our Vice Chairman
18 Patrick Fuchs.

19 VICE CHAIRMAN FUCHS: Thank you, Chairman
20 Begeman. I will just -- briefly a word of thanks.
21 You know, thank you to all the commenters for all the
22 considerable time and thought that went into the

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1 filings. Thank you to staff for all the work that
2 went into making this possible. And a special thanks
3 to everybody who traveled to be here.

4 I think that there will be plenty of time
5 to discuss views and explore topics, so I will just
6 say I very much look forward to discussion and thank
7 you very much, Chairman Begeman, for having this
8 hearing.

9 CHAIRMAN BEGEMAN: Thank you. Marty?

10 BOARD MEMBER OBERMAN: Thanks Ann. Very
11 briefly, I want to echo with what both Ann and
12 Patrick have said, particularly, the amount of effort
13 that has been put into this whole project by our
14 staff and all of the industry representatives and
15 commenters because I've not read every word, but I've
16 read a lot and I know a great deal of effort and time
17 has gone into it.

18 And we cannot undertake this effort on our
19 own. We need the input from the people who are
20 affected. Just one observation on logistics, just on
21 a personal note on my speaking only for myself. I
22 know there were some logistical concerns about

1 recording and streaming, because we're not in our own
2 space, and that has presented logistical challenges
3 for doing what I think most of us, all of us would
4 feel would normally be preferable and that is
5 videotaping and live streaming.

6 And I understand that our friends at the
7 AAR have tackled this problem and are now able to
8 accomplish that in this space. So, I for one, I
9 think all are grateful. But that happened, and I
10 guess I would make the observation that perhaps this
11 is an example of, in an unregulated setting, the
12 private sector tackling a problem and solving it.
13 So, thanks to our friends at the AAR.

14 CHAIRMAN BEGEMAN: And to the extent that
15 AAR is able to do some recording, you are invited to
16 submit that for the record, so thank you.

17 So, why don't we begin with the first
18 panel. We will hear from the American Chemistry
19 Council and the Association of American Railroads.

20 MR. SLOAN: Members of the Board, good
21 morning and thank you for holding this important
22 hearing on railroad revenue adequacy. My name is

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1 Jeff Sloan, and I'm pleased to speak here on behalf
2 of the American Chemistry Council.

3 Our member companies manufacture a wide
4 variety of products that make our lives better and
5 our world healthier, safer, and more sustainable. To
6 deliver these positive benefits, ACC members depend
7 on the U.S. transportation system, especially rail.

8 In 2017, railroads transported 2.1 million
9 carloads of chemical products. Because of our
10 industry's investments in new capacity, shipments are
11 expected to increase by 300,000 carloads annually by
12 the year 2022.

13 The U.S. has a competitive advantage in
14 chemical production. Unfortunately, this advantage
15 is hindered by increasingly high rail rates.
16 Excessive rates act as a tax on ACC members, as well
17 as on other manufacturers, farmers and energy
18 producers. It hinders our ability to invest and
19 innovate.

20 The STB's current stand-alone cost
21 standard is so cumbersome, costly and lengthy that
22 it's become unworkable, particularly for carload

1 shippers. It's time for a better methodology to
2 determine rate reasonableness. As stated by Chairman
3 Begeman, developing a new approach has to be a top
4 Board priority.

5 In both the freight rail policies
6 established by Congress in the Board's own rate
7 review guidelines, railroad revenue adequacy is
8 inextricably linked to rate reasonableness. This
9 raises two fundamental questions. First, how much
10 more does a captive shipper pay solely because it
11 lacks access to competitive transportation options?

12 And two, how much of this differential is
13 necessary for the railroad to be long-term revenue
14 adequate? Today, and in our written testimony, ACC
15 proposes an alternative rate review methodology that
16 gives the Board the tools to answer these questions.

17 ACC has developed the benchmark method,
18 working with Economist Dr. Kevin Caves, who will
19 speak in more detail after me. In short, the
20 benchmark method is a two-step approach. It uses an
21 economic model to predict a benchmark rate, meaning
22 the rate that would be expected for that specific

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1 captive shipment if it existed in a competitive
2 market.

3 The second step determines the margin
4 above that benchmark rate that is necessary to
5 maintain the railroad's long-term revenue adequacy.
6 To bring a rate challenge using this standard, a
7 shipper would need to prove market dominance for that
8 shipment, show that the individual rate is above the
9 competitive level, and demonstrate that the
10 non-competitive rate premium exceeds what the STB
11 determines is needed to protect the railroad's
12 revenue adequacy. This approach does not cap rates
13 across the board, nor does it limit the profit that a
14 railroad can earn from competitively priced traffic.

15 Rather, it specifically limits the
16 additional margin that a captive shipper must pay,
17 solely because it lacks effective competition. As
18 Jeff Moreno will discuss more fully, this approach
19 is entirely consistent with the Board's statutory
20 authority and legal precedent.

21 The benchmark method would be much quicker
22 than a SAC case and less costly for shippers,

1 railroads and the Board. The approach is grounded in
2 widely accepted economic principals, and unlike SAC,
3 it mimics competition based on actual market data
4 rather than a fictional paper railroad.

5 Dr. Caves has developed a fully formed,
6 working model as a baseline proposal. However, ACC
7 recognizes that there are many choices and decisions
8 inherent in our proposal that warrant further
9 consideration and stakeholder input. Therefore, we
10 ask the Board to initiate a rulemaking with the goal
11 of adopting a final version of the benchmark method
12 as an alternative rate methodology.

13 One additional topic I want to touch on
14 briefly is the Board's bottleneck rules. As stated
15 recently by Board Member Oberman, competition should
16 be the Board's guiding light. Past decisions to
17 foreclose competition may have been justified to
18 protect the struggling rail industry, however, once a
19 carrier has achieved long-term revenue adequacy, the
20 Board should revisit these decisions and establish a
21 more balanced approach.

22 Permitting shippers to access competitive

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1 service along routes would allow the markets to work
2 and greatly reduce the need for regulation. The mere
3 existence of an alternative would facilitate more
4 competitive rates and better service, even if the
5 shipper ultimately decides to stay with the
6 originating carrier.

7 I compare the situation of a captive
8 shipper to a housing development where the only road
9 out is a privately owned toll road. As a homeowner,
10 I'd accept paying that toll to use that road. What
11 I would not accept is a requirement to stay on that
12 company's toll roads for the entire length of my
13 trip.

14 If other roads are available, I should
15 have the option to choose one that offers cheaper
16 tolls, shorter route and fewer potholes. Rail
17 customers should have a similar option. Thank you
18 for your time this morning. I'll now turn it over to
19 Dr. Caves.

20 MR. CAVES: Thank you Jeff. Let's see I
21 have a slide deck to go with my presentation. And
22 I'm not sure how to call it up. Okay, thanks.

1 That's it. Okay, thank you. So, I'm Kevin Caves
2 and as Jeff mentioned, I'll be talking about the
3 competitive benchmark model that we've developed
4 using masked waybill data that was provided by the
5 STB.

6 So, broadly speaking, what this model does
7 is it mimics competition as competition actually
8 occurs in the industry. And by that, I mean the
9 competition, the railroad space, when they are
10 forced to set their rates in competition with other
11 railroads, and with intermodal competitors.

12 How do we do that? We have access to data
13 on literally millions of competitive outcomes in the
14 industry, so there are lots and lots of shipments
15 thanks to deregulation. There are lots and lots of
16 shipments out there that are subject to competition
17 and were able to fit in an econometric model to that
18 data to predict what the competitive rate will be
19 given the characteristics of a shipment.

20 Once we've done that, we can take that
21 model and use it to make comparisons between the
22 competitive rates the model predicts, and the actual

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1 rates that are being paid by captive shippers. And
2 we can pinpoint on a shipment by shipment basis,
3 exactly which shippers are paying rates that are
4 substantially in excess of the competitive level.

5 It is those shipments and only those
6 shipments which are potentially subject to regulation
7 under the method that we are proposing. Everything
8 else is off limits. I just want to be clear about
9 that. So, that's the basic verbal description of how
10 the model works and now I'd like to walk you through
11 three illustrative charts that I think will clarify
12 the concepts for everybody.

13 So, here we see a hypothetical simplified
14 illustration of how the model works. I'd like to
15 stress this isn't the actual model, in reality it's
16 significantly more complicated than this. But this
17 boils down the basic intuition into two dimensions.
18 So, hopefully everything is fairly clear here.

19 And as you can see, we have a model. And
20 in this case a model is just a straight line that
21 predicts the competitive rate that would be charged
22 as a function of the distance of a shipment. As the

1 distance increases, the competitive rate tends to go
2 down in this illustration.

3 And we fit the best curve that we can
4 given the data and competitive rates. Once we've
5 done that, we can take data on potentially
6 non-competitive rates, and compare it to what the
7 model's predicting. And if something is
8 substantially higher, if a rate that a shipper is
9 paying is substantially higher than what other
10 shippers are paying on comparable shipments, under
11 competitive conditions, and that will jump out of the
12 model as you can see in points A, B and C here.

13 So, we can break that down into two
14 different steps. Step one is simply establishing the
15 benchmark or fitting the model. So, in step one, we
16 get data on competitive rates and we try to predict
17 it as best we can, using econometric techniques.
18 That's all we're illustrating here.

19 In step two, we use the model to come up
20 with some notion of rate reasonableness. So, here
21 the idea is that once the model has been fit, the
22 Board can decide how far above competitive rates --

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1 how far above competitive rates railroads should be
2 allowed to charge captive shippers, right?

3 How much -- so, if a shipper is captive,
4 if it's found to be market dominant, how much in
5 excess of the competitive rate should it be able to
6 charge? If it's within a threshold that we call a
7 competitive threshold, then nothing would happen.
8 The shipper would continue to pay a rate, perhaps
9 substantially above competitive levels.

10 But beyond some level, the rate would be
11 deemed unreasonable. And those rates, and only those
12 rates, would be subject to regulation and potentially
13 reduction under the model that we're proposing.

14 So, hopefully that's clarified the
15 concepts. I want to walk through a little bit of the
16 detail of how we actually build the model. Of
17 course, this is all laid out in my verified
18 statement. So, I'm going to gloss over a lot of the
19 details. But essentially, we were granted access to
20 the carload waybill sample for a given set of years,
21 just to perform this exercise.

22 We were not given unmasked data. All the

1 data that we have was masked, but our presumption is
2 that if and when this model is adopted and
3 implemented for purposes of actually setting rates,
4 the unmasked data would actually be used.

5 So, we have revenue per ton mile, which
6 has been masked. And then we have characteristics of
7 the shipments. And that's essentially what the CWS
8 gives us. And then we import some data from other
9 sources to use in the model. And those are primarily
10 information on origins and destinations of different
11 shipments and information on the distance of
12 different origins and destinations to rail and water
13 competition.

14 So, in broad strokes, those are the data
15 sources we're using for the model. Once we've got
16 all that data together, we have to figure out which
17 of these shipments are actually subject to
18 competition. So, to implement that, we came up with
19 a variety of screens which are described in detail in
20 my verified statement, but in broad strokes, this is
21 what we did. A shipment had to have either rail
22 competition at the origin destination, or water

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1 competition, or it had to be subject to trucking
2 competition based on the screens that we've provided.

3 We did robust checks where we tried
4 different screens other than the ones I'm showing
5 here, but this is sort of the baseline model that I'm
6 showing you. And so, if you apply these screens,
7 just over three-quarters of the CWS shipments in the
8 sample we looked at would be classified as
9 competitive. 25 percent would be potentially
10 non-competitive.

11 And the model would be fit again, only to
12 that 76 percent. So, after we implement the model,
13 the last step, or the next step I should say, is
14 comparing the actual -- the rates that the model's
15 predicting to the actual rates that captive shippers
16 are paying -- the potentially captive shippers are
17 saying, I should say.

18 And these are the broad results that we
19 got when we took the -- again, the model that was fit
20 to three quarters of the data, to the competitive
21 sample and compared those predicted rates to what
22 the other one-quarter of the sample of potentially

1 non-competitive shipments were paying.

2 And we found that on average, as you might
3 expect, the potentially non-competitive samples,
4 rates in the potentially non-competitive samples were
5 significantly higher -- about 48 percent higher on
6 average than the rates in the competitive sample.
7 And again, this is controlling for all of the
8 shipment characteristics and the factors we control
9 for the models.

10 All else equal, potentially
11 non-competitive rates are higher than competitive
12 rates. And then beyond that, you can break it down
13 further and you find that within the non-competitive
14 sample, there's a relatively small slice that is
15 increasingly -- appears to be paying increasingly
16 higher rates relative to the competitive level.

17 So, 12 percent paying about double the
18 predicted competitive rate, 4 percent are paying
19 three times or more than the predicted competitive
20 rate, sorry, and 1 percent paying more than five
21 times the predicted competitive rate.

22 So, this is again, suggestive of the

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1 illustration we saw at the beginning where you have a
2 small number of shipments that were significantly in
3 excess of competitive levels. So, that's all of the
4 econometric model that I just described.

5 The next step is this application of the
6 competitive threshold. And this is simply a way, a
7 method or a framework that we're proposing for the
8 Board to determine once we know which shippers are
9 paying abnormally high rates, how do we decide how
10 high is too high? That's the entire purpose of the
11 competitive threshold.

12 So, it's a multiplier that would be
13 applied to the competitive benchmark. So, for
14 example, if the multiplier is equal to two, that
15 would say anything -- any rate that is more than
16 twice as high as it would be under competition is
17 going to be deemed unreasonable, assuming the shipper
18 can demonstrate market dominance.

19 And our idea is that the STB would have
20 the flexibility to determine what the competitive
21 threshold should be. It could take revenue adequacy
22 into account, measure however the Board thinks it

1 would be appropriate to do so. And it could take
2 into account other factors.

3 But regardless of how it's done, we
4 illustrate -- I illustrate in my verified statement
5 how this could be applied and how it would be, once
6 you have the model in place, how it would be
7 transparent to apply the competitive threshold.

8 So, just a couple notes about the
9 competitive threshold. Obviously, it preserves
10 differential pricing, right, for allowing shippers
11 and for allowing railroads to charge shippers twice
12 the competitive rate, that is differential pricing by
13 definition. It's not a cap on aggregate revenue or
14 aggregate profit for the railroad.

15 Again, only shipments that can be shown to
16 be substantially above competitive levels are even
17 potentially subject to regulation. All of the
18 traffic is off limits, including of course, rates on
19 competitive routes. And rates are only -- yeah, the
20 last bullet just makes that same point. Rates are
21 potentially constrained only if they're substantially
22 above competitive levels.

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1 So, we do -- I go through a purely
2 illustrative application of the competitive threshold
3 in my verified statement. I use a six year revenue
4 adequacy period. Any timeframe could be used, any
5 definition of revenue adequacy could be adopted, and
6 it would be applied in an analogous fashion.

7 In our illustrative example, we first
8 showed that over the time period from 2008 to 2013,
9 which includes the great recession and the aftermath,
10 the worst economic crisis since the great
11 depression, without rate regulation you can show that
12 three railroads are revenue adequate.

13 And then if you assume that all three of
14 these railroads have been subject to the rate
15 regulation we're proposing, and that all of the
16 potentially captive traffic had gotten the maximum
17 possibly relief, that all three of these railroads
18 would have remained revenue adequate. So, this is an
19 illustrative application that's suggestive of the
20 idea that revenue adequacy, as it's defined here,
21 would be preserved under rate regulation, even if you
22 make these fairly aggressive assumptions about how it

1 would be applied.

2 And the last slide just touches on how the
3 model would be implemented in practice as we envision
4 it. Obviously, we'd want to use unmasked data,
5 rather than masked data. We want to use the most
6 recent CWS data available. Presumably, there would
7 be comments on how the econometric model would be
8 specified and that would probably be tweaked in one
9 way or the other and then the STB would have to
10 select the competitive threshold.

11 I think my time is just about up. So,
12 I'll turn it over to Jeff Moreno.

13 MR. MORENO: Thank you Kevin. Good
14 morning. The benchmark method has been developed to
15 comport with statute precedent and the constrained
16 market pricing principal that the Agency adopted as
17 the foundation for rate reasonableness determinations
18 in the coal rate guidelines decisions.

19 It specifically implements the revenue
20 adequacy constraint in that decision, which is a
21 constraint on the extent to which a railroad may
22 charge differentially higher rates on captive traffic

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1 as quoted in the first block of the slide.

2 In guidelines, the Agency declared that
3 captive shippers should not be required to continue
4 to pay differentially higher rates than other
5 shippers, when some or all of that differential is
6 no longer necessary to ensure a financially sound
7 carrier capable of meeting its current and future
8 service needs. In other words, when that carrier is
9 revenue adequate.

10 The rail industry represented by the AAR,
11 has urged the Board to abandon the revenue adequacy
12 constraint all together because earning revenue above
13 a revenue adequate level is not a problem to be
14 solved by regulation, and the regulation of earnings
15 is antiquated and discredited.

16 We all agree -- disagree with the general
17 principles that have been laid out by the AAR to
18 earnings based on system, or constraints based upon
19 system earnings. The flaw in the AAR's argument,
20 however, is that it wrongly assumes that the only way
21 to apply the revenue adequacy constraint, is by
22 restricting system earnings.

1 A revenue adequacy rate constraint,
2 however, can be applied to individual movements
3 without restricting overall system earnings. The
4 benchmark method applies to the revenue adequacy
5 constraint without implicating either of the AAR's
6 concerns. As required by statute, the benchmark
7 method first requires a market dominance
8 determination, which is the basis for concluding that
9 market power exists.

10 Differential pricing is permissible -- is
11 a permissible exercise of that market power under
12 constrained market pricing principles, but only to
13 the extent needed to attain and maintain revenue
14 adequacy.

15 The econometric model developed by Dr.
16 Caves, determines a competitive rate for the issued
17 traffic. And it determines the competitive threshold
18 which determines the appropriate degree of
19 differential pricing needed to maintain revenue
20 adequacy.

21 The benchmark method is not rate of return
22 regulation. There is no limit imposed on a carrier's

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1 total earnings. For individual market dominant
2 movements, a maximum prescribed rate will be subject
3 to a floor. A floor that is the higher of the
4 competitive rate predicted by the econometric model,
5 or the 180 percent jurisdictional threshold.

6 A rail carrier can retain all revenue that
7 exceeds a system-wide revenue adequate level, so long
8 as that revenue is earned at competitive levels
9 represented by that floor. Indeed, AAR and several
10 individual railroads have testified in both this
11 docket, and previously in the Ex parte 722 hearing
12 that competitive traffic is making a growing share of
13 contribution to revenue above variable cost. None of
14 that revenue would be affected by the benchmark
15 method.

16 The AAR also wrongly contends that the
17 revenue adequacy constraint in guidelines violates
18 the statute, agency precedent and sound economics.
19 This is the rebuke of their testimony from the 2015
20 hearing the Board held in Ex parte 722.

21 The Concerned Shipper Associations in that
22 proceeding, of which ACC was a participant,

1 thoroughly debunked AAR's claims. I refer you to
2 page 9 to 19 of the Concerned Shipper Association's
3 reply comments. Also, at pages 22 to 26 they made
4 the point that the rail industry attacks on revenue
5 adequacy constraint are predicated upon the false
6 premise that revenue adequacy necessarily equates to
7 rate of return regulation.

8 The revenue adequacy constraint as
9 articulated in guidelines, has direct support in the
10 statute. In the second quote on the screen, Section
11 10-1016 of the National Rail Transportation Policy
12 expressly charges the Board to maintain reasonable
13 rates where there is an absence of effective
14 competition and where rail rates provide revenues
15 which exceed the amount necessary to maintain the
16 rail system and to attract capital. In other words,
17 to maintain reasonable rates where those rates exceed
18 the amount needed to be revenue adequate.

19 This correlates with the preceding
20 statement and guidelines on the same slide. Only
21 captive rates are subject to a revenue cap, as is the
22 case whenever any form of regulation prescribes the

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1 maximum rate, including stand-alone cost. There is
2 no cap on system revenue under the benchmark method.

3 In affirming guidelines, including the
4 revenue adequacy constraint, the Third Circuit
5 clearly comprehended that revenue adequacy
6 constraints individual captive rates, not system-wide
7 revenue.

8 Paraphrasing the guideline's statement on
9 the previous slide, the Court declared in other
10 words, "When a carrier has achieved revenue adequacy,
11 the rate charged to a captive shipper will be the
12 same as that determined by competition for
13 non-captive shippers." That is precisely what the
14 benchmark method does when it uses an econometric
15 model to determine a competitive rate for the captive
16 movement and then employs the competitive threshold
17 multiplier to determine the appropriate amount of
18 differential pricing above that competitive rate
19 level.

20 The rail industry's insistence that the
21 Board abandon the revenue adequacy constraint means
22 that no matter how high a railroad's revenues are

1 above what the Agency determines to be an adequate
2 level, however the Agency defines revenue adequacy,
3 and no matter how much captive traffic is forced to
4 pay differentially higher rates that exceed what is
5 necessary to be revenue adequate, the Board must
6 blind itself to those circumstances in determining
7 whether that rate is reasonable. That clearly is not
8 what the statute requires.

9 Such a result would be antithetical to the
10 type of regulation contemplated by the statute,
11 controlling precedent and economic theory. ACC urges
12 the Board to initiate a rulemaking proceeding to
13 adopt some form of rate benchmark method that
14 shippers can use to challenge the reasonableness of
15 rates published by revenue adequate carriers.

16 The purpose of the rulemaking would be to
17 adopt an econometric model, and a methodology for
18 calculating the competitive threshold. The same
19 proceeding also would address corollary matters, such
20 as rate prescriptions and procedures. ACC has
21 discussed these and other matters appropriate for a
22 rulemaking in more detail in its written testimony.

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1 The benchmark method should not be a
2 simplified standard with restrictions like those that
3 exist for existing simplified standards. It should
4 be treated as the economic equivalent of SAC.

5 In the interim, however, the benchmark
6 method is ideally suited for the final offer rate
7 review process proposed in Ex parte 755. And ACC has
8 presented the benchmark method as such an
9 alternative option in the coalition association
10 comments, in that docket.

11 In the final offer process however, each
12 complainant would be required to develop its own
13 econometric model and competitive threshold
14 calculation, and address corollary matters anew, in
15 each individual case. In contrast, by addressing
16 such matters through rulemaking, the Board can
17 provide greater predictability and consistency and
18 enhance the defensibility of its decisions.

19 Also, once the model is established by
20 rule, it will be relatively straight forward and easy
21 for the Board to update the model annually with the
22 most current waybill data and revenue adequacy

1 determinations.

2 On behalf of ACC, I thank the Board for
3 consideration of the benchmark method, and we look
4 forward to receiving your questions.

5 CHAIRMAN BEGEMAN: Thank you. We'll turn
6 to AAR.

7 MR. KALT: I also have slides. We have
8 slides we can put up, just push go. Thank you very
9 much. My name is Joe Kalt. I'm a Professor Emeritus
10 at the John F. Kennedy School of Government at
11 Harvard University and I've been asked by AAR to
12 provide my views on the issues before us today.

13 In my discussion, I'd like to cover four
14 main topic areas. One is what we call the mimic
15 competition principle, which appropriately serves as
16 the guide to sound regulation. I'll also discuss the
17 proper and improper measurement of this concept of
18 revenue adequacy. And the uses and misuses of
19 revenue adequacy in railroad regulation.

20 And finally, I will talk about what I
21 think represents an appropriate approach for this
22 industry, which is what I call smart simplification,

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1 improving the capacity of regulation to mimic
2 competition for all traffic and all shippers.

3 Let me turn first to this question of the
4 mimic competition principle. What is it? It's
5 pretty straightforward. It says allow competition to
6 set rates where competition is present and use
7 regulation to mimic competitive prices where
8 competition is absent.

9 This principle actually grows out of Nobel
10 Prize winning economics, which demonstrates that
11 setting prices at competitive levels, whether through
12 actual competition, or through regulation where
13 competition is not viable. Setting rates at
14 competitive levels is in the public interest and the
15 public's interest in particular, in a healthy
16 economy.

17 Now, I think just to state the principle
18 that way, we all recognize that the Staggers'
19 framework embodies this principle, allowing rate
20 freedom, contract freedom across wide swaths of the
21 network, but also applying regulation where there are
22 pockets of market power in the industry.

1 So, mimic competition is deeply embedded
2 in the Board's framework. And I think we all
3 recognize, pretty straightforwardly, once you read
4 those principles, that SAC is the mimic competition
5 principle. And in fact, I'll stress that SAC, with
6 its underlying concept of contestable markets, is the
7 appropriate kind of competition that we have to apply
8 and imagine in the railroad sector.

9 Staggers' framework also wisely rejects
10 old style rate of return earnings triggered rate
11 tightening or regulation. It's wise to do that as I
12 will point out in a moment, because that is
13 extremely distortionary as regulator after regulator
14 across the developed world has learned.

15 And lastly, the mimic competition
16 principle and the framework embodied in the Staggers'
17 Act, in your regulation, is the heart of the rail
18 renaissance. We're all familiar with that
19 renaissance, but what does the mimic competition mean
20 in this industry -- in the railroad industry?

21 This is important because the rail
22 industry is subject to massive economic scale and

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1 scope. The economists, Dr. Caves and I, we're very
2 prone to jargon in this phrase, massive economy is a
3 scale and scope, fundamentally means that over vast
4 portions of the country it would be wasteful of
5 society's resources and ultimately harmful to
6 consumers to operate multiple railroads.

7 We're going to have a system where one
8 large provider -- one large supplier, can provide
9 service at less social cost than any combination from
10 multiple smaller suppliers. This massive economy as
11 a scale and scope also means that customers
12 inherently share network facilities and ultimately
13 bear the costs of those facilities.

14 Now what does competition look like when
15 you have these economies of scale and scope? I think
16 in Econ 1, when people start taking economics, most
17 of us teach a model of perfect competition in which a
18 multiplicity of firms, each of them small relative to
19 the overall business in the market, compete head to
20 head for a customer's business -- for consumer's
21 business.

22 When you get to Econ 100 or 101, things

1 change a little bit because there we start to
2 recognize the implications of these economies of
3 scope and scale. As I've just said what they mean,
4 what those economies mean is that one large firm is
5 more efficient for society's purposes than a
6 multiplicity of small firms competing against each
7 other head to head.

8 What does competition look like under
9 those conditions? What competition looks like is
10 this word that you hear, and it's embodied in
11 language and orders and so forth. And that's the
12 word contestability. And the idea here, and you can
13 think in your mind of something like the airline
14 sector where we deregulated, multiple firms don't
15 operate necessarily where their economy is scaled to
16 scope, but rather multiple firms contest to build and
17 run the winning system.

18 Secondly, this competition, this contest
19 produces differential prices, differential prices as
20 one of its core outcomes, particularly, in relatively
21 low density portions of a network system. We're
22 going to find that the contestable competition

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1 outcome is one in which you have a single supplier,
2 but the contestable result produces differential
3 prices, and on low density rate, low density portions
4 of a system.

5 You're going to see relatively high shares
6 of cost being borne by customers on a low density
7 system, simply because there's less traffic to carry
8 the costs. Importantly, under railroads, economies
9 of scope and scale, competition does not mean that
10 multiple firms are competing everywhere.

11 It does not mean that prices are pushed to
12 narrowly calculated marginal costs. And it does not
13 mean that a contestable market produces customer
14 control, network access or routings. The mimic
15 competition principle in an industry like railroads,
16 produces at least over large portions of the system,
17 single carrier service, prices which are pushed to
18 the contestable SAC level costs and bringing of the
19 control over network access and routings inside the
20 firm, rather than leaving it to customer decisions.

21 And I'll talk more about that in just a
22 moment. I'll jump forward slightly here. Let me

1 talk about the renaissance that this framework that
2 has been adopted, this appropriate measure of
3 mimicking competition has resulted in the railroad
4 industry. This is a familiar picture, I won't dwell
5 on it, but its familiarity is reasonable.

6 We need to take heed of the fact that we
7 economists can't find any other industry where a
8 regulatory change has such a dramatic impact on the
9 productivity, the magnitude, the rates and the
10 revenues of an industry. And we're all familiar with
11 that -- with what that's meant for the recovery of
12 the railroad industry over the last 30 or 40 years.

13 Let me turn to the question of the proper
14 measurement of revenue adequacy. Accounting returns
15 on the book value of net investment -- the way rate
16 of return is calculated currently in revenue adequacy
17 calculations. The ROI cannot reliably identify
18 revenue adequacy. The reason for this is because
19 book accounting doesn't attempt to capture revenue
20 adequacy if revenue adequacy truly means the ability
21 to earn rates of return sufficient to attract
22 capital and cover its cost.

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1 A simple illustration we all use in our
2 teaching and it shows up in my verified statement is
3 the proverbial -- to economists at least, proverbial,
4 fully depreciated apartment house. In a study
5 perhaps of 1,000 apartment houses, a very competitive
6 market. What rates will competition set? For that
7 apartment house, rates which are comparable, given
8 its quality to the other apartments in the industry.

9 What rate of return will that produce on a
10 fully depreciated apartment building? An infinite
11 rate of return. Because you'll have income.
12 Anything over zero is infinite. So, a fully
13 depreciated apartment building has an infinite rate
14 of return. Is it gouging customers? Is it ripping
15 them off? No. It's going to have to price
16 competitive levels. What is that competitive level?
17 That competitive level is the level needed -- what we
18 call, what we see economists call, replacement cost.
19 It's the cost needed to replace and keep the capital
20 in the industry of the capital that is needed to keep
21 bringing apartment houses into the industry and keep
22 them operating.

1 So, the core point that we need to
2 understand -- and this is not a subject of
3 professional disagreement. Accounting majors of ROI
4 simply do not capture revenue adequacy. Moreover,
5 accounting revenue over adequacy is the norm across
6 industries. It's actually the norm across
7 industries.

8 And seeking rates of return higher than
9 the cost of capital, is in fact, the driving force of
10 investment. That's why you invest. You're just
11 trying to make a profit. You're trying to beat your
12 cost of capital. I'll show you some data that's in
13 my verified statement very quickly.

14 This is taken from some data and academic
15 research that was done over the period from 2004 -
16 2013, that's the period of available data in the
17 study. And we're going to put on the vertical access
18 here. We'll put the rate of return, the ROI, in
19 various industries and S&P 500, and we'll -- on the
20 bottom access down there, we'll put the rated average
21 cost of capital.

22 High school geometry I guess, the diagonal

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1 line tells you where the two are equal. That is the
2 diagonal line tells you where ROI equals the cost of
3 capital, or the accounting rates of return equal the
4 cost of capital. And down here, firms start
5 reporting ROIs which are less than the cost of
6 capital, and up here they're reporting in this
7 quadrant, rates of return that are greater than cost
8 of capital.

9 Now, I've made the point here that this is
10 the norm across industries. What does the data
11 actually look like? Here's the group of Fortune 500
12 sectors for which the data is available. And you can
13 readily see that the cluster of dots, if you will, is
14 up in the quadrant, up in the upper half of the
15 diagram where ROI is greater than the cost of
16 capital.

17 This is a repeated result that we find
18 across industry after industry. Rates of return,
19 accounting rates of return higher than the cost of
20 capital are, in fact, the norm. What does it tell us
21 about the railroad industry? Railroad industry has
22 to compete with those industries that you see on that

1 chart and other industries for the capital.

2 And the cost of capital for the railroad
3 industry reflects that competition. Coherent
4 measurement of revenue adequacy as I've said, uses
5 replacement cost. This is not a matter of principle
6 disagreement and the Board already recognizes it
7 because the Board's long-standing SAC framework is
8 properly a replacement cost framework. It asks the
9 question if there were a contest for this business,
10 for this market, who would win the contest? The
11 winner of the contest would offer customers and
12 shippers differential prices, but in total those
13 revenues would just cover the stand-alone cost of the
14 perspective entrance of the contestants of the
15 winning contestant.

16 Neither book accounting, nor economic
17 revenue adequacy can reliably identify above
18 competitive pricing. That is even if revenue
19 adequacy is properly measured and doesn't run into
20 the fully depreciated apartment house problem, even
21 if revenue adequacy is properly measured, it doesn't
22 identify above competitive price. This is for two

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1 reasons.

2 One, firms can earn above their cost of
3 capital because they are efficient. We call them
4 efficiency rents. That is, they figure out a better
5 mousetrap and they do better in running their
6 business and they beat their cost of capital.

7 Secondly, firms indeed can earn above
8 their cost of capital if they have the ability to
9 exercise, and they do exercise market power. But an
10 overall firm-wide measure of revenue adequacy tells
11 us nothing about where, what traffic, what shippers,
12 where any such market power may be in the system.
13 There is no substitute for detailed analysis of
14 competitive conditions on specific traffic if one is
15 to really identify problems with market power and
16 implement and mimic competition form of regulation.

17 Let me pause and say a few words about
18 the -- well actually let me move forward slightly.
19 Let me talk about the uses and misuses of revenue
20 adequacy. Revenue adequacy triggers represent a
21 threat to the nation's railroad system. Because the
22 railroad system has what we call a sitting duck

1 problem.

2 We economists sometimes talk about sitting
3 duck industries. What do we mean by that? What we
4 mean is if you have a long line of some capital
5 network, it invites regulatory opportunism to get
6 the network healthy, get all the capital invested,
7 it's not going anywhere, and it becomes an
8 individual's interest to nibble away at that system.

9 To nibble away at that system because the
10 individual shipper, et cetera, doesn't bear the full
11 cost of the gradual decay of a network. For that
12 reason, a sustained revenue adequacy policy is
13 actually protection. It provides regulators with a
14 guide toward avoiding the sitting duck problem.

15 Revenue adequacy triggers for rate
16 constraints are distortionary. There's a general
17 principal at work here. If increased earnings
18 trigger rate constraint, regulation creates
19 incentives to avoid triggering the constraints. This
20 is the perennial problem that old style public
21 utility franchise public utility regulation ran into
22 and it's the reason that form of regulation is now so

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1 widely discredited.

2 What do those distortions look and feel
3 like? If I'm approaching my revenue constraint, one
4 way to avoid it is to raise my invested capital. If
5 I can get a return on it, raise my invested capital
6 by gold plating -- by gold plating.

7 I put in capitals, it's not really
8 necessary and it's wasteful. Or, if the rate of
9 return constraint is excessively tight, I just don't
10 invest at all. You end up with distortions to
11 investment decisions. Similarly, you can distort
12 operational decisions. If innovations will in fact,
13 if innovations will in fact raise my returns, but
14 trigger rate constraints, I will be less likely to
15 undertake innovations, and I will tend to undertake
16 more expensive innovations to avoid triggering the
17 regulatory rate constraint.

18 Pricing could even be distorted. If
19 competitive forces are actually pulling up my rates
20 in parts of my system and I will realize more revenue
21 as a result of that, perhaps diesel prices have gone
22 up and trucks have gotten more expensive, they're

1 pulling up my rates. Then in that kind of situation,
2 I may forgo raising my rates in order to avoid
3 triggering an overall revenue adequacy rate
4 constraint.

5 So, these kinds of distortions to
6 investment operations in pricing are the preeminent
7 examples of regulatory distortions. I won't go
8 through all of the research. I have this in my
9 verified statement, but economic study after economic
10 study would probably fill this room with studies on
11 this problem.

12 Documents how triggering rate constraints,
13 revenue constraints, in the fashions that have been
14 proposed by the task force, lead to these distortions
15 of operations investment and pricing. They also lead
16 in the regulatory arena, to ever-burgeoning
17 regulation.

18 Any of you who have worked at all in the
19 public utility sector, under old style public utility
20 regulation will recognize that these kinds of
21 distortions lead regulators to try to prevent those
22 distortions through things like prudence review, used

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1 and useful standards. Endless hearings about those
2 kinds of things as regulations snowballs on itself to
3 try to prevent the distortions that are created by
4 rate constraints triggered by overall firm revenue
5 adequacy.

6 Let me now turn briefly to the task force
7 proposals. And specifically, the revenue increase
8 constraint. Because it is a constraint, regardless
9 of how it's characterized, that would be triggered
10 upon revenue adequacy determinations, it would carry
11 the distortions that I've just discussed --
12 distortion to investment operations and pricing.

13 Access triggers, an indirect way to try to
14 impose rate constraints triggered by revenue adequacy
15 have exactly the same incentive effects to cause
16 firms to try to avoid the trigger. And in
17 particular, access triggers, such as remove the
18 bottleneck protection, violate the mimic competition
19 principle because the kinds of scale and scope
20 industry such as we have here, with the high costs,
21 we do not see as the competitive outcome customer
22 controlled access in routing.

1 I would very much like this evening when I
2 fly west, to not have to stop in Dallas. If I have
3 the ability as a customer to tell American Airlines
4 to stop in Dallas, what happens? I will be better
5 off. There is no question about it. But because the
6 firm has to run a network and consider what we call
7 network externalities, that is ripple effects across
8 the network, it's unwise for American Airlines to let
9 me just dictate where I have access, my routing, et
10 cetera.

11 Let me comment briefly now on the ACC
12 proposals. The ACC proposal represents an ambitious
13 academic exercise, but I don't think that it actually
14 satisfies either the mimic competition principle, or
15 the goal of streamlining regulation in ways that
16 would actually allow us to better implement the mimic
17 competition principle, where there are pockets of
18 market power in the railroad system.

19 First, the regression analysis that is
20 used does not actually model the right kind of
21 competition. It models the Econ 1 competition,
22 whether multiple railroads, for example, were

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1 present. It does not manage competition in an
2 industry characterized by massive economies of scale
3 and scope.

4 It does not matter contestability. It
5 does not discover the presence of market power. In
6 determining what were labeled in the proposal and in
7 the slides this morning as anti-competitive rates,
8 but no account is taken in the modeling of exactly
9 where we worry about market power problems. Low
10 density portions of a system where there's only a
11 single carrier, those are precisely the areas that
12 the model doesn't model how a competition actually
13 occurs in industries with these economies of scale
14 and scope.

15 Importantly, the explanatory power of the
16 ACC model is quite low. I won't go into the details,
17 but you'll start to hear words like our squared
18 adjusted for fixed effects and these kinds of
19 things. The model can't actually even tell you why
20 it's -- what it calls competitive rates are
21 determined. It can't tell you why that's a
22 competitive rate.

1 Moreover, the model of regression and
2 statistical regression model is nothing more than a
3 complicated way of taking a kind of weighted average.
4 It passes through the blue dots in the picture. In
5 that framework for a carrier, which is at the
6 competitive threshold in the model with 1.0
7 competitive threshold, that carrier's -- half of its
8 rates are above the competitive benchmark.

9 Half of its rates, the arrows in the
10 picture with red arrows, those red arrows would go
11 down to all the blue dots above the regression line
12 for a carrier that is at the competitive threshold.
13 So, in other words, rates that would be competitive
14 according to the model, turn out to be labeled
15 non-competitive, or anti-competitive.

16 Lastly, if we think that this kind of
17 approach is going to make regulation more simple,
18 less complicated, more understandable, I would pause
19 and not invite you into our seminar rooms where we
20 discuss words like heteroscedasticity,
21 multicollinearity, adjusted R squares, left out
22 variable bias. These are the kinds of economic or

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1 econometric statistical problems that lie within any
2 attempt to use this broad brush approach to regulate
3 rates.

4 Let me turn and talk briefly about as I
5 have, briefly, talk about the question of non-rate or
6 indirect mechanisms of controlling railroad revenues
7 through various consumer control of access of
8 routing, such as the elimination of bottleneck
9 protection. What we find in the research, and I cite
10 it in my verified statement. What we find in the
11 academic research is that consumer control of access
12 or routing is especially poorly suited -- and I know
13 there's some jargon in the second line of this title,
14 to congest -- especially poorly suited to
15 congestible, non-linear complicated web networks with
16 non-fungible traffic.

17 By fungible, we mean something like
18 electrons or molecules of natural gas. Molecules of
19 natural gas, one molecule is as good as another. But
20 in the railroad industry, we have a highly
21 congestible system as we all recognize. We have a
22 web system, particularly in the United States with

1 multiple nodes, and we have non-fungible traffic.

2 The furniture shipment needs to go to my
3 destination, not to somebody else's. In that kind of
4 situation what we find is two primary problems.
5 Customer control of access of routing results in
6 what I referred to earlier as network externalities,
7 ripple effects.

8 I might like to put my traffic in control
9 where it goes, but there are costs to doing that,
10 that I, as an individual, don't take into account.
11 Those are externalities. As the effects of adding
12 congestion to the system, disrupting interchanges and
13 switchings and so forth, those things are
14 appropriately and in a contestable, competitive
15 market, held within the firm, not granted to
16 consumers or shippers for them to control.

17 Secondly, what we find in the research is
18 that in these kinds of systems, those problems of
19 consumer disruption through consumer control of
20 access or routing, result in under investment. And
21 so, you find for example, in the English situation,
22 massive under investment in the rail network, under

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1 this system of open access.

2 Leading them now to now -- and in a number
3 of countries who've tried the open access regime,
4 leading them now to look at nationalizing,
5 renationalizing the rail networks because the
6 private sector is unwilling to send capital into such
7 a crazy system.

8 So, how do we do better? It is everywhere
9 always the case that the regulators, the policy
10 makers should be concerned that its regulatory
11 systems are efficient, accessible, and able to carry
12 out the goals of regulation. In this case, the mimic
13 competition principle.

14 What do we mean by smart simplification?
15 The general principle is don't throw out the baby of
16 SAC mimic competition, rate making contestable market
17 competition. Don't throw it out with the dirty
18 regulatory bath water.

19 And in my verified statement I make a
20 number of recommendations about possible approaches
21 here, rebuttable once and for all decisions on
22 recurring cases, standardizing of recurring matters

1 and the utilization of third party experts and
2 technical conferences.

3 I've had considerable experience in the
4 FERC arena where these approaches -- they allow the
5 regulator to narrow down arenas of debate, to reduce
6 the cost of the regulatory proceedings, and to make
7 better and more effective regulation. Thank you very
8 much.

9 MR. ATKINS: So, between the rate reform
10 task force and ACC, the Board has before it three
11 different concepts, all of which are really designed
12 to suppress railroad earnings towards their cost of
13 capital. You've got the concept of system-wide
14 earnings regulation, which we believe, and we'll talk
15 about it in a moment, that ACC's approach falls
16 pretty squarely into that category.

17 You've got forced competitive access,
18 which is tied to concepts of revenue adequacy, and
19 you have the idea of a rate freeze. And so, what I
20 would like to do is talk a little bit about the legal
21 obstacles that either of these proposals, and then
22 end by talking a little bit about some -- whether the

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1 empirical data actually supports any of these
2 proposals, even if you think they might be lawful.

3 So, let's start with earnings regulation.
4 And that's actually a bit comforting to hear ACC
5 right out of the gate, that they agree with the AAR
6 that earnings regulation really isn't part of the
7 Staggers Act. But I just want to emphasize the point
8 so that we don't lose it.

9 Earnings regulation is a highly -- is a
10 discarded form of utility style regulation which at
11 its essence says you can only earn your cost of
12 capital and no more. But this is a form of
13 regulation that Congress did not use for the freight
14 rail industry, even pre-Staggers. And so, the
15 question is by introducing the concept of revenue
16 adequacy in the four R Act and Staggers, did
17 Congress somehow reintroduce this concept back into
18 the freight rail industry.

19 But, you know, the Supreme Court has
20 cautioned that Congress does not make fundamental
21 changes to the basic framework of an industry
22 lightly, and ancillary terms are in vague meaning.

1 The Supreme Court demands some clear showing of that
2 type of fundamental shift in how you regulate
3 industry, and that does not exist here.

4 Here, earnings regulation is our
5 proverbial elephant and the Staggers Act is our
6 proverbial mouse, a mouse hole. And the question is
7 can you find the clear direction from Congress to
8 adopt earning regulations? And the answer is no. It
9 doesn't appear anywhere in the statute. What does
10 the statute actually say?

11 Well, of course, as you know, it has an
12 obligation for you to make a continuing effort to
13 help the industry achieve revenue adequacy. In the
14 definition of revenue adequacy itself, it speaks
15 about permitting railroads to earn an economic
16 profit. You'll see it in the definition of revenue
17 adequacy.

18 And an economic profit is a term of art.
19 It's well-known in the economic literature that
20 economic profit means earning above your cost of
21 capital. And in addition, in 1980, Congress put in
22 place the zone of rate flexibilities. One of them

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1 permitted revenue adequate carriers, carriers already
2 earning over their cost of capital, to increase their
3 rates 6 percent over inflation.

4 There is no way to reconcile that
5 directive from Staggers Act with the concept that
6 they thought the cost of capital or revenue adequacy
7 was going to be a constraint on the system. Well, in
8 our opinion, this is probably the most significant
9 bone of contention between the AAR and ACC. We
10 believe that the ACC's proposal is indeed, earnings
11 regulation.

12 And so, what I would like to do is just
13 walk you through some of the key features of earning
14 regulations and see how they compare to the ACC's
15 proposal. Well first of all, earnings regulation
16 treats the cost of capital as a revenue requirement.

17 If you look at Table 5 of Dr. Caves'
18 testimony, it does appear that they are using the
19 revenue adequacy as a revenue requirement. Chairman
20 Begeman, I see my time is expired. I have probably 7
21 minutes left if you'll indulge me? 5, alright, I'll
22 go quick.

1 System-wide earnings constraint as driven
2 down to the cost of capital. You can look at Table 5
3 as well. It has that. Rate relief is tied to what
4 you earn from competitive traffic. Here they say
5 that well, we're not regulating competitive traffic.
6 But the revenues that you earn from competitive
7 traffic drives the competitive threshold.

8 So, what a railroad earns on his traffic
9 for intermodal traffic, will affect the reasonable
10 rates that it can charge to chemical traffic, and it
11 has the effect of discouraging innovation if you
12 drive earnings down to the cost of capital, you
13 deprive them of the opportunity to earn an economic
14 profit. That is the carrot that drives innovation in
15 the freight rail industry.

16 What about the idea of revoking the
17 bottleneck protection? Based on a finding of whether
18 the fact that a carrier is revenue adequate? Well,
19 in these circumstances you'd look to the language of
20 the statute to see did Congress tie that long held
21 protection to the finding of revenue adequacy.

22 And nowhere in this statute will you find

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1 that connection. In fact, in Staggers Act, Congress
2 did deliberately tie certain protections to revenue
3 adequacy. This was not one of them. And the
4 standard of statutory construction is if Congress
5 tied one protection to revenue adequacy and did not
6 do so here, you have to assume that that decision was
7 deliberate.

8 And that has led the Board to previously
9 say that it's decisions in this area are compelled by
10 the law. They are not driven by considerations of
11 revenue adequacy, they are driven by these long
12 standing directions from Congress to permit railroads
13 to be efficient and their entitlements to the long
14 haul, absent very specific statutory limitations.

15 And when I went up on a -- you know, when
16 this concept went up to the D.C. Circuit in its
17 various contexts, the shipper communities were making
18 the point that I know you've heard, which is
19 competition appears all over the place in the
20 statute. Isn't it really your obligation to
21 encourage and create as much competition as you can
22 so that more customers have head to head rail

1 competition?

2 And the D.C. Circuit said twice that
3 there's no indication anywhere in the Staggers Act
4 that Congress intended to move the industry towards
5 that of perfect competition. Well what about the
6 rate increased constraints? Well, we appreciate the
7 rating constraint was designed to try to avoid some
8 of the flaws of variance regulation, but it's likely
9 to have some unintended consequences by capping the
10 rate increases on the upswing, but not on the
11 downswing as markets move.

12 It's going to drive the rates down
13 towards the RIC, transforming it from a rate freeze
14 into a rate cap, but perhaps, more fundamentally from
15 a legal perspective, you're assuming the rate is
16 unlawful.

17 Any rate increase above a certain
18 threshold is unlawful, without actually looking at
19 the particulars of the rate. So, it could be on a
20 white density line where you need more money to earn
21 a sufficient return on those assets, and yet you're
22 deeming it an unlawful rate increase.

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1 But if you believe this may be some
2 flicker of hope here that these might survive
3 judicial review, does the empirical evidence support
4 all the assumptions that underline every one of these
5 proposals, which is generally, that the railroads are
6 making too much money?

7 But as Professor Kalt has explained to
8 you, your findings of revenue adequacy are
9 insufficient to make that -- to draw that kind of
10 conclusion. And to emphasize this point, I would
11 like to focus the Board's attention on a different
12 industry. I'd like to focus your attention on the
13 chemical industry.

14 And so, what this chart shows you is the
15 return on invested capital minus their cost of
16 capital for every member of the American Chemistry
17 Council, who appears in the S&P 500. And now this
18 data is drawn from what the submission by Professor
19 Murphy and Professor Z, they'll talk to you more
20 about the data tomorrow. The key point for you is
21 that this data replicates your analysis exactly.

22 The return on invested capital is done the

1 same way you do with the book value, less accumulated
2 deferred taxes. The cost of capital is done the same
3 way as the railroad industry with the use of the cap
4 and the multi-phase DCF. And what does it show?

5 Well, it shows you that ACC members are
6 earning 19 percent over their cost of capital. Now,
7 does that suggest that their members are exploiting
8 market power in some fashion that demands some sort
9 of government solution? Of course not. They operate
10 in a fiercely competitive market, just as the
11 railroad industry.

12 Does that kind of appearance of a
13 staggering return on investment suggest that you
14 should be forcing a company like Dupont to open up
15 its facilities to another chemical company to create
16 more competition and enforce leverage in order to
17 drive down rates towards that floor? The answer, of
18 course, is no. That would be as catastrophic for the
19 chemical industry as it would be for the freight rail
20 industry.

21 And does this suggest that you should
22 impose the kind of earnings constraint that ACC is

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1 proposing for the railroads on its own members? So,
2 returning again to Table 5 of Doctor K's report,
3 what he's saying is that the repeated application of
4 his approach would deprive Union Pacific, Norfolk
5 Southern and being a staff of roughly 1.5 billion
6 dollars a year. Now that's a massive wealth
7 transfer.

8 But it pales in comparison to the 50
9 billion dollars ACC members are earning over their
10 cost of capital as measured by the Board. Now, we're
11 not here, of course, proposing that you do anything
12 of the sort, but we are here to ask you the empirical
13 data, what it does show, is that here is insufficient
14 evidence from your findings to make a determination
15 to make the kind of seed changes that are being
16 proposed at today's hearing. Thank you very much.

17 CHAIRMAN BEGEMAN: I'd like to start by
18 thanking the two panels as I indicated, it was going
19 to be interesting, and you succeeded. So, thank you.
20 Some of it I found really far-fetched, but that was
21 also what I expected.

22 I'm going to start, I think with ACC, just

1 sort of a question and maybe to you, Mr. Moreno.
2 Throughout the carrier's written testimony, not
3 simply AAR's testimony just now, but sort of the
4 drum beat is that the Board does not have the
5 authority to really make any changes with respect to
6 bottleneck.

7 I wouldn't say just with respect to
8 revenue adequacy prompt a bottleneck, but across the
9 board we really don't have any authority. However,
10 you know, if the Board were to do something with
11 respect to revenue adequacy, and perhaps, you know,
12 finessing the task force proposal, so that it
13 wouldn't be an automatic change to bottleneck, but
14 perhaps a shipper would have to show that the
15 bottleneck route would be more efficient.

16 Do you think that would be a better legal
17 approach? More defensible?

18 MR. MORENO: The Board does have the
19 authority clearly, and within the three exceptions
20 that are enumerated within the statute to short haul
21 a carrier. And none of the -- ACC is correct when
22 the say that revenue adequacy does not appear in the

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1 statute. But revenue adequacy can be a relevant
2 consideration with respect to some of the statutory
3 considerations.

4 At the risk of pre-empting the testimony
5 I'll give tomorrow as part of FTI specifically on
6 this subject, we are -- the Board would have rational
7 basis for adopting additional standards beyond just
8 revenue adequacy for purposes of deciding when to
9 grant bottleneck relief.

10 And we think, for example, one of the
11 exceptions that is enumerated in the statute, is the
12 reciprocal switching. And the Board has a proposal
13 before it right now which includes standards that are
14 not tied to revenue adequacy at all, which could be
15 considered.

16 But if the Board wanted to link revenue
17 advocacy to the reciprocal switching standards, that
18 might be one additional method for it to do so. In
19 the TFI presentation tomorrow, TFI will be
20 suggesting factors in addition to revenue adequacy
21 that the Board could consider when deciding whether
22 bottleneck relief is appropriate. And you'll note

1 that several of those factors are very similar to
2 what appears in Ex parte 722 and I think would be a
3 reasonable proposal from the Board.

4 CHAIRMAN BEGEMAN: You know, one of the
5 things that I actually would like both you and Mr.
6 Atkins, if he would talk as well. But you raised the
7 Board's competitive switching proposal and I'd like
8 you to both kind of talk about how you see -- what
9 you see the difference between bottleneck access
10 versus a competitive switch. Is it really a distance
11 issue?

12 MR. MORENO: I think distance is the most
13 obvious differential that reciprocal switching is a
14 form of a short distance bottleneck. Bottleneck
15 scenarios might arise in a more varied set of
16 scenarios than reciprocal switching, which is solely
17 at the origin and the destination.

18 But yeah, I think distance is the
19 predominant different distinction.

20 MR. ATKINS: I would just add that the
21 reciprocal switching provisions in the AAR's -- that
22 only is permissible a terminal area. So, there's a

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1 limitation that Congress contemplated both on
2 reciprocal switching and traffic rights that would be
3 contained within a terminal area.

4 The distance outside of the terminal area
5 is for traffic rights only, not for reciprocal
6 switching, so there's a very strict geographic
7 limitation on the use of reciprocal switching. If
8 you were to adopt a revoked bottleneck decision, that
9 would apply across the entire network, so anyone,
10 anywhere could ask for an in-change anywhere on the
11 network.

12 It would be an order of magnitude more
13 problematic than reciprocal switching, which in
14 itself is from the industry's perspective, a recipe
15 for some significant operational disruption.

16 MR. MORENO: I would take issue that the
17 statute limits it to a terminal. I believe the
18 statute would first determine areas in a reasonable
19 distance beyond the terminal areas. And in fact,
20 that's solely in the traffic rights context. There's
21 no such language in the reciprocal switching portion
22 of the statute.

1 VICE CHAIRMAN FUCHS: So, within the ACC
2 testimony, there was appended a verified statement
3 from Professor Faulhaber on the stand-alone cost
4 test. And I think he identified four key issues.
5 That there was no profit constraint, it's not a pure
6 monopoly, not every rate is regulated, and the
7 overall complexity.

8 And for obvious reasons, can I just, you
9 know, start with the first one. And, you know, as I
10 understand it, the whole theory behind SAC is that,
11 you know, if you have a profit constraint
12 hypothetically efficient railroad, the costs or
13 sorry, the rates will fall somewhere between the
14 incremental costs and stand-alone costs such that if
15 you exceed the stand-alone costs, someone is below
16 incremental cost, and that's the cross subsidy.

17 And that cross subsidy is bad because it's
18 inefficient and people see it as unfair. So, I guess
19 I'm wondering, you know, Professor Faulhaber said
20 that because railroads are not profit constrained,
21 the entire model of cross subsidy goes away. And
22 that's a part of why he finds SAC invalid. Do you

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1 all agree with that general assessment as one of the
2 core criticisms of SAC?

3 MR. SLOAN: I do, yes. It's one of the
4 core criticisms, yeah.

5 VICE CHAIRMAN FUCHS: So, for railroads
6 making economic -- but if a railroad is making
7 economic profits, doesn't that just mean that there's
8 an additional player in the game and it's just
9 investors that are kind of getting the cross subsidy,
10 and so a shipper would still be entitled to relief if
11 they're over stand-alone cost?

12 MR. SLOAN: Well it depends on what method
13 you're using to give relief to the shipper. But --

14 VICE CHAIRMAN FUCHS: Should a shipper
15 ever have to pay more than stand-alone costs?

16 MR. SLOAN: Oh, more than stand-alone
17 costs?

18 VICE CHAIRMAN FUCHS: Yes?

19 MR. SLOAN: No. And I think the problem
20 is the stand-alone cost is generally such a high
21 threshold that it will prevent monopoly pricing well
22 above competitive levels, but yeah. No, but I can't

1 think of a circumstance where the shippers would have
2 to pay more than that in order for the rate to be
3 deemed competitive.

4 VICE CHAIRMAN FUCHS: Then talk me through
5 why the profit constraint is defeating for SAC? So,
6 he puts forward if there's not a profit constraint
7 for the railroad overall, then model cost subsidy
8 goes away, but if it's just that the money goes to
9 investors, and shipper is still entitled to relief,
10 why does that defeat the purpose of SAC?

11 MR. SLOAN: Yeah, I'm not sure I follow.
12 I mean the purpose of SAC is, as you point out
13 correctly, is and as Faulhaber points out is to
14 prevent cross subsidization, right?

15 VICE CHAIRMAN FUCHS: Right.

16 MR. SLOAN: Right. So, under a very
17 specific set of circumstances that don't really apply
18 here. So, I think right out of the gate, SAC's
19 purpose is just -- it's very difficult to translate
20 to the rail industry.

21 VICE CHAIRMAN FUCHS: Right.

22 MR. SLOAN: But to the extent that it does

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1 apply, it involves a hypothetical competitor that
2 would have to construct its own network from the
3 ground up and pay all those costs up front. And all
4 SAC says is that as long as the railroad is not
5 charging such a high price that it would induce their
6 entry, it's competitive.

7 VICE CHAIRMAN FUCHS: Sure, sure. So, Mr.
8 Atkins, you generally agree that if a shipper is
9 paying more than the stand-alone cost, they're
10 entitled to relief?

11 MR. ATKINS: If you can demonstrate a lack
12 of effective competition, yeah.

13 VICE CHAIRMAN FUCHS: And so, you know,
14 one of the things I saw within your revenue adequacy
15 testimony is you know, and I think Dr. Kalt, you
16 mentioned it today that SAC uses replacement costs.
17 And you all contemplate using replacement costs for
18 revenue adequacy and not on a long-term basis.

19 So, thinking about SAC tests, for a
20 stand-alone -- when are rates found unreasonable,
21 stand-alone railroad, after relief is given? What is
22 the ROI? What is the return on replacement cost

1 that that SAR has, the stand-alone road?

2 MR. ATKINS: Yes, the Board uses the
3 industry average cost of capital to set the
4 threshold.

5 VICE CHAIRMAN FUCHS: Right, but so, talk
6 me through, what is -- how much is the ROI greater
7 than the costs of capital? After the relief is given
8 on the stand-alone railroad.

9 MR. ATKINS: So, if we're talking about
10 what the hypothetical railroads ROI would be.

11 VICE CHAIRMAN FUCHS: Yes.

12 MR. ATKINS: It's -- the Board sets it at
13 the cost of capital. So, it would be hypothetical
14 railroad, the SAR.

15 VICE CHAIRMAN FUCHS: So, the hypothetical
16 railroad, understanding what costs -- can never earn
17 more than its cost accounting?

18 MR. KALT: That's correct. But the rate
19 of -- the ROI portion.

20 VICE CHAIRMAN FUCHS: Is not a replacement
21 cost?

22 MR. KALT: Is not a replacement cost. Not

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1 the accounting book cost, yeah.

2 VICE CHAIRMAN FUCHS: But here's the
3 thing -- is if we do replacement costs for the entire
4 network, then if every segment that was subject to
5 the SAC has no ROI that exceeds the cost of capital,
6 then at a system-wide basis, ROI can exceed the cost
7 of capital.

8 MR. KALT: That's correct.

9 VICE CHAIRMAN FUCHS: So, how can a
10 railroad ever be revenue adequate?

11 MR. ATKINS: Well, like you said, that's a
12 good question and it's certainly one that I've
13 heard -- we've grappled with for years. So, there's
14 a couple things about SAC in the application of CMP
15 that I think are important. It's generally not done
16 on a system-wide basis, right? So, the key to SAC is
17 looking at what are the facilities that are being
18 used to serve a particular customer who lacks
19 effective competition?

20 So, there will be pockets of captivity.
21 And what the Board has done is it's embraced this
22 contestability theory in those limited circumstances

1 where it has to inject itself. But that does not
2 mean that the revenues that are earned from traffic
3 that's a thousand miles away, has any bearing
4 whatsoever, on the reasonableness of that rate.

5 And if those lanes that you're speaking of
6 are all competitive traffic, then there will be --
7 the SAC constraint will never be placed on those
8 particular lanes or networks in the industry. It
9 only -- it is only applied in those small
10 circumstances where there's a lack of effective
11 competition, and that's 70 percent of the traffic is
12 not governed by that.

13 VICE CHAIRMAN FUCHS: I'm with you, but in
14 those pockets where there's a lack of effective
15 competition, those would be particularly likely, I
16 would think, to have an ROI that meets the cost of
17 capital, or exceeds it, right? Because if it's
18 competitive traffic, you're going to have, you know,
19 you're going to try.

20 And so, I guess I'm wondering where is the
21 pocket that the ROI exceeds the cost of capital using
22 replacement cost?

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1 MR. KALT: It's readily the case that in
2 competitive markets, firms are -- yeah, I go back to
3 the way we teach it, but I make a mistake as an
4 economist. We start out teaching every firm is
5 identical.

6 VICE CHAIRMAN FUCHS: Right.

7 MR. KALT: In the rail world, firms are
8 not identical.

9 VICE CHAIRMAN FUCHS: Right.

10 MR. KALT: And they can earn what we refer
11 to as efficiency rents. What we really mean by that
12 is even in competitive markets they may be able to,
13 for example, produce better quality at lower cost,
14 and earn returns which exceed their cost of capital.

15 So, in that kind of situation you wouldn't
16 be using SAC style regulation, because they're
17 competitive segments, and yet they would be
18 generating revenues that would be in excess of their
19 cost of capital.

20 VICE CHAIRMAN FUCHS: Using replacement
21 costs?

22 MR. KALT: Yes, yes. Just yes.

1 VICE CHAIRMAN FUCHS: So, in a
2 competitive -- if on that segment the railroad was
3 making returns.

4 MR. KALT: A competitive segment?

5 VICE CHAIRMAN FUCHS: The competitive
6 segment, the railroad was making returns above its
7 cost of capital. Then the Board could not lower it,
8 because it could not apply a SAC test and there would
9 be barriers to entry such that nobody could come in
10 and take that traffic, or how does it -- I guess, if
11 it's a truly competitive segment, then why can't
12 someone come in and take those profits?

13 MR. KALT: Well people may be coming in.
14 Things like trucks. Those are competitors.

15 VICE CHAIRMAN FUCHS: So, it will be a
16 temporary thing?

17 MR. KALT: No, not necessarily. Again, if
18 you've got a situation where you have particular
19 efficiencies, particular -- sometimes guessing right.

20 VICE CHAIRMAN FUCHS: Right.

21 MR. KALT: On technology change and so
22 forth. You can have sustained periods where someone

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1 can in fact, not duplicate what you're doing, but
2 you're not in monopoly profits, you're constrained by
3 competition, you're earning what we call efficiency
4 rents, excess profits if you will, but they are not
5 attributable to the exercise of market power.

6 They can be fairly long lived until
7 someone catches up with you.

8 MR. ATKINS: And so, and let me just
9 emphasize that you know, you're talking about
10 replacement cost. I think what Congress envisioned
11 for the freight rail industry was that there will be
12 two constraints on it and the first constraint is the
13 giant. It's competition, just like any others out
14 there, whether it's the chemical industry or the
15 railroad industry, competition is going to act to
16 constrain the overall profitability and you might
17 earn above your cost capital because you're more
18 efficient than your competitors, you've found a
19 better way to build a mouse trap.

20 The market, your market will reward that
21 type of behavior and where there are pockets of
22 captivity, that's where it's your role to come in and

1 try to simulate that competition. That doesn't --
2 so, over time, there should be, if the railroads are,
3 you know, if somebody is particularly innovative, and
4 has found something particularly new that the -- a
5 new way to innovate and compete with traffic, it
6 should earn true economic province --

7 VICE CHAIRMAN FUCHS: Even on that
8 segment.

9 MR. ATKINS: On those segments. Over time
10 competition is, you know, the greatest disciplinary.
11 It will eventually force through whether it's from
12 trucks, or rails, or barge or products, you've got
13 the competition, whatever the form might be.

14 VICE CHAIRMAN FUCHS: And so, your point
15 is when ROI exceeds the cost of capital, in a
16 regulatory regime that has a SAC constraint, and
17 they're both based on replacement cost, necessarily
18 the money that's over the revenue adequacy threshold
19 is all due to efficiency and economic.

20 MR. KALT: Let me say in the real world,
21 that is -- in the real world there are two
22 possibilities. Is that SAC test being applied in a

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1 way that is ferreting out the actual pockets of
2 market power?

3 VICE CHAIRMAN FUCHS: Right.

4 MR. KALT: And I've tried to stress in my
5 testimony. I don't know if AAR even likes it, but
6 that is appropriately what we need to focus on.
7 That's the challenge here is ferreting out. But yes,
8 if you've been successful across all those pockets of
9 market power, then you'll find rates of return in
10 excess of the cost of capital, if firms, railroads
11 have these efficiency rents, these payoffs, if you
12 will, to their innovation, cost savings and so forth.

13 VICE CHAIRMAN FUCHS: ACC, what is your
14 view on the flaws in that logic?

15 MR. CAVES: I don't, sorry. I don't see
16 any flaw in the idea that railroads could earn
17 returns in excess of their cost of capital on
18 competitive roads. I don't see anything wrong with
19 that.

20 BOARD MEMBER OBERMAN: Good morning, thank
21 you all. I have some sort of basic questions I
22 wanted to explore. My first question Dr. Caves, is

1 just, and I didn't have time to really absorb the
2 entire model. It's something I hope to do soon, but
3 is one of the screens, the 180 percent measurement?

4 MR. CAVES: It's a good question. No, for
5 two reasons. First, we were given masked data, so we
6 couldn't compare a railroad's actual revenues to its
7 URCS costs, given the data that we were given.

8 And of course, we recognize that you know,
9 if this were applied in practice, any railroad with
10 an RVC less than 180 wouldn't be subject to
11 regulation. As an economic matter, I'd be reluctant
12 to apply that as a screen from a modeling perspective
13 because there are well-known economic problems with
14 URCS that TRB and others have pointed out.

15 So, I wouldn't want to -- so there are two
16 separate issues there.

17 BOARD MEMBER OBERMAN: Well under the
18 current statutes.

19 MR. CAVES: Yeah.

20 BOARD MEMBER OBERMAN: If your model were
21 to be utilized, would you not have to use the 180 as
22 a screen in order to comply with the statute?

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1 MR. CAVES: You would certainly --

2 BOARD MEMBER OBERMAN: But given its
3 inadequacies.

4 MR. CAVES: Yeah, you would certainly have
5 to use it in the sense that you couldn't, you know,
6 if the model told you that rates should be reduced on
7 a route, and it turned out the RVC was below 180,
8 then it would be a non-starter. I agree with that.

9 BOARD MEMBER OBERMAN: But even in terms
10 of just figuring that threshold part of the graph.

11 MR. CAVES: Yeah.

12 BOARD MEMBER OBERMAN: Are a threshold in
13 order to get into that wouldn't you have to use the
14 180 as a screen?

15 MR. CAVES: You could. I don't. I mean
16 you could do it if you had to and I don't think it
17 would -- it certainly wouldn't be detrimental to the
18 model to impose that constraint, but if you don't
19 think RVC is a good measure of competition, then I
20 don't see any reason, and again purely from a
21 modeling perspective, if one of those -- I don't see
22 any reason to use that as a screen to determine

1 whether or not a rate gets included in the blue dots
2 that you saw on my first graph.

3 But if someone told me that I had to do it
4 that way, I could accept that.

5 BOARD MEMBER OBERMAN: My only question is
6 whether the statute requires it to be done.

7 MR. CAVES: Well for modeling purposes, I
8 mean I'm not a lawyer, but I don't know if the
9 statute says anything about how you're supposed to
10 model these things.

11 BOARD MEMBER OBERMAN: Jeff?

12 MR. MORENO: I would say from a legal
13 perspective, the 180 percent threshold sets the floor
14 below which the Agency can prescribe a rate, but it
15 doesn't necessarily prohibit the Agency from
16 considering in the econometric model rates are below
17 180. That may be a factor when the Board decides how
18 to set the competitive threshold level that the Board
19 might consider, but it's not a requirement.

20 BOARD MEMBER OBERMAN: Let me Jeff, ask
21 you a question. I don't want to get too far into the
22 final offer part, because we've got a lot of work to

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1 do here in the next two days, but you suggested, or
2 the ACC is suggesting that the Board got this model
3 as a rule. I assume you're not suggesting that it be
4 the only model, but just adopt it as one of the
5 alternative models that could be used.

6 MR. MORENO: Yes. It would simply be an
7 additional model to what currently exists.

8 BOARD MEMBER OBERMAN: So, that in the
9 final offer setting, a shipper who wanted to use the
10 final offer approach could make their argument based
11 on the ACC benchmark test as opposed to SAC or three
12 benchmarks, or whatever?

13 MR. MORENO: Absolutely. We consider that
14 to be a possibility and that it's a good fit for the
15 timeframe and the other limitations that the Board
16 has proposed in Ex parte 755.

17 BOARD MEMBER OBERMAN: But as the proposal
18 is currently drafted, even if the Board did not
19 formally adopt this, Dr. Caves' model as a rule,
20 don't you agree the proposal the way it's drafted
21 now, it would allow a shipper to say well we're going
22 to argue this one anyway because we think it's bad.

1 You're not restricted just because it's not a rule?

2 MR. MORENO: No. There's nothing that
3 prevents a shipper to use this methodology in the
4 final offer process. The reason we're requesting a
5 rulemaking proceeding is that in the final offer
6 process, we start from square one in every situation.
7 So, every shipper has got to come in and develop the
8 econometric model that Dr. Caves has already
9 developed.

10 They've got to come up with their own CT.
11 They need to defend their competitive screens. All
12 of those will have to be defended in that case. If
13 the Board takes this up in a rulemaking, all those
14 issues can be addressed by all stakeholders, and then
15 we'd get the certainty and the consistency that we
16 get with the level of SAC, at least in understanding
17 how the model will work.

18 BOARD MEMBER OBERMAN: Alright, I'd like
19 to shift over to Dr. Kalt and to Ray. I've started
20 out by going through your written presentations, and
21 I just have a number of questions about that and
22 somewhat based on the presentations. Let me ask you

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1 this Dr. Kalt, and Ray both. Throughout your written
2 presentations, there's reference to you know, the
3 overwhelming vast majority of rail traffic faces
4 competition, only in small slices lacking
5 competition.

6 Are you referring to traffic that's just
7 above or below the 180 mark? What are you talking
8 about when you say 76 percent is competitive?

9 MR. ATKINS: So, that figure that we put
10 in as the amount of traffic that falls below 180
11 percent and by law, is deemed to be reasonable from
12 Congress.

13 BOARD MEMBER OBERMAN: So, when you say
14 traffic can conclusively presume to be competitive,
15 you're just talking about the 180 threshold.

16 MR. ATKINS: That's correct.

17 BOARD MEMBER OBERMAN: So, recognizing
18 that we now have a statute that we have to follow,
19 but in the real world that assumes that URCS and the
20 measurement of traffic that's above as low as 180, is
21 really an accurate measure of what's competitive.
22 Does it not?

1 MR. ATKINS: Right. It's a commandment
2 from Congress to use that tool and that threshold as
3 a safe harbor for railroad pricing.

4 BOARD MEMBER OBERMAN: But Congress didn't
5 command the particular URCS that we have, it just
6 commanded some uniform system.

7 MR. ATKINS: That's correct.

8 BOARD MEMBER OBERMAN: Because as I think
9 has been mentioned, TRB, but they're not unique.
10 They have a lot of criticism of URCS as it's now
11 framed, and as it might be framed in the future. So,
12 it just strikes me that the way you speak in your
13 presentations with certainty about the vast majority
14 being competitive, has a certain artifice to it,
15 because it assumes that the 180 as currently
16 calculated, is somehow an accurate reflection of
17 competition in the real world. And we don't really
18 know that, do we?

19 MR. ATKINS: So, it's obviously in the
20 statute creating the 180. It is the law of the land.
21 So, I don't think it's inappropriate for us to
22 observe that roughly 70 percent of traffic is outside

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1 your jurisdiction, because Congress has a presumption
2 that those rates are reasonable. The railroad's
3 position is, in fact, most of the freight rail
4 industry is subject to intensive competition,
5 particularly the most intense competition flow is
6 from product and geographic competition which is a
7 function of something that the Board declines to look
8 at because it's too complicated.

9 BOARD MEMBER OBERMAN: Well, I understand
10 that and yes, we have to limit ourselves in terms of
11 what we actually have power to do to what Congress
12 has restrained.

13 MR. ATKINS: Correct.

14 BOARD MEMBER OBERMAN: But I'm also trying
15 to grapple with the actual real world. You know, I
16 made an observation once years ago when I was in a
17 different role, about PTC, that if Congress passed a
18 law mandating that all Metro trains levitate, you
19 know, they could say that, but we couldn't do it.

20 And that you know, we had that same
21 problem with artificial deadlines in PTC. So,
22 Congress could pass a law saying we are declaring all

1 of this traffic to be competitive, and for the moment
2 we have to follow it. But in the real world I'm
3 trying to figure out if it's really competitive or
4 not.

5 It could be that more traffic is
6 competitive, or less is, but all of these -- I just
7 want to make sure I understand that when you and when
8 Dr. Kalt, an economist says, the vast majority is
9 competitive, is he referring simply to the 180
10 measurement or is he referring to some other way of
11 our determining what's really competitive?

12 MR. KALT: In my case I'm not really
13 referring to the 180 measure. There is considerable
14 research, the Christianson studies and others, that
15 find -- I use the phrase vast swaths of the network.
16 And I believe that in the ACC study, they don't use
17 the wide screen, but rather use structural screens
18 about whether there are other railroads, and I
19 believe they find 24 percent of the traffic as being
20 in the non-competitive benchmark area.

21 So, in fact, that kind of number is
22 consistent with a 180 based calculation, but that's

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1 not the sole basis for recognizing the extensive
2 competition on a network.

3 BOARD MEMBER OBERMAN: Well, is there
4 anything other than the Christianson study for us to
5 look at to figure out how we really determine what's
6 competitive, other than the 180? Is there some
7 other -- that's what I'm just trying to get at, what
8 are you facing?

9 MR. KALT: Well and it's been a while, but
10 in various exemption proceedings, and in the
11 treatment of intermodal and so forth, there is data
12 around those studies and proceedings and so forth. I
13 haven't reviewed it recently, but there is certainly
14 data on that.

15 There's also data, I believe by Cliff
16 Winston, Congress -- looking at the impacts of
17 mergers which attempts to measure some of that
18 regarding multi-serve locales and so forth.

19 MR. ATKINS: I do believe that the
20 Christianson study is probably the most robust
21 analysis of the particular freight rail industry. I
22 mean I know it's about a decade old, but it was

1 promulgated by, you know, an independent consultant
2 retained by the Board to look into the state of
3 competition in the freight rail industry.

4 BOARD MEMBER OBERMAN: Alright, well I
5 appreciate that. I was only trying to get at. You
6 know it's important I think, to all of us to be able
7 to rely on and understand the submissions. Because
8 I think your assignment is to educate us and I, for
9 one, need it.

10 So, I'm trying to really understand what's
11 in here and what is reliable and how I determine
12 that. And in that vein, I wanted to ask I guess, Ray
13 you're the responsible part for this submission, so
14 I'm going to ask a few questions about it because I
15 was trying to get at it.

16 So, one of the things I have been plowing
17 through in the last year when I have time and you
18 don't leave me a lot of time, are both InterVistas
19 and TRB. And you say right off the bat at the
20 beginning of your submission that the task force
21 proposal of using a revenue adequacy measure flies in
22 the face of our studies, and you cite TRB and

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1 InterVistas. I have combed through those looking for
2 their attack on revenue adequacy, and all I find --
3 and I want you to disagree with me on this, are TRB's
4 statements that the annual determination of revenue
5 adequacy is anachronistic. That's what you quoted.

6 I can't find anything in any of the
7 studies that says don't use some mechanism such as a
8 task force here to propose. So, am I missing
9 something?

10 MR. ATKINS: Well, so the task force, the
11 TRB clearly didn't address the specific proposals
12 from your task force because those task force
13 proposals came afterwards. So, it's more of a
14 general observation looking at revenue adequacy and
15 that concept.

16 And they did point to your annual
17 determinations was antiquated and inconsistent with
18 Staggers, but they were making the more profound
19 point that an earnings cap is a discredited form of
20 regulation that is inconsistent with the deregulatory
21 thrust of the freight rail industry.

22 And so, I don't think there is any

1 suggestion in the TRB report that adopting
2 regulations designed to curtail revenues down
3 towards the cost of capital is a good idea.

4 BOARD MEMBER OBERMAN: Well, I didn't find
5 anything that said we shouldn't use the revenue
6 adequacy standard as a constraint either. That's the
7 problem I'm having, and you seem to be telling us
8 that's what they're doing. So, maybe I need to go
9 back and read it again.

10 But if there is something more concrete
11 that supports the notion that they are on the side of
12 the AAR on this, I'd like to know what it is so I
13 can.

14 MR. ATKINS: Well I would just refer you
15 to every indication where they cite about revenue
16 adequacy in their task force, they do it several
17 times, their affirmative recommendation is that you
18 stop doing the annual determination of revenue
19 adequacy because it's trading the misperception that
20 you're going to use it to curtail revenues and that
21 misperception is what's led to the two proposals of
22 the rate reform task force and the ACC's proposal

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1 that you're hearing about today.

2 BOARD MEMBER OBERMAN: Well, to me, one
3 response to what TRB said was to have the multi-year
4 approach that the task force has recommended, which
5 is not something that they criticized. So, in any
6 event, let me move forward.

7 Professor Kalt, the constant reference of
8 both you and Dr. Caves to mimicking competition is
9 actually, you know, a constructive Board concept.
10 But from a regulatory point of view, and maybe this
11 is actually a question for Ray or Jeff. Is the
12 concept of mimicking competition mandated somewhere
13 in our statute? Anybody who wants to address that.
14 Because I realize it's maybe a good idea, but I'm
15 trying to figure out what our statute requires.

16 MR. ATKINS: So, I guess I -- Jeff, I'll
17 start with that. But I mean clearly, the term
18 "demanding you to mimic competition," doesn't appear
19 in the plain language of the statute. The point that
20 Professor Kalt is making is that commerce worldwide
21 will recognize that the role for the federal
22 regulator, when they step in and intervene in a

1 market is two-fold.

2 First, is you don't step in unless there's
3 a market -- clear market failure. And that when
4 there is a market failure, the way that you try to
5 guide your decision-making is trying to mimic the
6 result and limit competition. Now we have a pretty
7 sharp disagreement between the ACC and the AAR over
8 what that term actually means and what type of
9 competition you're supposed to be mimicking.

10 But I actually think there's a consensus
11 amongst economists, and even amongst the lawyers that
12 what you should not be doing is to try to mandate
13 outcomes that would not flow naturally in a
14 well-functioning competitive marketplace.

15 BOARD MEMBER OBERMAN: But if we chose an
16 approach that didn't mimic competition, I'm trying to
17 figure out if we'd be violating the statute and try
18 some other approach?

19 MR. ATKINS: It certainly depends on what
20 idea you had. But I would bet money that if you
21 tried to do something that doesn't mimic competition,
22 it would either violate the statute, or it would be

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1 arbitrary and capricious. It wouldn't survive
2 judicial review.

3 BOARD MEMBER OBERMAN: Well, I guess what
4 I'd like to learn is that if there's something in the
5 statute which says, no, this is the way you've got to
6 do it, where is it and what language are we relying
7 on? I don't think the specific direction was in
8 there.

9 Now, maybe that's a matter of policy we
10 should. I'm not correlating with that, but I'm -- my
11 starting point for all this is whereby it is created
12 by statute, you have to stay within the statutory
13 guidelines. I understand that and the court
14 interpretations, so I'm trying to figure out where
15 this one comes from. If it's there.

16 MR. KALT: If I could comment at the risk
17 of doing legal interpretation. I think the reason
18 your economist focused in this way comes about for
19 the following reasons, at the risk of being accused
20 of legal interpretation, I cite in my verified
21 statement the actual segment of the federal law which
22 says, "Railroads will have contract freedom unless

1 determined to be abusing market power," or some
2 phrase like that. I don't know what the phrase is.

3 Then you couple that -- there's an
4 economist reasoning now. You couple that with, and I
5 think you had it on one of the slides. What's the
6 definition of reasonable if you do regulate because
7 you have found market power? And when that says you
8 will regulate to allow recovery of costs plus an
9 economic profit, that's immediately telling me as an
10 economist, that's the model of mimicking
11 competition, that you're going to allow people to
12 recover their costs, and you're going to have an
13 economic profit that is not an accounting notion,
14 it's an economic notion of profit.

15 That's the chain of reasoning by which I
16 think economists have, you might disagree, fallen
17 into if you will. But how we get to this notion that
18 we're watching mimic competition regulation,
19 appropriately and successfully apply.

20 BOARD MEMBER OBERMAN: Yeah, I don't
21 disagree at all. I wanted to just figure out what
22 the guidepost is.

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1 VICE CHAIRMAN FUCHS: On the mimic
2 competition point, it's to one of the criticisms that
3 Faulhaber puts forward about how the rail industry is
4 not a pure monopoly, and that of course, there is
5 competition and there's competition across railroads.
6 So, I guess, you know, what he puts forward a
7 schematic -- a diagram, that says that actually the
8 way you should be doing SAC is not the full kind of
9 de novo OD pair, but if there's another railroad
10 that's close by, you should just do the SAC on the
11 spur, such that you know, you have the SAC calls for
12 that spur, and then he says you know, take a market
13 price for the segment that exists.

14 Obviously, there's some difficulties in
15 getting that market price. Beyond, so what other
16 difficulties with that approach and if a, you know,
17 and if AAR, if you could comment on the logic of Dr.
18 Faulhaber there.

19 MR. MORENO: If I could just, that's the
20 whole point for which we submitted Faulhaber's
21 testimony and it really goes to the bottleneck relief
22 aspect of this. I don't think you need to try to

1 figure out what the competitive price would be on the
2 segment. I think you just simply create a bottleneck
3 rate and you've modeled the stand-alone railroad on
4 the bottleneck segment alone and let the competition
5 on the rest do what it must.

6 VICE CHAIRMAN FUCHS: How do you get that
7 market price?

8 MR. MORENO: You simply allow the
9 railroad -- you allow the shipper to get a rate from
10 both carriers and compete.

11 VICE CHAIRMAN FUCHS: But how do you stop
12 the carrier that you're going to connect the spur to
13 what could be a competing carrier if there were no
14 barriers to entry and exit, how do you get that
15 carrier to not game the system such that that creates
16 a difficult situation for the incumbent carrier?

17 MR. MORENO: I'm not sure what you mean by
18 gaming the carrier?

19 VICE CHAIRMAN FUCHS: So, if you have the
20 stand-alone costs for the spur and then you have the
21 other carrier, the non-incumbent carrier that has to
22 quote a market price as you've described, right? Why

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1 would that other carrier quote the actual market
2 price -- because it's just for the purpose of a rate
3 case, it's not actually to deliver anything.

4 MR. MORENO: Okay. This is where I think
5 the disconnect is coming from.

6 VICE CHAIRMAN FUCHS: Yeah.

7 MR. MORENO: In our concept, that
8 competition should be allowed to exist, so the
9 alternative carrier actually does have the option.
10 So, you only regulate the bottleneck rate. This is
11 what the bottleneck decisions really were all about,
12 the shippers wanted to be able to get a regulated
13 rate just for the bottleneck segment and allow that
14 competition to actually function in reality.

15 VICE CHAIRMAN FUCHS: But in Dr.
16 Faulhaber's schematic, it's -- there's not a
17 bottleneck. I don't think. It's just that there's
18 no spur connected to switch point X, and switch point
19 X can take you to the facility. So, in that sense,
20 let's say -- so, you have an incumbent railroad that
21 could go to the origin of destination.

22 Then you have another railroad that can

1 take you to the destination, but it just hasn't
2 connected to the origin.

3 MR. MORENO: Right.

4 VICE CHAIRMAN FUCHS: So, you have a SAC
5 for the origin to that switch point of the other
6 railroad, right? There's no bottleneck. So, you
7 can't get a market price. So, my question is how
8 would you get that market price without that road
9 gaming the system?

10 MR. MORENO: Well, we're assuming in the
11 bottleneck situation, is we're talking about
12 situations where the two railroads do interchange,
13 and what is that closest interchange point to the
14 origin.

15 VICE CHAIRMAN FUCHS: Right, I'm with you
16 there. I'm just talking about you know, Dr.
17 Faulhaber's potential critique. And so, you know, if
18 you could get a market price, let's say there was
19 one, what would be the issues with Dr. Faulhaber's
20 critique.

21 MR. KALT: From an economy perspective.
22 With all due respect to Dr. Faulhaber, I think it's

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1 actually improper or incorrect economic analysis.

2 And the reason for that is when you take that single
3 spur focus.

4 VICE CHAIRMAN FUCHS: Yeah.

5 MR. KALT: You're not focusing on the fact
6 that you have a network industry, at a very
7 fundamental level. And we push you, urge you to go
8 back and look at some of the testimony submitted by
9 Mr. Reineke, in 722, or in the switching --
10 reciprocal switching, who described these things in
11 detail.

12 But the reality is what SAC has done,
13 which you attempted to do with your SAC test, is ask
14 well, what's a reasonable arena in which to try to
15 take account, if you will, the spillover effects of
16 the change here by looking at the issued traffic,
17 crossover traffic, and trying to define what the
18 traffic is that the SAR is going to carry.

19 VICE CHAIRMAN FUCHS: Right.

20 MR. KALT: Okay. That's evolved because
21 we recognize that there are these network
22 externalities, if you don't do that. Okay. And so,

1 in that situation, that's why the whole framework in
2 the diagram actually is inconsistent with the
3 underlying economics of a network industry where
4 people share facilities. It is as if I came in and
5 said to, you know, American Airlines, I'd like you to
6 stop in Dallas on this non-stop flight to the west
7 coast.

8 I can show you that's only going to cost
9 you \$1,000 and I'm willing to pay for it. That
10 actually ignores that I might be messing up American
11 Airlines' entire network.

12 VICE CHAIRMAN FUCHS: I'm not sure, I want
13 to make sure because as I understand it the
14 contestability theory is premised on the notion that
15 if -- that it's the hypothetical efficient carrier
16 that can come in his best position to swoop in and
17 take the traffic.

18 MR. KALT: That's correct.

19 VICE CHAIRMAN FUCHS: And so why wouldn't
20 the other carrier that's already close by, can build
21 a cheaper SAC than the de novo carrier, why isn't
22 that the carrier that swoops in?

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1 MR. KALT: If that's actually the case,
2 it's already disciplining rates. If it's realistic.
3 Not SAC, in SAC tests, however, the SAC railroads
4 have to -- the competition you're imagining.

5 VICE CHAIRMAN FUCHS: Right.

6 MR. KALT: If it's inefficient, it messes
7 up the network, no one comes in and builds a single
8 spur. Even the railroad that's coming in to add that
9 spur, okay, has to take into account the network
10 economics, take into account.

11 VICE CHAIRMAN FUCHS: I understand.

12 MR. KALT: Network economics, so that in
13 fact in a contestable market that spur would not be
14 built. If it is realistic, and we do have cases of
15 build ins and build outs, it's already disciplining
16 rates. If it's really -- in other words, if that's a
17 feasible entry, in other words there aren't barriers
18 to entry, it's already disciplining rates.

19 MR. ATKINS: Let me make a couple of
20 points too on three of them. The first one is your
21 building point was where are you going to find the
22 rate? The answer is you're not going to, right,

1 because for that to work you'd have to compel a
2 carrier to be able to code a rate to any fictional
3 point where the build out might actually happen.

4 And this is not just a hypothetical about
5 15 years ago, either UP or BNSF was in a rate case
6 where they were arguing there should be -- there's an
7 easy build out to a competitive railroad, and the
8 Board rejected that as a sign of effective
9 competition, because they couldn't find a rate from
10 that other carrier to get to the Powder River Basin.
11 So, it's not just a hypothetical, it's a fact.

12 Second, is that if you adopted that
13 approach, you're going to strand assets all over the
14 network, because what you'd be saying is let's say
15 hypothetically, like take the CSX Consumers rate case
16 where you figure out exactly what CSX needs to earn
17 to earn a reasonable profit from Chicago to the
18 plant, and now you're saying well, we're going to
19 lower the rate down further because some
20 hypothetical railroad might put it on a different
21 network. That's going to strand CSX's assets in the
22 ground that are being used to serve that customer.

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1 And the final point is that there are some
2 limitations that the Board has imposed on SAC. Even
3 if theoretically you think it might be something that
4 you'd see in a fully contestable marketplace, so the
5 economist might say that's appropriate. You've said
6 that is just not something we can tolerate in this
7 framework.

8 And the example I'll give you again, is I
9 think it was the AEPCO case, or one of the ones out
10 west, where the hypothetical railroad was proposing
11 well how about if we merge the traffic of UP and BNSF
12 South into a single SAR. Wouldn't that generate
13 tremendous efficiencies and wouldn't that be what you
14 would expect in a contestable market?

15 And the answer is probably yes. But the
16 point that the Board made was we're never going to
17 permit that to happen. It will be a cold day in hell
18 that UP and BNSF are permitted to merge. We're not
19 going to gauge the rates of this based on that type
20 of hypothetical.

21 So, I appreciate that -- I think there are
22 serious practical problems with that Faulhaber

1 approach, but also as Professor Kalt indicated, I
2 think there's theoretical problems with it as well.

3 MR. KALT: You just sent their stock price
4 down.

5 MR. ATKINS: And I apologize to those in
6 the room from those companies.

7 MR. SLOAN: Yeah, I just want to make a
8 comment. I mean I think part of the purpose of the
9 Faulhaber statement and kind of the overall criticism
10 we have of a SAC is that it simulates or mimics one
11 particular type of competition, not broader
12 competition.

13 And that's kind of the basis of our entire
14 proposal is looking at the real world data from
15 competitive markets that's out there and using that
16 as a basis to mimic competition and think that that
17 is at least as reasonable and as economically founded
18 as stand-alone cost is for the purpose of rate
19 regulation.

20 MR. MORENO: And I would add to that that
21 the statute does say that the policy is to allow
22 competition to function and to minimize the need to

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1 regulate rates. And if you regulate solely, the
2 bottleneck segment, which is going to be the low
3 density segment, you're regulating on a replacement
4 cost basis as AAR says for that low density segment,
5 so the carriers still recovering that cost. We're
6 just allowing the competition to work on the rest of
7 the route.

8 VICE CHAIRMAN FUCHS: So, I want to kind
9 of one more on the Faulhaber's just to make sure,
10 because this is the third one and the last one is
11 complexity, which I think we all talked about quite a
12 bit. And that's that rates aren't fully regulated,
13 right? And that's one of the conditions within you
14 know, Faulhaber's SAC test.

15 So, implied if a railroad is not making
16 economic profits overall, which I think, you know,
17 AAR's intention is that they're not, then somebody
18 must be getting cross subsidized when a segment is
19 over the stand-alone cost. So, somebody, somewhere
20 in the network is getting below their incremental
21 cost. Do you generally agree with that logic?

22 MR. ATKINS: I don't think I'd agree it's

1 below incremental cost, but it means that those
2 customers are not themselves, recovering the full --
3 providing a return that gives you the full economic
4 return on those assets. So, the idea behind cost
5 utilization, this is something that the shippers
6 themselves embraced is that if I'm a coal customer
7 and I operate 200 miles on the network, that all I
8 should be responsible for paying for is, in this
9 hypothetical world, is the replacement cost of the
10 assets that are being used to serve me and not from
11 other facilities from which I don't receive a
12 benefit.

13 That's the concept of cost utilization
14 that the SAC test is designed to root out where there
15 is a showing of a lack of effective competition. So,
16 it doesn't necessarily mean that intermodal traffic
17 in California or on the east coast is below it's, you
18 know, directly variable cost. What it means is that
19 you can't -- that there, you can't use revenues or
20 the rates of these -- from these pockets to pay for
21 the entire revenue market.

22 Because if that weren't the case, then

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1 when a railroad is revenue inadequate all rates would
2 be lawful, so in the ICC test, that's just not an
3 acceptable outcome in 1985 when they document the --

4 MR. KALT: And the cost subsidy would only
5 occur if the revenue inadequacy was being used to
6 justify above competitive pricing anywhere in the
7 system. So, it's perfectly consistent with a network
8 industry, contestable markets and all of that, some
9 of the segment is very dense and subject to a lot of
10 competition, either intra or intermodal, or private
11 and cheap traffic. That's perfectly consistent with
12 the fact that you may have long segments of a network
13 with relatively low density.

14 So, there's not a contradiction in the SAC
15 test, the fact that we have some of the revenues are
16 coming from competitive markets. That's perfectly
17 expected if you will.

18 VICE CHAIRMAN FUCHS: And I think, the TRB
19 report said that it's because some of the revenues
20 come from a competitive market and that area is not
21 regulated, then that makes the application of SAC, I
22 think it's highly questionable.

1 MR. ATKINS: So, your contention is that
2 TRB had it wrong, or were they referring to something
3 else?

4 MR. KALT: I'm going to say the TRB got it
5 wrong. I don't understand. The fact that the market
6 is largely competitive, although I understand for a
7 minute, he might not share the perspective on how
8 much it's competitive, but I think all indication,
9 certainly a majority of it.

10 That doesn't undermine the validity of the
11 SAC test. The SAC test is about looking at the
12 facilities that are being charged to a particular
13 customer. If they're -- and then it looks to see
14 what other customers use those same facilities, so
15 you can determine how much of the joint and common
16 cost of that network can be borne by competitive
17 traffic, and the rest of it has to be recovered from
18 the residual supplier of capital, which is the other
19 customers on the line.

20 The fact that there's a lot of competitive
21 traffic 1,000 miles away, has no bearing on the
22 Board's application of the SAC test. And so, the

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1 mere fact that there's -- we understand this market
2 to be robustly competitive in most lanes, does not
3 undermine the theoretical foundation for the SAC test
4 that the Board has been applying for the past 30
5 years.

6 MR. KALT: Let me just add to that if I
7 could very quickly. When we conduct these
8 contestable market analyses, that we anticipate, or
9 we understand that different customers on a network
10 will have different elasticities of demand. Some
11 will be very responsive and move off if you try to
12 raise the rates, others won't.

13 The implication of that is that when you
14 have highly competitive markets, the demand for your
15 particular service as a railroad can be highly
16 elastic, very responsive to raising prices. Well,
17 whether that's due to competition or just underlying
18 characteristics of the shippers with no competition,
19 doesn't change the reality that the contestable
20 railroad is out there saying, "Well, these customers
21 can't charge them as much because they've got very
22 elastic demand." I don't know why, maybe they're

1 running to other competitors, maybe they're just
2 going out of business. I don't know, but I can't
3 charge them very much.

4 I have to have more of the cost -- this is
5 where differential pricing comes from, appropriately,
6 when you have a network industry where these
7 economies scale.

8 MR. CAVES: And can I have a quick
9 follow-up question, or comment I mean. So, I just --
10 first I say it seems to me that the railroads are
11 claiming that both the author of SAC and the authors
12 of the TRB report have completely misinterpreted the
13 SAC standard.

14 So, I fall on the side of the author of
15 SAC and the authors of the TRB report. We can go
16 into the reasons why if you want. And then second of
17 all, I do think it's an excellent point to talk
18 about the relative elasticities of different
19 shippers, probably don't want to get into detail, but
20 an important point that sometimes gets lost in these
21 discussions is that yes, it's true that a captive
22 shipper holding all else constant, will have a

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1 less -- tend to have a less elastic demand than a
2 non-captive shipper.

3 But it's also true that if the railroad is
4 maximizing profit, which I think we can all agree
5 they are doing their best to do, they're going to
6 raise their price to the captive shipper to the
7 point where the captive shipper's demand becomes
8 elastic, not in-elastic. So, they're going to be
9 pricing on an in-elastic part of the demand curve.
10 It's a little bit of a subtlety, but I think it's
11 worth pointing out. Those are my two comments.

12 CHAIRMAN BEGEMAN: Just a couple of things
13 I wanted to touch on. First of all, I want to thank
14 ACC and Mr. Kalt. Thank you for -- or Caves,
15 apologies, for the effort that you went to help, to
16 you know, to put a proposal forward. I know it took
17 well over a year and it is appreciated.

18 I also really appreciate the fact that you
19 recognize that it's a proposal that the Board wants
20 to really delve into and perhaps, you know, adopt,
21 that it really would merit a separate proceeding
22 where we could have much more, I think, conversation,

1 and you know, input from all interested stakeholders.

2 Today, in preparation for this hearing
3 really is a bigger issue than just your proposed
4 benchmark method. But thank you for that. I do, I
5 really think that you know, put up or shut up and
6 you put up, so thank you.

7 Mr. Kalt, one of your slides, and you went
8 through really quickly so, bear with me. But it was
9 the one where you had sort of the comparison of all
10 the industries that are not earning their ROI, I
11 believe it was. And the only thing -- so it was the
12 railroads in green and then the electric utilities a
13 smidge, and then everybody else is like really out
14 there.

15 Was that just illustrative, or did you
16 touch on every -- I mean what did you touch on every
17 single industry, or was it?

18 MR. KALT: In that study, I have the
19 source statement. I can't recall. In that study
20 what they did was they went and took, and it wasn't
21 for purposes of this case, I believe, the study it's
22 Bloomberg data that was used. They just went and

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1 took the S&P 500 companies in those industries, about
2 15 of them, or 10 or 15 of them, and just calculated
3 the accounting rate of return relative to the cost of
4 capital using the Bloomberg data.

5 CHAIRMAN BEGEMAN: So, there are other
6 industries that don't earn their cost of capital
7 either that is not on the list?

8 MR. KALT: There may be, but in other
9 studies that I cite in my verified statement, where
10 we actually have hundreds of industries, it's the
11 graph in my verified statement, you'll see it's kind
12 of a vertical graph like this graph here, but it's
13 got all these dots on it. When you've looked at the
14 broader samples, you find that the average is
15 produced, the result that a rate of return in excess
16 of the cost of capital is in excess of the cost of
17 capital, is the average -- the more greater frequency
18 and the averages are higher than simple cost of
19 capital on rate of return.

20 And I -- that study, I think this study
21 that I put up was actually done for 722 using the
22 Bloomberg data. But the other studies were not even

1 done for the railroad industry, they were just
2 studies of rates of return across industries, and
3 many industries.

4 CHAIRMAN BEGEMAN: I want to talk just
5 briefly or ask a question on another question on
6 bottleneck for both panels -- Jeff and Ray, probably.
7 Why doesn't the contract exception work?

8 MR. MORENO: I wouldn't say it doesn't
9 work in all circumstances. Whether it does tend to
10 work is on traffic moving east to west across the
11 Mississippi River gateways. So, for example.

12 CHAIRMAN BEGEMAN: So, it's working, we
13 just maybe not be aware of it?

14 MR. MORENO: No. It's -- the problem is
15 the contract exception is too narrow for one, in that
16 it does not apply when the origin carrier is capable
17 of serving both the origin and the destination. The
18 mid-American example is the classic. But if you take
19 the Dupont and the other chemical rate cases that
20 were filed, those were contract exception rates.
21 They were rule as in rates that were filed against
22 the -- either the origin carrier or the destination

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1 carrier, depending on the case.

2 And in order to be able to do that, they
3 had to have contracts with the carrier on the portion
4 of the route that was not -- where the rate was not
5 being challenged. But we're talking about
6 situations like in the mid-American bottleneck, where
7 you had a BNSF staff and UP that both could originate
8 the traffic in the Powder River Basin, the
9 Mid-American Power Plant however, was captive to UP
10 over the last 90 miles of a 750 mile route, I
11 believe.

12 Because of that, the contract exception
13 was not allowed to work there because UP had the
14 ability to serve both the origin and destination in
15 single line service. Whereas, if it had been
16 allowed to work, they could have gotten a contract
17 from BNSF for its 700 miles, and then brought a rate
18 case just against UP's final 90 mile segment.

19 MR. ATKINS: So, Chairman, I would
20 reiterate that and just emphasize it is working. So,
21 you just heard, almost every rate case brought has
22 been a rule of rate. The contract exception would

1 have -- without that, they would have been required
2 to challenge the rule 11 rate, and the contracting as
3 unreasonable from origin to destination.

4 So, precisely what the Board contemplated
5 would happen, happened. Now when you hear him say
6 what's not happening, that -- the Board chose not to
7 override. Not chose, it was required by law, not to
8 override the right to the long haul. So, that's not
9 part of the contract. There's no contract exception
10 to the right to the long haul.

11 So, it's working precisely as it was
12 designed to in 1996 or '97 or so, when it was adopted
13 by the Board.

14 CHAIRMAN BEGEMAN: Alright, I'm just going
15 to ask one more quick question and then turn to my
16 colleagues. Ray, in your opening statement, actually
17 on page 1, you said that you kind of mentioned
18 your -- AAR's support to the Court for -- the Board,
19 I think just general effort to improve some of our
20 existing tools, et cetera.

21 And at the end of your first paragraph,
22 you said that AAR would support further efforts by

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1 the Board to explore ways to promote alternative
2 dispute resolution. And that's something, as you
3 know from your time at the Board, and my new members
4 know this, my old members feel it's something that
5 the Board really values. We encourage, we sometimes
6 impose it even when a particular party may not want
7 it, and there's someone in the room that they knew
8 who we were talking to.

9 But I would love to know, I really like to
10 know any recommendations that you have that kind of
11 back up that language. And I also would be happy to
12 hear any ideas that you have that we can do to
13 promote alternative dispute resolution. You know, we
14 have an arbitration program, never been used.

15 We are out seeking arbitrators for our
16 yearly list of folks that will possibly never be
17 tasked to do anything for us, but thoughts?

18 MR. ATKINS: Well I welcome the question
19 because I do think that alternative dispute
20 resolution is a, you know, extraordinarily useful
21 tool that is used in every industry across America to
22 resolve disputes. And I don't have a specific

1 proposal, because I know it would have to come from
2 the AAR and I'm not prepared to give you any
3 specifics, although I will take back to them, of
4 course, that you'd like to see somebody put up, you
5 know, to come in with actually specific ideas of how
6 to improve that.

7 But I will share with you, just a personal
8 story of just a couple of weeks ago which is, you
9 know, I've been around and seen the ADR process at
10 the Board, and gone through numerous rulemakings and
11 in long conversations with my staff about the things
12 that we might think about to improve it. One thing I
13 did not realize, as a senior practitioner in this
14 space, was that rate cases were now subject to our
15 alternative dispute resolution under the Board's
16 rules.

17 Now, that may -- I mean it may come as a
18 bit of a surprise, but it came in in the fast facts
19 of their STB Requisition Act, thank you, and you
20 know, it kind of just slid into the provision and no
21 one has signed up for it.

22 I'm not -- no railroads, but also no

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1 shipper organization or shipper group has come in and
2 said I'd be willing to, I'll do alternative dispute
3 resolution of rate cases. And so, from my
4 perspective, the fact that I'm not as aware of it as
5 perhaps I should have been, is maybe a call to the
6 Board to put a bigger spotlight on that particular
7 tool that's in your tool shed of ways to try to find
8 solutions, particularly for really small customers
9 who can't justify 3B or simplified SAC, and we know
10 the concerns with the large SAC process.

11 So, I would personally urge the Board to
12 take a hard look at that particular model and ask
13 yourself why isn't it being used more aggressively.
14 It's voluntary, but it does have public disclosure
15 of the result. Is that a concern? Is that something
16 that drives people away from the program?

17 It does tie to specific arbitrators that
18 you've got listed. Is that a problem from people's
19 perspective? Is that discouraging people from using
20 it?

21 CHAIRMAN BEGEMAN: Well you could choose
22 your own. That's just sort of the back drop.

1 MR. ATKINS: Right, so I honestly believe
2 that it's something that it would be certainly worth
3 the Board taking a hard look at. The one, and I know
4 the AAR is firm on this, is mandatory arbitration,
5 that's not the solution. Trying to take a round peg
6 and jam it into a square hole is not the right
7 result. And I know, respectively, that you have a
8 proposal in front of you that where you're going to
9 try to basically mimic the features of arbitration in
10 an adjudicatory process.

11 I don't think that's a workable solution,
12 and the AAR's position is it's not, but voluntary
13 arbitration, there's really no reason for you not to
14 explore that more in greater depth, and I will just
15 commit to you that I will go back to the AAR and
16 we'll put our heads together and see if we can come
17 up with some specific recommendations for you to
18 explore, or maybe even just the idea of having a
19 hearing and letting people come to and talk about why
20 isn't it being utilized. Why aren't people signing
21 up for it?

22 CHAIRMAN BEGEMAN: ACC, would you like to

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1 make any comments?

2 MR. MORENO: Yeah, over 20-some odd years
3 of my career, I've had both successes with alternate
4 dispute resolutions, and I've been stiff armed in
5 alternative dispute resolutions. And frankly, I've
6 not been able to figure out what the common
7 denominator is between them.

8 From -- with respect to the Board's
9 current rules, most shippers when we talk about --
10 when I talk about them, my client shippers, it's
11 really a question of has the railroad opted in? If
12 the railroad hasn't opted in, then we look at it
13 okay, that's not an option.

14 I think only Union Pacific, I believe, had
15 opted in, at least for the longest while.

16 CHAIRMAN BEGEMAN: A number have opted in
17 since.

18 MR. MORENO: More have done so since, yes.

19 CHAIRMAN BEGEMAN: At least with respect
20 to the demurrage.

21 MR. MORENO: And I will also say that a
22 lot of shippers do use.

1 CHAIRMAN BEGEMAN: A lot of shippers have
2 opted in.

3 MR. MORENO: The open gap process which is
4 kind of a -- which is an alternative forum. It's not
5 formal arbitration and may have used it successfully
6 and then others have used it and been totally -- had
7 no -- hit a brick wall when it comes to it. And
8 beyond that I can't explain rhyme or reason as to
9 why.

10 MR. SLOAN: I think, as it pertains to
11 rate dispute, I think there's a concern that without
12 you know, a back stop of more accessible, workable
13 rate review procedures, that you know, it's the
14 belief that we're not going to get something
15 significantly better than that in an alternative
16 dispute resolution. I think if there was you know,
17 workable, meaningful, rate relief available, that
18 required you know, a process to go through the Board.
19 I think alternative dispute resolution would be seen
20 as a good alternative to maybe get you quicker and
21 more agreeably to a similar end.

22 But I think without that back stop of a

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1 functioning regulatory system for rate reviews, the
2 alternative dispute resolution may not work.

3 MR. CAVES: Yeah, and my only comment
4 would be I can't speak to the details obviously, of
5 how this might work. But to the extent it just gets
6 us away from SAC, and towards something that targets
7 or benchmarks competitive rates based on how
8 competition actually works in the industry, I think
9 it's a good idea. On the other hand, if the railroad
10 knows that it always has SAC as a back stop, I don't
11 know why it would ever settle for a rate better than
12 what it could get in the SAC case.

13 BOARD MEMBER OBERMAN: Jeff, are you
14 saying Jeff, that the existing methodologies before
15 the Board don't work for most shippers and therefore
16 you don't have enough leverage going into a AAR
17 situation?

18 MR. CAVES: Yeah, I think that's what my
19 point was.

20 MR. ATKINS: Member Oberman, can I respond
21 to that? Because you can't leave that out there that
22 the idea that they don't work and your job is to

1 create more leverage for customers, right? So, does
2 it work? It works if it establishes the proper
3 maximum lawful rate when there's a lack of effective
4 competition.

5 If you can't prevail and can't win, that
6 doesn't mean it doesn't work.

7 BOARD MEMBER OBERMAN: Well when I
8 suggested it didn't work, I mean that it wasn't a
9 practical, supportable, usable methodology. You
10 know, and Professor Kalt said that we shouldn't throw
11 out SAC with the bath water. But based on what I've
12 learned since I've been here, we're now throwing out
13 anything. The shipping world has thrown out SAC
14 because they, except for coal, and maybe chemical
15 occasionally, nobody files a SAC case. So, somebody
16 threw it out.

17 Unless you assume, and I know AAR has
18 tried to persuade us of this, that all, except for
19 the 51 cases that have been filed in the last 30
20 years, all other shippers are happy with their rates.
21 And that is not consistent with all of the shippers
22 who have traipsed into my office since I've been here

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1 in January, saying how unhappy they are.

2 MR. ATKINS: Right, but Member Oberman,
3 the question is not whether they're happy with
4 they're happy with their rates. Because I guarantee
5 none of them are ever going to be happy. You always
6 have -- understandable, you will always have a parade
7 of shippers walking into your office if they think
8 that that office might drive rates down below the
9 level that's being set, either by regulation or by
10 competition.

11 So, you cannot use that as a gauge as to
12 whether or not the SAC test is producing the right
13 results. And you can't use the absence of rate cases
14 either, because the railroads conform their behavior
15 to the guidance from the Agency.

16 And so, I can attest personally, that if a
17 complaint comes in, we'll work with the railroads and
18 try to figure out whether it violates SAC, does it
19 violate the simplified SAC, or does it violate the
20 three benchmark approach? So, the absence of cases
21 also can't be used as a gauge that you need to come
22 up with a fourth, fifth, or sixth rate constraint on

1 railroad pricing.

2 BOARD MEMBER OBERMAN: Well, you know,
3 you're assuming that all of the entire population of
4 people who have brought their concerns to us, are
5 overstating it or insincere just ingenuous.

6 Some are. People will always complain,
7 although I did make the observation that I have had
8 many, many shippers come in and complain not only
9 about rates, but service and de-marketing and so
10 forth. I haven't had one railroad come in and
11 complain to me that they're not making enough money.

12 So, you know, I have to go with what I'm
13 hearing. Ultimately, whatever the Board does has to
14 be court ordered and Congressional ordered standards.
15 I think we all agree on that. But to me, the notion
16 that somehow everything is fine, and we should make
17 no changes in our procedures, that's not consistent
18 with at least that I have.

19 Let me get back Ray, to a few questions
20 from your presentation. At page 44 you say that
21 Congress's prior directive not to presume unlawful
22 rate increases by revenue adequate carriers is an

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1 insurmountable obstacle to the RIC concept.

2 MR. ATKINS: Yep.

3 BOARD MEMBER OBERMAN: So, Congress's
4 prior directive. Is that its own inflexibility, is
5 that what you mean?

6 MR. ATKINS: Correct, yep.

7 BOARD MEMBER OBERMAN: But that's been
8 repealed.

9 MR. ATKINS: Well yes, taken away because
10 it was no longer necessary.

11 BOARD MEMBER OBERMAN: Well, but --

12 MR. ATKINS: But there's no way you can
13 interpret it as taking away that limitation, but
14 implicitly letting you put in place its own rate
15 inflexibility in its place. It's also deregulatory.
16 So, let me just for everyone's perspective, in 1980,
17 Congress created zone and rate flexibilities.

18 One of the first zones is exactly RIC. It
19 was a you can raise your rates for inflation. And
20 you could do so without any concern that the ICC will
21 have the authority to suspend that rate or challenge
22 that rate under its own authority. That remained in

1 place from 1980 all the way to ICCTA.

2 It was removed with ICCTA because they
3 simultaneously removed the STB's authority to suspend
4 rates or challenge rates on its own initiative. So,
5 it was no longer a necessary commandment. But it's
6 clear indication that Congress did not intend for you
7 to put in place rate freezes and presume the rate to
8 be unlawful when the statute specifically says, "A
9 rate increase above inflation may not be presumed to
10 be unlawful," as it was put in place in 1980.

11 BOARD MEMBER OBERMAN: Yeah, but that's
12 the statute that's not there any longer. So, well
13 let me proceed, because you also tell us that the
14 Coal Rate Guidelines are untethered from the statute?

15 MR. ATKINS: Yes.

16 BOARD MEMBER OBERMAN: Since untethered is
17 one of my favorite words I focused on that. And I'm
18 trying to figure out what your statement is tethered
19 to because we have statutes that specifically refer
20 to this, including, as Dr. Caves mentioned,
21 Subsection 6 of the RTP, which specifically talks
22 about maintaining rates where revenues you know,

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1 exceed the amount necessary to maintain the rail
2 system.

3 And to attract capital. So, the Coal Rate
4 Guidelines are not tethered to the RTP? I mean I'm
5 trying to figure out what's the basis of your --

6 MR. ATKINS: So, I say no. First, re-read
7 that language of the RTP. All it says is you're
8 supposed to be regulating rates where there's a lack
9 of effective competition and where rates are
10 sufficient to provide adequate revenues. That
11 doesn't mean you cap them at the level that that
12 minimal threshold established by Congress as a goal,
13 it just says that's when you're supposed to be
14 regulating rates.

15 The point we were making in our pleading
16 is the idea of twisting the revenue adequacy
17 directive into a count is completely untethered from
18 the statute. There is no indication in the statute
19 that that goal that Congress envisioned for you to be
20 continuously looking to achieve, is suddenly to be
21 transformed into a rigid constraint on the overall
22 earnings of the freight rail industry.

1 BOARD MEMBER OBERMAN: Well let me pursue
2 that a little bit. Because of the original challenge
3 to the guidelines.

4 MR. ATKINS: Yes.

5 BOARD MEMBER OBERMAN: In the Third
6 Circuit, resulted in the Third Circuit stating, "We
7 are convinced that the ICC's basic approach on
8 revenue adequacy is consistent with 4 R and
9 Staggers." And they were specifically referring to
10 the Coal Rate Guidelines statement which says
11 carriers do not need greater revenues than the
12 standard permits.

13 MR. ATKINS: Yes.

14 BOARD MEMBER OBERMAN: Which is revenue
15 adequacy. So, it seems to me the Third Circuit found
16 some tethering there and language that wasn't
17 repealed.

18 MR. ATKINS: So, I would disagree.
19 Because if you look at the challenges to the Court of
20 Appeals only reviews the issues that are brought to
21 its attention. And nobody was challenging the
22 revenue adequacy constraint as being an inappropriate

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1 application of the statute. They were challenging
2 the managerial constraint. They were challenging the
3 SAC constraint. And somebody was saying that the
4 whole thing was amorphous and that you weren't doing
5 anything at all.

6 So, you need to be very careful about
7 taking a case where an issue was not presented to the
8 court, and presuming it gives you a green light to
9 apply that constraint.

10 BOARD MEMBER OBERMAN: Well, I didn't
11 suggest that it gives a green light. I'm only
12 talking about at least the one court that
13 specifically looked at tethering the overall
14 guidelines of the statute, which it did. But it
15 certainly didn't suggest that those guidelines were
16 untethered to the statute, because it had -- I
17 understand what the case litigated. I read it.

18 But they have the opportunity, because the
19 guidelines were being challenged, to say that they
20 aren't consistent with the statute, and they didn't.
21 But beyond that, we've got, you know, the Koch
22 Brothers case, in which it's true. The Koch Brothers

1 didn't challenge the existence of the guidelines.

2 MR. ATKINS: Right.

3 BOARD MEMBER OBERMAN: So, my hunch is
4 that the Koch Brothers would have challenged it if
5 they thought that the guidelines were untethered in
6 the statute because that would have been a way to win
7 their case.

8 MR. ATKINS: Maybe they would and maybe
9 they wouldn't. Koch's a great illustration. I'd
10 like to sit on it for just a moment because you're
11 right. So, our position is you can't use that case
12 to defend the revenue adequacy constraint, because
13 the D.C. Circuit was very specific in observing that
14 it was not being asked to call upon to opine on it,
15 for whatever reason Koch, and the parties in that
16 case just assumed its existence, and they were
17 fighting over its application.

18 But it's a much more interesting story
19 behind CF Industries case that I think the Board
20 should be mindful of, is what happened after that
21 case? So, that case you decided to set the maximum
22 lawful rates based on a determination of revenue

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1 adequacy that was premises on the acquisition price,
2 that Koch paid for that railroad. And Professor Kalt
3 has already told you that when you tie a rate
4 constraint to that type of metric, it creates
5 significant disincentives in the industry.

6 And Koch Brothers are a very bright group
7 of people and they figured out immediately what the
8 flaw was in that approach because if you tie what I
9 can charge to what I pay for it, I'm going to sell it
10 to somebody else, and they're going to charge a
11 higher amount of money.

12 And it's just indicative of the problem of
13 using system-wide revenue adequacy, and what the
14 acquisition price of an asset to set the
15 reasonableness of a particular rate.

16 BOARD MEMBER OBERMAN: I want to come back
17 to that because of what the Third Circuit said, tying
18 it to the acquisition price was appropriate. It was
19 consistent with the statute.

20 MR. ATKINS: Which Third Circuit decision
21 are you referring to?

22 BOARD MEMBER OBERMAN: I'm sorry. The

1 Koch Brothers case, I'm sorry, not the Third Circuit.

2 MR. ATKINS: That was the D.C.C.

3 BOARD MEMBER OBERMAN: I'm sorry, I
4 misspoke. So, I want to get back to the argument you
5 cited in terms of arguing that we shouldn't adjust or
6 change the bottleneck rules because you know,
7 Congress hasn't suggested that we should. And you
8 make the argument, and I think it's solid precedent,
9 about in connection with the bottleneck cases, you
10 tell us, "Once an agency's statutory construction has
11 been brought to the attention of the public and the
12 Congress, and the latter has not sought to alter that
13 interpretation, although it has amended the statute
14 in other respects, then presumably the legislative
15 intent has been correctly discerned."

16 So, here we have on using revenue
17 adequacy, we have the Coal Rate Guidelines. We have
18 the Third Circuit's decision. We at least have the
19 impact of it, even if it wasn't challenged in the
20 Koch Brothers case. It's been on the books since
21 1985, the concept.

22 We have ICCTA, we have the Reauthorization

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1 Act and we have any number of times that various
2 people in Congress have tried to come up with other
3 approaches. And no, the Congress has never said
4 don't do it. So --

5 MR. ATKINS: So, what does that mean, I'm
6 curious?

7 BOARD MEMBER OBERMAN: So, you make a
8 dramatic attempt -- AAR makes a fairly dramatic
9 approach to the task force saying it's untethered and
10 we can't do it, whether it's a good idea or not. I
11 don't find it here, including in your own argument
12 that's been around and Congress hasn't told us
13 abandon it, so I'm just sort of lost.

14 MR. ATKINS: So, let me draw a distinction
15 between -- and this concept between forced switching
16 and revenue adequacy. So, the key point is that
17 Congress reenacts statutes all the time. And the
18 courts do not adopt a policy that says every time you
19 reenact a statute, every decision of the Agency is
20 now been ratified, because that's just absurd.

21 There's no way that Congress actually
22 knows everything that ACC's been doing. So, the law

1 that's developed in the Supreme Court is very
2 specific. What it looks for is a clear indication
3 that Congress considered replacing it and chose not
4 to.

5 So, on the forced competitive access
6 proposal, 18 different times legislation was proposed
7 in Congress to change the Board's competitive access
8 rules. And 18 different times Congress chose not to
9 adopt it. That is a -- now, you know, whether you --

10 CHAIRMAN BEGEMAN: Are you saying just
11 because a bill got proposed that means that the
12 Congress is considering it?

13 MR. ATKINS: Well you know better than I
14 do what -- the background.

15 CHAIRMAN BEGEMAN: I think that's correct.

16 MR. ATKINS: But from the legal
17 perspective, is that the type of indicia that you
18 look for. Because you can't just assume, you need
19 some indicia that Congress was aware of this
20 condition and they acted on it. And there's -- I
21 don't have it in front of me but there's more than
22 just 18 different measures, particularly with ICCTA.

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1 There was a lot of discussion at the time
2 about the competitive access rules and whether they
3 should be transferred or not. The details of it are
4 in the AAR's and prior railroad submissions. But the
5 point I'm trying to make, Member Oberman, is so, on
6 the one hand you've got a Board policy that we know
7 with absolutely certainty, that people were lobbying
8 Congress to change, and they chose not to.

9 Versus revenue adequacy which I don't
10 believe there's a single indication ever, since it
11 was adopted, that Congress has ever -- was even aware
12 of it, or had made any effort at all, or was even
13 asked to modify what it may or may not have meant.
14 And that's an important distinction in the law.

15 BOARD MEMBER OBERMAN: I don't think that
16 as I read the case law, not only what you've cited,
17 it doesn't turn on whether some random Congressman
18 has tried to amend a bill. It turns on whether
19 Congress has dealt with this subject, in this case
20 reenacted the authorization, enacted ICCTA, which was
21 fairly far reaching, actually repealed some of the
22 rate matters that we were just talking about, the

1 zone inflexibility.

2 And left in place the Coal Rate
3 Guidelines, you know, it didn't pick and choose. It
4 left in place the entire Coal Rate Guidelines, and
5 there was plenty of reason to reexamine those by
6 people who have been arguing about SAC since day one.
7 They didn't choose to do anything.

8 So, I don't think that the court
9 precedents are so tightly drawn as to whether a
10 revenue adequacy standard is, or is not, to use your
11 language, tethered to the statute. I still go back
12 to the RTP subsection 6, which is supposed to guide
13 us. And it's been there, you know, in ICCTA and
14 nobody's changed it.

15 And it's staring you right in the face
16 there. I don't think it's a far reach.

17 MR. ATKINS: So, Member Oberman, I would
18 just ask you to address how do you address, how do
19 you reconcile that with other language of the
20 statute, like the idea that economic profit shows up
21 in the definition, or the idea that there were rate
22 increases that were specifically identified, or the

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1 entire concept of permitting the railroads to be
2 regulated more like ordinary businesses, with the
3 concept of resurrecting a firm earnings constraint
4 that wasn't even in place pre-Staggers?

5 That's the part of revenue adequacy
6 constraint that we think is untethered. Now, if you
7 looked back as to how it was actually proposed in
8 1983, and so if you're saying to me, well actually
9 maybe Congress did sufficiently ratify that we can
10 use it, well then what the ratified was what the
11 Agency proposed to adopt and any changes they made to
12 it in the final rules.

13 But the initial proposal that they were
14 adopting was to look and only be concerned if you saw
15 a pattern of returns substantially in excess of the
16 cost of capital. So, that builds right in the idea
17 of economic profit and not using it as a ceiling.
18 And they propose not to use it as a rate freeze, but
19 only to use it to probe more carefully the types
20 of -- to look a little more carefully at the rates.

21 And so, even if you believe that you know,
22 that Congress somehow endorsed with ICCTA, the idea

1 of revenue adequacy constraint, it still leaves a
2 question what are we talking about? What does the
3 constraint actually mean and I just will emphasize
4 the AAR's position is that if you interpret that to
5 mean there's a cap on earnings as to cost of capital,
6 we believe that is completely untethered from the
7 statute.

8 BOARD MEMBER OBERMAN: Well, I would just
9 say this on this particular point. You raised a very
10 appropriate question and that is how do we reconcile
11 these various parts of the statute. And my answer to
12 that is that's what we get the big bucks for because
13 the statute has many contradictions in it as I've
14 observed and others have, and we're sitting here, and
15 you have the assignment at one point, of trying to
16 reconcile conflicting directives.

17 But that doesn't mean we should throw out
18 one of the directives. It means that we have to
19 balance all of these directives, and I don't think
20 it's an easy task, which is why I'm pursuing this.
21 Let me just ask one more question at this point. I
22 know Patrick has a couple and then I'll come back.

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1 Throughout your presentation Ray, and
2 Professor Kalt, you refer to the task force proposal
3 as a system-wide rate freeze. And I'm not sure what
4 you're talking about because a rate challenge based
5 on the task force proposal, first of all requires the
6 shipper to prove market dominance.

7 So, if there's relief, it's only going to
8 apply to a shipper who's market dominant, which is
9 something the generally accepted notion here that
10 most 24 percent of the population, that is
11 non-competitive.

12 And secondly, the complex MMM formula, and
13 I don't -- I have had it explained to me, I couldn't
14 repeat it to you, results in rate relief or freeze,
15 only for the highest person being charged, and then
16 only at that highest level, so everybody else could
17 be charged up to that and may get no relief at all.

18 So, where does this concept of system-wide
19 rate freeze -- all of the railroads traffic that's
20 revenue adequate is not going to be frozen at all, as
21 I understand the way it's proposed. So, if I'm
22 misapprehending it, I'd like you to explain that.

1 MR. ATKINS: Well, I mean it's your --
2 it's their proposal. When we talk about system-wide,
3 we mean it's going to apply across the entire system,
4 to all of the traffic that is designed by the
5 proposal to have a rate freeze on it. I mean it
6 obviously --

7 BOARD MEMBER OBERMAN: I think you
8 misunderstand it, and we may need another hearing to
9 have our staff --

10 MR. ATKINS: I'm confident we understand
11 it. It's going to impose a rate freeze on certain
12 traffic above the rate pre-defined levels if you can
13 make a showing of market dominance, which let's all
14 confess, in today's environment with the Board not
15 looking at product and geographic competition, and
16 with the limited price test, doesn't have much bite
17 to it anymore. So, it's largely going to be a rate
18 freeze on all of that traffic across the board, and I
19 will tell you that the idea of injecting yourself
20 into the markets across all those commodities and all
21 those observations, simply because somebody has
22 become revenue adequate, is -- it just brings back

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1 all of the problems that Congress was well aware of
2 from the 1980's with that failed policy from the
3 1970's.

4 You can't respond to market forces. You
5 can't raise rates if there's a surge in costs. You,
6 as we've said, it actually is the unintended
7 consequence of ratcheting down rates over time. The
8 idea of rate freezes is something the ICC
9 specifically looked at in terms of whether that's
10 something they would propose, and they said no,
11 that's not a good idea.

12 BOARD MEMBER OBERMAN: And I don't think
13 that's what's being proposed. So, I think we need
14 further exploration of that, Patrick?

15 VICE CHAIRMAN FUCHS: I kind of have kind
16 of quick questions in a couple of different areas.
17 Dr. Caves, your model. It doesn't take into account
18 when it's looking at the RPTM, it doesn't take into
19 account the density of the line the shipper's on.
20 Does it? In terms of what rate relief that shipper
21 is entitled to.

22 MR. CAVES: I'm trying to think. It

1 certainly could, if you could find a way to measure
2 it, but in terms of the illustrative model that we've
3 presented, we account for characteristics of the
4 individual shipment.

5 VICE CHAIRMAN FUCHS: Right.

6 MR. CAVES: As opposed to the line
7 overall. That's correct.

8 VICE CHAIRMAN FUCHS: And does it account
9 for some things that are pretty common, like
10 interchange commitments and other things?

11 MR. CAVES: No, no.

12 VICE CHAIRMAN FUCHS: So, don't those
13 things affect the rate such that somebody maybe who's
14 on a higher density line or what have you versus a
15 lower density line, there might be perfectly good
16 reasons why someone is charged more than others, but
17 if we were to adopt a model, it might be blinded, if
18 there wasn't somebody that would get more relief than
19 others on an unjustified basis?

20 MR. CAVES: I would say any econometric
21 model has some factors that it's going to fail to
22 account for unless it has an R-squared of 100

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1 percent, which no model does.

2 VICE CHAIRMAN FUCHS: But in freight rail,
3 when economies scope and density are so important,
4 isn't the density of a line just a critical factor
5 that's missing?

6 MR. CAVES: I would say -- I wouldn't see
7 how that would introduce any systematic in the model.

8 VICE CHAIRMAN FUCHS: Well it would make
9 some shipper get a lot more money than another
10 shipper?

11 MR. CAVES: It could, it could generate
12 predictions in the model, which is why we -- which is
13 one reason why we're not proposing that anyone who
14 makes one penny above the predicted competitive rate
15 be --

16 VICE CHAIRMAN FUCHS: Right. And I'll say
17 that you know, the Board has comparison group
18 approach through the 3 benchmark test, and that also
19 doesn't include density. And you know, there may be
20 a trade-off reason for that in terms of
21 simplification and other things.

22 MR. CAVES: Yes.

1 VICE CHAIRMAN FUCHS: But this is, of
2 course, it's not a small -- it's not a simple. I
3 mean you might say it's simplified, but it's
4 obviously it is system-wide, right? And we're
5 talking about over a billion dollars. So, that's why
6 I ask whether or not that kind of leads to a greater
7 importance when you're talking about that kind of
8 redistribution. Greater importance on making sure
9 that's right.

10 MR. CAVES: Yeah, yeah, I'd say you
11 could -- I apologize. I'd say if there were a way to
12 measure density, you could directly incorporate it
13 into the model. And if you couldn't it could always
14 be an after the fact issue where a rate appeared to
15 be particularly high. You could say, oh, well
16 that's, maybe the model made a mistake.

17 VICE CHAIRMAN FUCHS: And you have a great
18 description of type 1 and type 2 errors, I thought it
19 was really clear in your verified statement. And you
20 know, one of the things that kind of struck me is the
21 treatment of exemptions.

22 MR. CAVES: Yes.

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1 VICE CHAIRMAN FUCHS: And you presumed
2 everything that's exempt, to be competitive. And
3 obviously, we've got a pending proceeding, which we
4 don't need to get into the merits of that.

5 MR. CAVES: Yeah.

6 VICE CHAIRMAN FUCHS: But I just wonder
7 whether or not you think that the information in that
8 docket casts any doubt in your mind about that
9 particular screen?

10 MR. CAVES: I'd have to familiarize myself
11 with the docket.

12 VICE CHAIRMAN FUCHS: Okay.

13 MR. CAVES: I will say that you could run
14 a different version of the model where you didn't
15 apply that statement.

16 VICE CHAIRMAN FUCHS: Turning then to the
17 replacement cost. You know, obviously there was a
18 petition and a rate, and the Board made a decision.
19 And a few things the Board said in terms of why it
20 didn't go to replacement costs and I just want to
21 give you the opportunity, AAR, to address that.

22 First is -- maybe is, you know, the Board

1 uses a nominal cost of capital and if it went to
2 replacement cost, you agree that it would have to
3 shift to real? To real cost of capital?

4 MR. CAVES: I agree that that's an issue I
5 have to look out. I'm not sophisticated enough to be
6 able to tell you that the answer is clearly yes.

7 MR. KALT: I think the answer is yes, it
8 just has to be consistent, nominal on both or real on
9 both.

10 VICE CHAIRMAN FUCHS: And so, we went to
11 replacement costs would the consistency be real then
12 in the cost of capital?

13 MR. KALT: If you are -- it's complicated
14 by the time pattern of investment that you're
15 imagining.

16 VICE CHAIRMAN FUCHS: Right.

17 MR. KALT: The replacement occurring. And
18 again, you'll want to be consistent between how you
19 treat inflation over the time period.

20 VICE CHAIRMAN FUCHS: Okay. And then
21 another issue, I think the most significant issue the
22 Board raised was this notion that not everything is

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1 going to be replaced, and you know, and it's hard
2 to -- within a SAC test, you can kind of cast aside
3 some assets and the like in building hypothetical.

4 It's hard to do that on a system-wide
5 basis I assume. How would you propose the Board get
6 around that problem?

7 MR. ATKINS: We don't have a specific
8 proposal to go back to because I think, we just feel
9 like we brought this proposal to the Board's
10 attention on several occasions, and it said it's not
11 interested. I will observe.

12 VICE CHAIRMAN FUCHS: But you have
13 replacement costs everywhere, I mean replacement cost
14 is a heavy theme.

15 MR. ATKINS: The idea though, is that if
16 you're not going to move to that measurement and you
17 don't think it's possible, it's feasible. I mean the
18 flawed measurement you've got should not be used as a
19 trigger for significant forms of changing how you
20 regulate the freight rail industry. So, to your
21 point about the unused assets, let me just say that
22 that decision by the Board, by the ICC, was in what,

1 like 1984-85, or so, when it said we really can't use
2 the replacement cost because there's too much
3 inefficiency in the network.

4 VICE CHAIRMAN FUCHS: The Board said,
5 resaid this in denying that, I think it was in '08,
6 yeah.

7 MR. ATKINS: That's right, you're right.
8 But the nature of the freight rail industry today
9 really is not at all what it was in prior years. And
10 the idea that there's a lot of excess capacity in
11 this system that should prove to be a significant
12 obstacle, in shifting to a replacement cost approach,
13 I don't think that that is as great a concern.

14 And it's not just me. In your decision
15 adopting some the Act and proposing that as a robust
16 model, the Board made the observation that the time
17 for being concerned about significant over --
18 under-utilization of the network is passed. What
19 we're actually more worried about is the capacity
20 constraints of the network and the need to expand,
21 not the strength.

22 VICE CHAIRMAN FUCHS: And I kind of think

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1 about replacement costs as kind of you know, not from
2 an asset standpoint for RPI and other assets, it's
3 kind of like SAC for the element in a sense, right?

4 MR. ATKINS: Yeah.

5 VICE CHAIRMAN FUCHS: Alright, so in a
6 couple rate cases, some of the hypothetical railroads
7 were quite large. So, we looked at the numbers and I
8 think in some cases, for two different cases with
9 Easterns, the hypothetical railroad was over 30
10 percent of their network.

11 So, if in one case the Board can figure
12 out the hypothetically efficient, or the replacement
13 cost for 30 percent of the network, so to speak, and
14 I know it's not quite the same thing, but how hard
15 would it be to just do the other 70 percent?

16 MR. MORENO: Five years and 12 million
17 dollars. That's what was spent just on the Dupont
18 case.

19 VICE CHAIRMAN FUCHS: Right.

20 MR. MORENO: To try to extend that to the
21 entire rail network, plus and every year.

22 VICE CHAIRMAN FUCHS: But we're talking

1 about a policy that could potentially have over a
2 billion dollar's effects a year, right? So, in
3 comparison, is that level of investment still out of
4 line?

5 MR. MORENO: Well, and frankly, there were
6 a lot of disputes as to how you calculated those
7 costs.

8 VICE CHAIRMAN FUCHS: Right.

9 MR. MORENO: That's where a lot of the
10 litigation was over.

11 VICE CHAIRMAN FUCHS: Right, right, right,
12 right.

13 MR. CAVES: Sorry, really a brief comment
14 if that's okay.

15 VICE CHAIRMAN FUCHS: Yeah, of course.

16 MR. CAVES: So, I just want to push back a
17 little bit on the replacement cost as the absolute
18 gold standard for measuring these sorts of things.
19 You know, you can find people doing research and
20 publishing articles, comparing replacement costs,
21 historical costs, and there's a tradeoff and neither
22 one is perfect.

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1 VICE CHAIRMAN FUCHS: Right.

2 MR. CAVES: And neither one is considered
3 the gold standard. And just one quick point, this
4 slide here from AAR does a nice job of demonstrating
5 something that we've emphasized earlier, which is
6 that it appears that the Board's method, which the
7 Board's ROI calculation appears to be conservative
8 because if you believe these numbers, the AAR are
9 earning less than their economic profit from I
10 believe it's 2006 to 2018, and they've invested about
11 25 billion dollars a year on average over that
12 period. So, clearly their investors thought they
13 were going to earn a decent return.

14 VICE CHAIRMAN FUCHS: But I hear you on
15 the kind of -- oh, I'm sorry. You know, using the
16 historical, you know, kind of book value. But
17 Canadian Pacific, in their testimony, kind of put
18 forward what I thought was a real interesting
19 example. Where they talked about how, you know, land
20 of course doesn't depreciate, but they, you know, a
21 lot of their own industry, the land was acquired very
22 long ago. Some of the assets are very old, you know,

1 some of the bridges, we all know that.

2 And you know, they put forward that prior
3 to their acquisition of DM and E, there was 4,500
4 miles of track and 7 million dollars in land assets
5 at book value for 4,000 miles. And when they
6 acquired DM and E, they went up to 8,000 and all of a
7 sudden, their book value of land went to 664 million.
8 So, it went up, you know, I think by nearly 10,000
9 percent.

10 Given how important land is, and that's
11 just one example, and we can talk about a lot of old
12 things. How can the Board defend something on a
13 historical basis that has that type of error?

14 MR. CAVES: Yeah, I'd say, you know, you
15 can -- that particular example is very hard to
16 defend. I agree. I think you could also construct
17 other hypotheticals using replacement cost that would
18 also -- using, yeah, replacement cost that would also
19 be very difficult.

20 VICE CHAIRMAN FUCHS: Can you give me that
21 hypothetical?

22 MR. CAVES: Sure, the railroad -- I'm

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1 trying to be as specific as I can.

2 VICE CHAIRMAN FUCHS: And I don't mean to
3 put you on the spot, that's alright, then.

4 MR. CAVES: No, I mean in general, the
5 railroad's investors are not -- okay, here's an
6 example. BNSF had an example from their deck where
7 they showed how a bridge was washed out by a flood.
8 And they had to replace the entire bridge.

9 VICE CHAIRMAN FUCHS: Right.

10 MR. CAVES: So, they had to do that. But
11 that was just one segment of their network, right?
12 And how often did it actually happen? How often do
13 their investors have to make those kinds of
14 adjustments?

15 VICE CHAIRMAN FUCHS: They just make small
16 adjustments over time as opposed to build the whole
17 thing.

18 MR. CAVES: Yeah, so that's the best one I
19 can come up with on the fly.

20 VICE CHAIRMAN FUCHS: Okay.

21 MR. KALT: Just one point, on the question
22 of how difficult is it to do essentially revenue

1 adequacy as a system-wide SAC test. Right, which is
2 what you're asking.

3 VICE CHAIRMAN FUCHS: Right.

4 MR. KALT: I believe in 2012 or 2013, in
5 722, Mr. Bernowski submitted actual calculations that
6 didn't take 5 years and 12 million dollars, for
7 railroads, by making some reasonable assumptions. I
8 won't go into all of that and try to repeat that
9 testimony.

10 But you can see by my graph, the
11 productivity in the railroad industry, is now
12 flattened out. That's what you expect after you get
13 all the fat out of the system.

14 VICE CHAIRMAN FUCHS: Right.

15 MR. KALT: And so, you're in a system
16 where the concerns that there's still a gross
17 inefficiency after all the mergers, all the
18 rationalizations of the system and so forth, you in
19 fact, have a sound basis for thinking, well, maybe
20 we've gotten most of the fat out of the system.

21 And in that case, and I think what was
22 proposed there and what was measured in terms of the

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1 actual replacement cost of an entire company, was the
2 notion that we won't change its footprint. We won't
3 try to rewrite, you know, pretend that we're going to
4 rip up the tracks, you know, and not run them through
5 Chicago anymore, okay.

6 So, you accepted realism there, I think
7 appropriately. I don't think anybody is going to get
8 into and lastly I will point out that regulators who
9 have gone for replacement costs, if you employed
10 that, and actually often put in productivity zones
11 where, for example, you tried to estimate -- forecast
12 2 to 3, 4 percent, something like that and so you
13 make adjustments for any remaining inefficiencies in
14 an otherwise rationalized system.

15 VICE CHAIRMAN FUCHS: And I'll be very
16 quick, because my other Board members have been very
17 generous in accommodating a number of questions. The
18 industry comparison, I think you cited a Mocker
19 article.

20 MR. KALT: Yes.

21 VICE CHAIRMAN FUCHS: The good, the bad
22 and the ugly, I think. They used for their cost of

1 capital, they used Demotorin's numbers, which are a
2 cap M, correct?

3 MR. KALT: That's right, that's right.

4 VICE CHAIRMAN FUCHS: And there's nothing
5 wrong with using cap M for estimating a cost of
6 capital, is there?

7 MR. KALT: I think it's very appropriate.

8 VICE CHAIRMAN FUCHS: Okay. And this is
9 going to be a little bit out of left field, but we
10 have Professor Sappington, you know, and you might
11 think everything's been out of left field. But
12 because you mentioned in your testimony, you know,
13 SAC is based on Nobel -- you know, there's elements
14 of Nobel Prize insights, right.

15 And there's a recent, for instance
16 Professor John Turrault talks about price caps. What
17 is his insights on university price caps and you
18 know, what does he say when it comes to the
19 incentives that they provide, and how does that apply
20 to the rail industry?

21 MR. KALT: Well, I have to go back and
22 reread that literature. But I believe what the

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1 central theme is, from an economist perspective is
2 that the theme that I think I put out there, which is
3 this notion of triggering, not rather than even
4 freeze. Just triggering tightening, okay, via some
5 firm-wide measure of revenue adequacy or inadequacy,
6 whatever you use, necessarily creates incentives to
7 avoid the triggering.

8 And so, this is --

9 VICE CHAIRMAN FUCHS: He differentiates
10 rate of return regulation from a price cap
11 regulation.

12 MR. KALT: Right, but if you're triggering
13 price caps, or triggering earnings -- the same
14 principal applies, and that's I think, the
15 applicability. A key thing that our economists are
16 worried about is the triggering mechanism in real
17 time, creates incentives. Whether it was a cap, or a
18 rate of return freeze, or an ACC proposal, whatever
19 it is, if it's going to tighten, you're going to
20 create incentives to avoid the tightening.

21 VICE CHAIRMAN FUCHS: So, in your view,
22 it's not that price cap regulation in and of itself

1 is the problem, it's that the rate of return screen
2 for price cap regulation is the problem?

3 MR. KALT: The price cap regulation has
4 other problems.

5 VICE CHAIRMAN FUCHS: Right, service
6 issues and other things.

7 MR. KALT: I'm old enough to have seen
8 gasoline lines with the Nixon price freeze.

9 VICE CHAIRMAN FUCHS: But I think Dr.
10 Turrault's talking about a different type of price
11 cap regulation.

12 MR. KALT: And the essence of that is the
13 problem that this industry faces is the triggering in
14 real time if you use revenue adequacy as a trigger,
15 or any measure of earnings. You can sense that. If
16 I'm approaching the trigger, I don't want to pull it.

17 MR. ATKINS: If I, oh, I was just going to
18 say just to clarify. If you're going to be doing a
19 comparison approach. Let's, like with the comparison
20 approach that's still up on the screen, the cost of
21 capital there used your existing approach. Other
22 models might do a benchmark in your comparison

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1 approach using just cap M. As long as you're using a
2 consistent cap methodology, so there's not apples and
3 oranges, that would make sense.

4 But the AAR's position is that when it
5 comes time to actually calculate the cost of capital
6 for the railroad industry, your approach of using
7 multiple models is actually the right approach. So,
8 we're not suggesting that you should be abandoning
9 one of your models. This is just for the analysis of
10 a comparison.

11 VICE CHAIRMAN FUCHS: I totally
12 understand. It's much easier to do, right. Dr.
13 Caves?

14 MR. CAVES: Just very briefly, under the
15 framework we've set out what triggers the regulation
16 and is pricing substantially above competitive
17 levels. Right, if the railroad is not pricing
18 substantially above competitive levels, then it will
19 never face any form of regulation.

20 And if it is pricing above competitive
21 levels, but then brings its rates not down to
22 competitive levels, but just closer, it will also no

1 longer be subject to regulation.

2 MR. ATKINS: Sure, and I just -- we just
3 disagree with that because their entire proposal is
4 premised on you being revenue adequate. So, it does,
5 by its own definition, it does not apply to CSX, or
6 the Canadian railroads. It only applies by
7 definition to UP, BNSF, and Norfolk Southern because
8 they are meeting your measurement of revenue
9 adequacy.

10 When if you look out at a comparison of
11 ACC members, or anyone in the S&P 500, everyone is
12 earning. Everyone meets that measurement because of
13 the flaws, which I don't think that you can correct
14 in that calculation. It's a useful tool for what it
15 was designed for, which is for you to monitor
16 direction of the health of the freight rail industry
17 to make sure it was going up and not going down.

18 But the idea that you use it with the type
19 of precision that you've said that shipper
20 organizations are giving it, just is you can't look
21 at the data and support that type of conclusion.

22 MR. CAVES: Yeah, so the problem, sorry,

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1 very quickly.

2 VICE CHAIRMAN FUCHS: Go ahead.

3 MR. CAVES: The problem, and I agree the
4 comments recognize this is a big problem, the rate of
5 return regulations that, you know, every time you do
6 something to increase your profits, you know, there
7 can be a one relationship right, that your prices get
8 regulated more.

9 Here there is, you know, you could argue
10 there's sort of a knife edge criteria that happens
11 when you become revenue adequate. But the idea that,
12 you know, you're going to be able to -- that there's
13 some kind of one-to-one relationship between extra
14 profits on this specific route, and whether or not
15 you're regulated, is very far-fetched, I think.

16 MR. ATKINS: So, and again, we would
17 just -- you don't even have to what you're looking
18 for, because we just disagree with that point. And
19 it's because of the competitive threshold that
20 they've designed. That chart that he showed you
21 where you've got the competitive threshold that's
22 moving around, that's what's going to determine the

1 maximum lawful rate, and it's a function of your
2 revenue adequacy.

3 So, if a carrier is earning, if they're
4 right at the threshold, there's no constraint. If
5 they become more revenue adequate, a company earns
6 another billion dollars on its intermodal traffic, or
7 it finds a new -- entirely new market, fracked sand
8 becomes more viable, and all of a sudden that revenue
9 is being used to take that competitive threshold and
10 drive it down. So, this proposal, I appreciate
11 you're not taking money out of the hands of
12 competitive traffic and giving it back to the
13 competitive traffic, but what you're doing instead is
14 taking the money the railroad has earned from the
15 competitive traffic, and you're giving it to the
16 customers like the chemical customers under their
17 approach, and tell that competitive threshold is
18 driven all the way down to the projection from their
19 model.

20 MR. MORENO: I'll take absolute issue with
21 that because what the ACC model does, is it sets the
22 appropriate level of differential pricing on captive

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1 traffic. As long as the railroad is earning revenue
2 from -- is exceeding its cost of capital with respect
3 to and from its competitive traffic, it gets to keep
4 all of that revenue.

5 We are not shifting from one pocket to
6 another, it's the differential pricing that the
7 captive traffic is paying that's accounting for that
8 excess. And as long as that excess exists, there
9 should be differential pricing needs to be capped at
10 that level. And that's what coal rate guidelines
11 says the purpose of rate regulation is for the rail
12 industry.

13 MR. KOLT: I'm going to make three points.
14 First -- 13 point, real quickly. First, there's
15 plenty of theorems in economics that tell us that
16 when you have so-called knife edge conditions, you
17 can magnify those because of their all or nothing
18 character. I cross one inch farther.

19 Secondly, I put up a quote on the screen
20 this morning and it's in my verified statement and
21 it's not by me or even by people looking at
22 railroads. But looking at earnings triggering rate

1 constraints. One of the things you have is you'll
2 see a phrasing in there by an economist, distorted
3 pricing in non-core markets, okay.

4 Well what does that mean? You may not
5 take the money away from a competitive market, but if
6 the competitive market is pulling up my revenue
7 adequacy because it's a good time in the market, I
8 have a sense to hold back on those competitive rates
9 and you start to distort. And you have a form of
10 cross subsidization going on via that. That's only
11 two points, but I'll stop there.

12 MR. ATKINS: And I would just ask not
13 Jeff, but Dr. Caves, I just -- maybe I am not
14 understanding our model, but it is my impression that
15 that competitive threshold moves. It is not -- once
16 you become revenue adequate, it doesn't stay where it
17 is. For Norfolk Southern, your project was it's 1.8.
18 For BNSF and UP it's 1, which means and the reason
19 for the difference is because BNSF and Norfolk
20 Southern have made more money, probably from
21 competitive traffic, which pushes down the
22 competitive threshold. And so, Jeff has just said

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1 that it is completely indifferent. That if you make
2 more money from competitive traffic, it has no impact
3 on your model.

4 So, I'm just looking for confirmation that
5 that competitive threshold is frozen. That it
6 doesn't move based on how far you are above or below
7 revenue adequacy.

8 MR. CAVES: Oh, okay. I think I can clear
9 this up. So, you're correct in the examples I gave,
10 we showed different competitive thresholds for
11 different time periods. Because we were not
12 calculating the competitive threshold that the Board
13 should or would choose, we were calculating what we
14 call the minimum viable competitive threshold.

15 Which is, if you believe that this revenue
16 adequacy calculation that we've performed, used
17 masked data you have all sorts of other problems, so
18 it's purely illustrative. But if you believe this
19 illustrative calculation, and if you wanted to know
20 according to these numbers, what the minimum viable
21 competitive threshold would be, we solved for it.

22 We're not suggesting that the Board go in

1 and readjust it whenever it feels like it.

2 MR. ATKINS: So, how are you proposing
3 that the Board calculated it? Because that minimum
4 threshold will move, right, based on how much money
5 they made from competitive traffic. So, it may be
6 one year for Norfolk Southern. It might be 1.8, but
7 if they make more money, it's going to fall down to
8 1.

9 MR. CAVES: No, it doesn't have to move at
10 all unless the railroad, you know, suddenly becomes
11 revenue inadequate, in which case it's not subject to
12 any form of regulation at all.

13 MR. MORENO: We contemplated that the
14 competitive threshold, as well as the economic model
15 itself, could be calculated annually based on updated
16 data, and keeping in mind that we're not looking at a
17 single year when measuring revenue adequacy. We are
18 talking about long-term revenue adequacy, however the
19 Board ultimately decides to define it.

20 We used a six-year period in our
21 illustrative analysis, but the Board could also
22 substitute the task force's recommendation as well.

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1 BOARD MEMBER OBERMAN: Dr. Caves, I just
2 had one question. When you were doing your chart,
3 did you compare the results of your benchmark test to
4 what the results would look like if a three benchmark
5 were applied to the same?

6 MR. CAVES: No.

7 BOARD MEMBER OBERMAN: Thank you.

8 MR. CAVES: Yep.

9 VICE CHAIRMAN FUCHS: One last question.
10 The rate chart, you know, showing that rates are
11 going down over time. That chart, that was included
12 in the testimony, doesn't control for private cars,
13 for system cars?

14 MR. KALT: Are you talking about the
15 alligator chart?

16 VICE CHAIRMAN FUCHS: Yeah, I mean it's
17 very impressive, but.

18 MR. KALT: Yeah, it's actually giving you
19 average rail rates, paid to Class I railroad is my
20 understanding.

21 VICE CHAIRMAN FUCHS: But it doesn't
22 control for a commodity mix or for private or system

1 cars. So, to the extent that captive shippers are
2 moving more to private cars, and the railroad is
3 taking on more competitive traffic, it doesn't have
4 that much insight for actually what we're here for,
5 which is you know, relates to captive shippers.

6 MR. KALT: I would agree with you. I
7 would agree with you that it doesn't have insights to
8 captive shipper because that is inherently an
9 issue-specific, shipment-specific analysis. It's
10 unfortunate that that's the case, I guess, but I'm
11 trained as an anti-trust economist, I can't just
12 broad brush things.

13 VICE CHAIRMAN FUCHS: Right, of course, of
14 course. Okay, thanks.

15 BOARD MEMBER OBERMAN: Could I just say
16 one thing I'd like to follow-up on, on the triggering
17 concern. In a rate challenge based on revenue
18 adequacy, if only the shipper who's complaining's
19 rate is at stake, and it's only a small percentage
20 that will even meet the market dominant test, so,
21 you've talk about disincentives to have capital
22 investment and invest in infrastructure and so forth,

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1 if they think they're going to be capped.

2 They are going to be capped on a small
3 portion of the shippers. Doesn't the railroad have
4 an incentive to keep its investments going to make
5 sure it has -- provides good service to all of the
6 other shippers for whom there is competition? I
7 don't understand how a railroad executive says, you
8 know what, they've adopted this new standard over at
9 the Board, I'm going to stop spending money on the
10 rail bed because a couple of shippers may be able to
11 cap their rates. What about all the others.

12 I just don't understand that concept. But
13 I'm not an economist.

14 MR. KALT: Well what we find with the
15 research is think of it as the following. There's a
16 segment of my business, say 24 percent, the number
17 that people float around. There's a segment of my
18 business, some things that will be triggered there
19 where I'm going to see greater constraints than I
20 otherwise would.

21 Some of those will be valid and I'll lose
22 the case as a railroad, and some of them won't be

1 valid because in a proper measure of market
2 dominance, I won't be found to be market dominant
3 and so forth.

4 But one way or another, there's greater
5 risk and less revenue in that 24 percent part of my
6 business. We're not saying that you just stop
7 investing, but you have incentives to distort your
8 investments. So, for example, if I could make
9 investments maybe in track, in physical equipment,
10 perhaps in other things -- software, whatever it
11 might be.

12 If I could make investments and they would
13 improve, for example, my performance in the other 75%
14 of my business, I now get closer to triggering this
15 process where I put my 24 percent at greater risk.
16 And that's where the distortion comes from. That's
17 why you see in our literature that's talking about
18 non-core and core markets.

19 Non-core markets were often left
20 unregulated and to public utility regulation. And
21 so, that's the underlying economics is crossing a
22 threshold at knife's edge, puts a sizeable chunk, in

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1 this case, maybe 24 percent, maybe other at risk.

2 MR. ATKINS: And Member Oberman, this is a
3 really great question. I mean a really great
4 question about how is it that what we do for just a
5 couple of customers who come in will actually have
6 much of an impact on the broader, freight rail
7 network, right? I mean how can that possibly be?

8 And I would just -- this is an important
9 point to emphasize. The actions that the Board take
10 here, have a magnified effect as they're carried out
11 by the railroads across their system. So, even if
12 just a couple of rate cases decided by the Board can
13 influence how railroads price their traffic.

14 And I'm going to give you an actual
15 example that your staff is familiar with. After
16 basically two rate cases in the west, the Union
17 Pacific railroad knew what the SAC test was going to
18 say as it came to be gauging its rates on
19 high-density corridors out of the coal market.

20 And it's well-known that what they did is
21 they shifted their pricing to price it at 180 percent
22 of variable cost. That resulted in a series of cases

1 that were brought when the parties would fight over
2 where 180 percent actually was, because at the time
3 you had numerous adjustments. You didn't really
4 quite know where that was.

5 Then the Board made some decisions about
6 how it was going to determine 180 and those disputes
7 went away as well, because now Union Pacific could
8 set those rates right precisely at the threshold and
9 avoid any sort of rate cases at the Agency.

10 And this is an example. I know it may be
11 hard to appreciate just how big of a microphone the
12 Board actually does have. So, when you're thinking
13 in your head there's just going to be a couple
14 people who come in and we offer a little bit of rate
15 relief, how is that really going to have the
16 implications that the railroad is concerned about.

17 I just hope you realize that when you make
18 those decisions, if you adopt a mechanical approach
19 to ratemaking, the executives, the marketing
20 department, the lawyers, will be advising their
21 clients on how to conform their behavior to the new
22 standards that the Board has set forth.

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1 BOARD MEMBER OBERMAN: No, I appreciate
2 what you're saying, and I'm new enough to measure the
3 impact of what we do is still something I'm learning.
4 I was trying to understand the disincentives to
5 investment part of just providing a revenue adequacy
6 constraint to isolated pieces of traffic, because I
7 still disagree with the idea that it -- as I
8 understand it, that's it's a system-wide freeze.

9 So, I don't understand how a railroad
10 executive who has all kinds of trains running on
11 their system says well, I'm not going to make capital
12 investments for a piece of it, they're all running on
13 the same system, the same yards, the same software,
14 same new technology and the locomotives pulling
15 different kinds of traffic.

16 I just don't get where they undermine
17 their entire investment strategy because one or two
18 of those shippers may have a revenue adequacy case.
19 I understand the concept of a trigger, if you really
20 had it, but I don't, with all due respect, Professor
21 Kalt, I just don't see this as forming gas lines kind
22 of a thing. It's just not quite the same. The

1 industry is much more complicated than providing
2 gasoline at gas stations, as I understand it.

3 So, that's -- I'm trying to apply this
4 trigger thing to the real world.

5 MR. ATKINS: I think we understand and
6 appreciate your observation. I really do think
7 though, it's going to depend on which of these
8 proposals and what specifically, are you proposing to
9 do?

10 Because if we take the worst case
11 illustration. We actually put an earnings cap on the
12 freight rail industry, so that anyone who satisfies
13 market dominance, can come in and bring a rate case
14 because the railroads are earning more in their cost
15 of capital, that is going to have a powerful negative
16 effect on investment and you're going to hear from a
17 number of executives from the railroads that will
18 explain to you how they go through their
19 decision-making process for making investments.

20 But just to a lay person, even like me,
21 Member Oberman, if I have to make a risky investment
22 and I don't have the possibility of earning a

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1 significant upside potential on an investment,
2 they're going to have to really justify to their
3 senior management why are you making that investment
4 rather than transferring those revenues back to the
5 owners of the railroad through stock buybacks or
6 dividend payments.

7 BOARD MEMBER OBERMAN: Buyback question is
8 for the railroad executives to come up here.

9 MR. ATKINS: Wonderful.

10 BOARD MEMBER OBERMAN: Thanks Ray, it was
11 a good segue.

12 CHAIRMAN BEGEMAN: Thank everyone.
13 Obviously, we're going really lickity split here.
14 Our first panel is now concluded, three point some
15 hours later. We are against my instincts, we are
16 going to take a break until 1:15, given that people
17 can't eat in this room. Our recorder needs a break,
18 so we will start at 1:15. Thank you for your
19 patience and your participation.

20 (Whereupon a brief recess was taken, to
21 reconvene this same day.)

22 CHAIRMAN BEGEMAN: Okay. We will resume

1 with Panel 2, BNSF Railway, Montana Department of Ag,
2 National Coal Transportation Association and Western
3 Coal Traffic League. And we will begin with Jill
4 from BNSF.

5 MS. MULLIGAN: Good afternoon. Thank you
6 for the opportunity to appear before the Board to
7 share BNSF's perspective on the revenue adequacy
8 proposals raised by the Board. I am joined with my
9 colleague -- by my colleague, Paul Bischler, who's
10 our VP of Finance, Controller and also our Chief
11 Sourcing Officer.

12 We would like to focus our time this
13 afternoon on select areas of interest and concern to
14 BNSF. At issue in the proceeding, is whether the STB
15 should alter its fundamental regulatory structure
16 and begin direct regulation to restrict the overall
17 profitability of railroads.

18 Sorry, I went one slide too far. For
19 BNSF, the answer to that question is no. BNSF's
20 profitability results from competing aggressively in
21 dynamic markets and earning a reasonable return on
22 that business. The return allows us to reinvest in

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1 our network to drive safety and efficiency benefiting
2 our customers. BNSF has done that over a 25-year
3 history.

4 Our profitability results -- sorry, the
5 historic regulatory balance that the STB has strived
6 to maintain, has encouraged exactly that activity by
7 a railroad. BNSF believes that the STB does that by
8 allowing markets to function by letting competition
9 in dynamic markets set transportation rates and drive
10 service efficiency, and reserving direct regulatory
11 intervention to instances where those circumstances
12 are not present.

13 We urge the Board to refrain from
14 abandoning its core function of regulating rate
15 reasonableness, and adopting regulations that
16 penalize a railroad for being successful in
17 competitive markets, and mandating rate reductions in
18 order to reduce profitability, regardless of what has
19 driven a railroad's returns.

20 Unfortunately, the proposals that you'll
21 hear about over the next two days do just that.
22 These proposals require the STB to ignore the source

1 of profitability for a railroad like BNSF. The vast
2 majority of BNSF's revenue comes from competitive
3 traffic. The Board's own measures reflect that.

4 On the slide, we have charted the last 10
5 years of the STB's annual RVC greater than 180
6 benchmark, for BNSF. This annual metric, published
7 by the Board, calculates the annual average revenue
8 to variable cost ratio on traffic that is above 180,
9 the jurisdictional threshold.

10 As you can see by the chart, this is a
11 remarkably steady metric over time. Continuing to
12 focus on the same population of traffic, moving at
13 rates above 180, over the same period, less than a
14 third of BNSF's revenue has been earned on traffic in
15 this category.

16 For example, in 2017 less than 30% of
17 BNSF's revenue was earned on traffic above 180
18 percent. Of that traffic, approximately 50 percent
19 of those moves are not subject to STB jurisdiction,
20 with the biggest category being BNSF intermodal
21 traffic.

22 None of these metrics fit with the story

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1 that you're going to be hearing over the next two
2 days about gross profitability, fueled by years of
3 dramatic rate increase on so-called traffic that's
4 captive. The reality is that BNSF's returns are
5 driven by offering market responsive rates into the
6 competitive marketplace.

7 We attract business to our railroad that
8 allows us to earn a return that we can put back into
9 our network. The Board should not adopt regulations
10 that are designed to disrupt that cycle. As my
11 colleague, Paul, is going to discuss, to do so would
12 have significant consequences for BNSF.

13 MR. BISCHLER: Good morning, I guess
14 afternoon now and thank you for allowing me to
15 present. So, I've been at BNSF 20 plus years now,
16 led our accounting and purchasing function as well as
17 various parts of the finance organization that
18 include financial studies.

19 The financial studies team I've led is
20 responsible for the financial analysis that supports
21 the company's decision-making around whether
22 individual infrastructure, equipment and other

1 capital investments are undertaken. As you can see
2 in the slide here, Jill touched on it, our business
3 model is focused on growing with our customers.

4 We will invest, if we're able to grow our
5 business, improve our operational efficiency, and
6 receive appropriate value for our services. This
7 enables us to earn appropriate returns, which then
8 creates the incentive for us to further expand and
9 continue this virtuous investment cycle.

10 So, next I'm going to talk about how we
11 think about our investment decision. So, first, as
12 you know, railroads are unique in that we pay for all
13 our own infrastructure and the key point there is our
14 returns are not guaranteed. Our investment includes,
15 first and foremost, replacing existing
16 infrastructure, but it also includes undertaking
17 projects to increase the efficiency or add capacity
18 to our network through equipment, technology,
19 infrastructure and people resources to meet the
20 service needs of our customers.

21 In order to undertake expansion or
22 efficiency projects, each individual project at BNSF

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1 is required to undergo a rigorous financial analysis
2 and generally requires approval by a cross-
3 functional team of executives. When we prepare the
4 business case for a project, we know the cost of the
5 project with relative certainty.

6 However, and this is important, we don't
7 have certainty at whether or not our estimates of
8 future volumes, market conditions and costs are
9 accurate. The important point I want to convey is
10 that it takes a long time for us to realize the full
11 benefits of the projects and ultimately get an
12 appropriate return.

13 So, we won't know for years whether or not
14 our investment decision was a good one. As a result,
15 we generally require return near our hurdle rate.
16 For BNSF, that hurdle rate is in the mid-teens and is
17 a target for what we hope to return. You'll hear
18 from coal representatives today, that business sector
19 is a great example of long-term investment risks
20 faced by BNSF.

21 The joint line in the Powder River Basin
22 that both BNSF and UP use to serve lines on behalf of

1 utility shippers, was expanded not long ago to carry
2 more than 400 million tons. Yet in 2018, only 243
3 million tons was transported over that line. That's
4 the challenge with making long-term infrastructure
5 capital investments.

6 When should I make them? Where should I
7 make them? And can I count on the earnings to occur
8 over a long period of time? BNSF's no different than
9 any other company in that we must invest wisely, and
10 our decision to invest is all about risk and returns.

11 You can see in this next slide the number
12 of rail equipment incidences as reported to the FRA
13 per million train miles that demonstrates the
14 improved safety and reliability of our railroad over
15 the last 20 years. This has been accomplished
16 because of our investment in infrastructure,
17 technology, our people and innovation.

18 Today's regulatory environment permits
19 exactly the type of behavior the Board and the
20 railroad customers would want to see from the
21 railroads. We constantly challenge ourselves and
22 support that with investment to make our railroad

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1 safer, more reliable and more capable of meeting the
2 service needs of our customers.

3 The next slide here speaks to our long
4 history of investing to improve and expand our
5 network to the benefit of our customers and the
6 overall economy. Since 2000, we've invested over 65
7 billion in infrastructure and equipment. Since that
8 time we've replaced approximately 58 million ties,
9 over 15,000 miles of rail, and added more than 45
10 million tons of ballast.

11 Adding new capacity, we've implemented 695
12 miles of double and triple track, constructed 36 new
13 passing sidings, and extended 48 sidings. These
14 projects, along with targeted terminal expansion
15 projects, and signal system upgrades, have allowed
16 BNSF to accommodate business growth on a continuing
17 basis.

18 Today, our two and a half billion dollar
19 maintenance program is what our entire capital
20 program was not long ago. We also believe that our
21 customer's investments are indicative of their belief
22 in our ability to provide excellent service over the

1 long-term at market responsive rate levels.

2 We've seen customers elect to build their
3 new facilities on BNSF and expand their existing
4 facilities on us as well. Since 2000, we've
5 increased the volume on our railroad by over 2.1
6 million units. As can be seen, we will reinvest the
7 business when we have a reasonable degree of
8 certainty that we'll be able to achieve a reasonable
9 rate of return.

10 A critical factor allowing us to make
11 these private sector investments is that we've had a
12 relatively stable economic regulatory environment
13 conducive to investment. This was referenced earlier
14 in the testimony, but you're all well aware we
15 experienced one of the worst weather disasters in our
16 company's history when severe flooding impacted our
17 network in the Midwest.

18 We think this provides a helpful example
19 as to why we believe the revenue adequacy calculation
20 doesn't effectively take into account the real world
21 replacement cost of the railroad. Despite spending
22 about 230 million dollars to date, to rebuild the

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1 railroad, the historical cost of those replaced
2 assets was about 70 million, less than 30 percent of
3 the actual replacement costs of the impacted assets.

4 Of course, our book value today on those
5 initially installed assets is significantly lower due
6 to depreciation. It was also referenced in the
7 testimony about bridges not needing to be replaced
8 often. The next couple years we've got 100 million
9 dollars plus bridge that we'll have to replace with a
10 book value that's essentially zero.

11 The long lived nature of our assets and
12 significant inflationary cost over time makes the use
13 of book value a flawed methodology for effectively
14 evaluating our terms. What often gets confused when
15 speaking about replacement cost is if there is an
16 assumption that when we replace something, the new
17 asset is more valuable than what existed before.
18 That's absolutely not the case.

19 We maintain the value of our historic
20 assets through our significant ongoing maintenance
21 program. As I mentioned earlier, we spent about two
22 and a half billion in maintenance capital each year,

1 simply to keep the railroad in the same shape it was
2 in the prior year.

3 Before I turn it back over to Jill, I just
4 want to conclude by saying that for the first part of
5 my career, we were challenged to get appropriate
6 returns. We're in a much different situation today
7 and have worked hard to get there. As a result,
8 we're well positioned to continue to support our
9 customers and the U.S. economy as one of the safest
10 and lowest cost modes of transportation in the world.

11 It's important the Board get rate
12 regulation right, we understand that. I would just
13 ask that you use caution as dramatic changes in
14 regulatory policy may likely result in unintended
15 consequences that cannot always be determined ahead
16 of time.

17 MS. MULLIGAN: Thank you Paul. I'd like
18 to turn to the Board's specific proposals. First,
19 the task force proposed definition for long-term
20 revenue adequacy contemplates a review of a business
21 cycle, capturing the ups and downs of a current
22 cycle, which BNSF believes is important.

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1 However, the STB should not completely
2 ignore current circumstances, to do otherwise is to
3 regulate by looking in the rearview mirror. This is
4 particularly important when the industry is facing
5 softness and uncertainty in key markets, such as a
6 continuing systematic decline of coal shown on this
7 chart.

8 Second, despite what you may hear, it
9 simply defies logic that BNSF does not compete to
10 secure coal tons. On the left side of the chart you
11 can see the precipitous decline in gas prices over
12 the last 10 years, and on the right the resulting
13 significant loss in market share that coal generation
14 has seen to gas plants.

15 It's a punishing competitive environment.
16 WCTL and NCTA's written testimony ignores the role of
17 gas as a fundamental constraint on rail rates. And I
18 believe they also hope that the Board continues to do
19 the same by refusing to consider the very large role
20 that product competition, here gas, plays in limiting
21 railroad rates.

22 In fact, at times BNSF has entered into

1 gas variable deals with rail rates moving down in
2 response to falling gas prices in order to retain
3 coal volume. As long as the Board continues to
4 ignore product and geographic competition, it is
5 handicapped in understanding the competitive markets
6 that BNSF participates in.

7 Turning to the other proposals. The task
8 force RIC and bottleneck revocation proposals are a
9 sharp step away from the Board's statutory mandate to
10 allow markets to function and to govern rail rates.
11 And when competition is not present, determine
12 reasonableness rates reflective of market outcome.

13 Of key concern to BNSF, is the fact that
14 the core purpose of the two proposals appears to be
15 guaranteeing better rates than a shipper would obtain
16 through market forces. Moreover, those rates are
17 being driven to below-market levels, based directly
18 on how successfully BNSF competes to secure business
19 in dynamic markets, many of which are not subject to
20 STB jurisdiction.

21 To put a fine point on it, under the task
22 force RIC proposal, when BNSF's successful in

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1 securing business away from truck, an inherently
2 pro-competitive act, the result is expanded rate
3 freezes on BNSF's regulated traffic. If the Board
4 were to implement either of those proposals, the
5 result is that every shipper, regardless of
6 competitiveness of their markets, will want to be
7 directly regulated by the STB in order to receive a
8 preferential below-market transportation rate.

9 The result will be significant disruption
10 to both transportation and commodity markets,
11 creating winners and losers, including between
12 shippers, wholly divorced from market outcomes.

13 In summary, it's important that the STB
14 get rate regulation right. That means allowing
15 competitive markets to determine transportation rates
16 and drive service efficiencies, while providing
17 effective oversight, when those market forces are not
18 present.

19 The approach that the Board has taken has
20 fostered the ability of the railroad, like BNSF, to
21 invest at a high level in infrastructure, technology
22 and innovation. Concerns about levels of rates

1 should continue to be addressed through
2 individualized analysis that maintains the
3 appropriate regulatory balance.

4 BNSF has supported rate reasonableness
5 reforms that ensure that stakeholders have access to
6 effective, appropriate rate oversight, and we
7 understand that there are concerns that the Board's
8 existing mechanisms don't fully accomplish that. In
9 our recent final offer rate review submission, we did
10 identify our support of specific proposals to enhance
11 the STB's existing rate mechanisms.

12 I believe the AAR's also recently outlined
13 options to the Board members which BNSF is fully
14 supportive of. The Board should continue to focus on
15 improving rate reasonableness methodologies, not on
16 the development of a revenue adequacy constraint that
17 market realities, economic principles, and the
18 Board's statutory charge do not require or support.

19 Thank you again for the opportunity. We'd
20 be happy to answer questions.

21 MR. COCCOLI: Good afternoon. My name is
22 Zach Coccoli. I'm the Deputy Legal Counsel at the

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1 Montana Department of Agriculture and I'm here today
2 representing the Montana Wheat and Barley Committee.
3 The Montana Wheat and Barley Committee is an
4 exclusively grower-funded organization, representing
5 the marketing research and grower education needs of
6 Montana's wheat and barley industry.

7 Today's proceeding and all the work of the
8 Rate Reform Task Force is especially exciting and
9 encouraging to Montana's 10,000 farmers who work
10 tirelessly to produce annually over 150 million
11 bushels of the world's finest wheat and barley.

12 It is said that the world passes through
13 Montana, but we are proud of our own contributions to
14 the world food markets, and value the nearly four
15 billion dollar industry that agriculture represents
16 for the economic health of each and every Montana
17 community. Of course, access to the world's markets
18 would not be possible without an efficient
19 transportation system, and we thank the Burlington
20 Northern Santa Fe Railroad, for their hard work
21 throughout the many seasons of Montana, and their
22 continued investments in safety, efficiency and

1 customer service to our shippers.

2 I wanted to be clear that Montana Wheat
3 and Barley's participation in these proceedings is
4 not a criticism of the work BNSF is doing across our
5 state, as much work has been done to build and
6 maintain those relationships. But rather, a new
7 opportunity to understand the business needs of each
8 institute and further explore the proper regulatory
9 role of the Surface Transportation Board in today's
10 modern shipping environment.

11 Montana agricultural producers support the
12 STB's efforts to develop more affordable, accessible
13 and practical procedures for handling both large and
14 small rate disputes. We stand in favor of proposals
15 to shift the burden of proof for proving
16 reasonableness, increasing transparency of railroad
17 operations as they pertain to rate setting, and
18 increasing the involvement of Surface Transportation
19 Board experts.

20 It is worth recognizing that Montana is
21 very captive with no navigable waterways, and over
22 800 miles and mountain passes between central Montana

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1 and the nearest port, competitive truck or barge
2 options simply do not exist. However, if a permanent
3 market dominance designation is not workable, the
4 Montana Wheat and Barley Committee supports the task
5 force's proposal to set a list of criteria that once
6 plead, will lead to a finding by rule that the
7 complainant has made its prima facie case of market
8 dominance over the traffic.

9 The notion that trains originating outside
10 of Montana in areas where competition exists
11 experience a lower price shipping option, despite
12 comparable shipping distances, continues to fail to
13 satisfy any notion of economic fairness to Montana's
14 agriculture industry.

15 Although we recognize the inelasticity at
16 play in our situation, the Lerner index, which
17 measures railroads' monopoly power as a markup ratio
18 above marginal costs, is higher for grain shipments
19 than any other commodity and is rising. Yet, if the
20 goal of rail regulation is to allow price
21 differentiation to occur, to achieve revenue
22 adequacy, the Montana Wheat and Barley Committee

1 supports the new definition of the revenue adequacy
2 constraint, including a determination of long-term
3 revenue adequacy at not less than five years, and the
4 establishment of a rate increase constraint.

5 Limits on differential pricing, for
6 long-term revenue adequate carriers just makes sense
7 and is in line with Congress's intent. Where
8 railroads consistently earn over time, a return on
9 investment above the cost of capital.

10 It is less clear whether the task force's
11 bottleneck or Simplified Stand-Alone Cost changes
12 would have a measurable affect on Montana's shippers,
13 but the Montana Wheat and Barley Committee supports
14 any efforts to improve and simplify that methodology.

15 A more hands-on approach by the STB, into
16 the process for setting and adjusting tariff rates on
17 captive ag shippers, would provide a substantial
18 check on market dominant price structures, and a
19 much-needed assurance of fairness to the agricultural
20 producer.

21 One additional meaningful regulatory
22 change involves shifting the burden of proving

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1 reasonableness of a rate to the railroad. For
2 example, for the Three-Benchmark process to be
3 effective, the regulation must first determine when
4 it should be up to the railroad to demonstrate that
5 its rate is reasonable.

6 If the revenue to variable cost ratio for
7 a contested movement is greater than the average RVC
8 for a comparable move, then the burden of proof
9 should fall on the railroad, not the shipper, to
10 demonstrate that a rate is reasonable. And movements
11 should be compared by commodity, load characteristics
12 and car types to ensure a level playing field across
13 all rail users.

14 No industry should receive preferential
15 treatment from a railroad to the detriment of another
16 industry. And the proposed revenue adequacy
17 constraints should reduce the shipper's role in
18 exerting unreasonable, downward pressure on the price
19 paid for grain at the elevator.

20 The Montana Wheat and Barley Committee
21 supports further development in measured application
22 of recommendations to this end. In some

1 circumstances, it maybe beneficial for the STB to
2 instigate such cases themselves, on a provisional or
3 limited scope basis, as new methods are applied to
4 present practices.

5 Along with mandatory disclosure
6 requirements to automate and expedite portions of the
7 discovery process, the STB should consider scenarios
8 where it will be willing to exercise investigatory
9 authority and to what degree. Any mechanism, to
10 assure fairness, outside of formal rate case
11 proceedings, is welcomed.

12 The Montana Wheat and Barley Committee
13 respectfully requests that the Board continue to give
14 due consideration to those shippers, like the Montana
15 farmer, removed from nearly all aspects of the
16 railroad's operations, but entirely dependent upon it
17 for their livelihood.

18 When deciding how to account for railroad
19 revenue adequacy in rate reasonableness
20 determinations, where to streamline market dominance
21 concepts, and when to conduct final offer rate
22 review, the ongoing efforts of the STB to learn from

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1 history, engage openly with stakeholders, and conduct
2 objective analytical decision-making informed by
3 accurate information, instills a renewed level of
4 confidence in the outcome of the Board's rate reform
5 efforts.

6 Like the task force, the Montana Wheat and
7 Barley Committee does not wish to undermine the rail
8 industry's financial health and long-term viability.
9 However, we support the STB's openness to new
10 regulatory structures and ultimate decision
11 authority.

12 The STB is again encouraged to exercise
13 its investigatory powers to access information,
14 otherwise not available, and review it from a new and
15 objective perspective. Any effort to simplify or
16 streamline rail rate case proceedings and provide
17 greater ease of access to information is encouraged.
18 Rail rate challenges and prolonged rate cases under
19 any test are not the preferred avenue for Montana ag
20 shippers, but it's critical for the shippers of
21 Montana that the Surface Transportation Board
22 provides adequate assurances that rail rates remain

1 fair and reasonable.

2 Montana grain producers welcome STB
3 oversight into our industry, should it wish to
4 further examine this distinctly captive shipping
5 environment. In the meantime, the Montana Wheat and
6 Barley Committee, along with the Montana Department
7 of Agriculture, will continue to collaborate directly
8 with BNSF to better understand their financial and
9 business considerations for long-term viability while
10 seeking out new market opportunities and cost savings
11 efficiencies. Thank you for your time and the
12 opportunity to appear in front of you today.

13 MR. WARD: Chairman Begeman, Vice Chairman
14 Fuchs, Member Oberman, my name is John Ward. I'm
15 Executive Director of the National Coal
16 Transportation Association. Our organization
17 consists of electric utilities, coal producers and
18 entities that produce, repair and manage all facets
19 of railcar components, parts and systems.

20 Our members have invested heavily in the
21 ownership, leasing and control of fleets of railcars,
22 which they provide to the railroads in unit trains,

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1 about 250 cars. These fleets represent about 45
2 percent of the coal cars in service in the eastern
3 U.S. and close to 90 percent of the coal cars in
4 service in the western U.S.

5 Today, coal represents, as a commodity,
6 about a third of the carloads originated by Class I
7 railroads. I'd like to use the brief amount of time
8 that we've requested today to counter a narrative
9 that's being constructed outside this chamber, in op
10 ed forums, and letters to Congress. Critics of this
11 and other current STB proceedings, have alleged that
12 they are the result of, and I quote, "Activist
13 policymaking, perhaps nudged by a select group of
14 powerful shippers seeking to take advantage."

15 And that proposed changes here, "Would
16 risk the massive gains to consumers from reforms
17 enacted over the last four decades." Well, coal
18 transporters today would no doubt like to be
19 powerful, the reality on the ground today is quite
20 different. Many of our members are recovering from
21 bankruptcies, and all of them are facing withering
22 regulatory pressure and competition from other

1 highly subsidized energy sources.

2 The exaggeration that proceedings like
3 this constitute a return to pre-Staggers Act
4 prescriptive ratemaking that spells doom for railroad
5 financial stability is laughable to those of us in an
6 industry where the goal of our regulatory opponents
7 is to eliminate us entirely.

8 Let me be clear, the coal industry wants
9 our railroad partners to be financially healthy and
10 operationally efficient. But our presence here and
11 in other STB proceedings places us in the company of
12 an incredibly diverse pool of shippers who have
13 testified that they have not received improved
14 service as the railroads have clearly improved their
15 profitability through the aforementioned regulatory
16 reforms and strategies, such as precision scheduled
17 railroading.

18 The fact that the vast majority of coal
19 shippers are captive to railroads is apparent on its
20 face. Few other options exist for transporting
21 millions of tons of an essential commodity long
22 distances over land. Accordingly, coal shippers have

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1 long viewed railroads as an essential partner,
2 investing many billions of dollars of their own
3 capital, to maintain rail as a viable option to
4 transport coal.

5 These investments extended beyond the
6 purchase of modern train sets to include fast loading
7 and unloading systems, multiple loop tracks and batch
8 way load out systems. Furthermore, mines and
9 utilities organized to meet railroad schedules on a
10 24/7 basis, and maintain large and expensive
11 stockpiles of products at both origin and
12 destination.

13 All of this capital investment exists at
14 no cost to the rail carrier. NCT requested only five
15 minutes today because we want to be respectful of
16 your time as you consider the highly technical issues
17 of revenue adequacy. I'm not a lawyer or an
18 economist, nor can our members afford to hire lawyers
19 and economists at this time.

20 That is precisely the point. Our
21 industry, and many others, need practical solutions
22 that don't cost millions of dollars and years of time

1 to obtain relief when providers of our only practical
2 transportation option engage in the kind of
3 rent-seeking that they now accuse us of seeking.

4 In conclusion, please let me reference
5 NCTA's written comments filed earlier in this
6 proceeding and also express support for the comments
7 made by the Western Coal Transportation -- Western
8 Coal Traffic League and the Freight Rail Customer
9 Alliance. As you make decisions in this matter, we
10 respectfully request that you keep in mind principles
11 of reciprocity, accessibility and procedures that
12 allow the expeditious resolution of disputes. Thank
13 you very much for your time and consideration.

14 CHAIRMAN BEGEMAN: Thank you. Betty?
15 Kelvin?

16 MS. WHALEN: Good afternoon. My name is
17 Betty Whalen, and I'm the Principal Fuel Specialist
18 for the Lower Colorado River Authority, based in
19 Austin, Texas. I'm also the President of the Western
20 Coal Traffic League, an association of major
21 consumers of western coal and western rail
22 transportation that is very familiar to the Board.

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1 WCTL members ship and pay the freight for
2 over 100 million tons of coal per year. And we are
3 the only organization that focuses primarily on the
4 transportation interests of utility coal consumers
5 and the ratepayers. I am joined today by WCTL
6 counsel, Kelvin Dowd.

7 Whether they are investor-owned utilities,
8 municipal authorities, or public power agencies, all
9 WCTL members operate under mandates to provide
10 reliable energy to their ratepayers at a reasonable
11 cost. For electricity generated from coal, the cost
12 of transportation is a major component of what
13 ultimately is paid by consumers in their monthly
14 bills.

15 Responsive rail service at reasonable
16 rates is essential to serving a public interest in
17 reliable and affordable energy. WCTL was an active
18 participant in the Board's revenue adequacy
19 proceedings in 2014-2015, and I personally was part
20 of a WCTL delegation that met with the Rate Reform
21 Task Force in June of 2018 to discuss how the Board
22 should implement the revenue adequacy constraint

1 under its Coal Rate Guidelines.

2 In my position at LCRA, I've also been
3 involved with issues related to the rail
4 transportation of coal for many years. Based on my
5 experience, the major railroads' perceived poor
6 financial health historically was used to justify
7 higher rates on coal and other shippers who depend
8 most heavily on rail service.

9 I also understand that in the guidelines,
10 the Board made clear that once a railroad earned
11 adequate revenues, that kind of differential pricing
12 would no longer be allowed. Back in 2014 and 2015,
13 WCTL presented considerable evidence to the Board
14 showing that for many years, the heavily concentrated
15 rail industry had shown strong profit growth, lower
16 operating ratios, and a ready ability to attract and
17 retain capital investment.

18 Our position is that the time is right for
19 the Board to adopt a meaningful and effective
20 approach to provide captive shippers the protections
21 they were promised under the Guidelines. While
22 captive coal shippers may constitute a minority, it

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1 has been my experience and that of other WCTL members
2 that the STB's policies and regulations regarding
3 rates on market dominant traffic, have a meaningful
4 impact on the railroad's overall rate structures, as
5 there are only four major rail systems in the U.S.
6 today.

7 And the opportunities and incentives for
8 concerted or parallel pricing are significant. So,
9 all of us at WCTL have an interest in the outcome of
10 these hearings. The Rate Reform Task Force report
11 earlier this year partially endorsed one of WCTL's
12 proposals in the prior proceeding. However, we have
13 serious concerns with respect to other aspects of the
14 task force recommendations which Kelvin will address.

15 On behalf of WCTL, we appreciate the
16 opportunity to share our concerns with the Board.
17 I'll give it over to Kelvin.

18 MR. DOWD: Chairman Begeman and members of
19 the Board. I'm Kelvin Dowd, I'm counsel to the
20 Western Coal Traffic League, and I join President
21 Whalen in thanking you for the opportunity to present
22 our views on the Rail Reform Task Force's

1 recommendations on revenue adequacy.

2 In Ex Parte number 722, WCTL presented a
3 complete proposal for enforcing the Guidelines'
4 revenue adequacy constraint, which under the
5 Guidelines is labeled "The first rate constraint."
6 And those proposals included a presumption of revenue
7 adequacy based on consecutive years of return on
8 investment in excess of the industry cost of capital,
9 an option to demonstrate revenue adequacy, using
10 recognized alternative measures of railroad financial
11 health, a rate increase constraint for market
12 dominant revenue adequate carriers, and the
13 preservation of existing regulatory remedies under
14 the Guidelines in the Board's Simplified and Three-
15 Benchmark approaches.

16 The task force's recommendations echo the
17 League's proposals in certain ways, including a
18 multi-year measure of revenue adequacy and the use of
19 a rate increase constraint, as the principal remedy
20 for shippers who can demonstrate they are subject to
21 market dominance.

22 However, in key respects, the task force's

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1 proposals fall short of providing captive shippers
2 with the rate protections that they are due under the
3 Guidelines. Those shortcomings are detailed in the
4 League's separate written statement, and I would like
5 to summarize them briefly here.

6 On the subject of measuring railroad
7 revenue adequacy under the Guidelines, we agree with
8 the task force that it should be a multi-year
9 analysis, and the League would be willing to extend
10 its proposed four consecutive year presumption, to
11 five years as the task force suggested.

12 However, other elements of the task
13 force's proposal should not be adopted. First, the
14 task force would have revenue adequacy under the
15 Guidelines determined solely on the basis of the
16 Board's snapshot test of return on investment,
17 compared to the cost of capital. This squarely
18 conflicts with established Board precedent,
19 including most recently, the 2018 decision in the
20 Consumers Energy case. Affirming decisions reaching
21 back to 1986, the Board in Consumers held that while
22 the ROI COC test was relevant, it should not be the

1 sole determinant and a captive shipper should have
2 the opportunity to present specific and alternative
3 evidence of a carrier's revenue adequacy.

4 As the Board knows well, the question of
5 how best to measure the railroads' cost of capital is
6 a contentious one. And however one comes down on the
7 issue, the current approach cannot be considered the
8 final word. As a matter of reason, the Board should
9 not put undue weight on its annual snapshot.

10 As a matter of law, the Board should
11 reject this component of the task force's
12 recommendation. Second, by endorsing an
13 ever-shifting measuring cycle, the task force invites
14 biases and distortions that would threaten the
15 effectiveness of the revenue or adequacy constraint.

16 This is not the first time that the Board
17 or its predecessor has considered expanding and
18 contracting study periods under the auspices of
19 replicating a business cycle. In the 1990's, the ICC
20 wrestled with the problems resulting from measuring
21 railroad productivity, using different length
22 measuring periods and ultimately settled on a fixed

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1 period, so that no particular change between years
2 would be given too much or too little weight.

3 Additionally, in this case, the Coal
4 League showed in its written statement that the
5 returns on investment of the major Class I railroads
6 do not necessarily correlate closely to general
7 economic trends as reported by the National Bureau of
8 Economic Research.

9 For example, while the general economy
10 contracted significantly during 2008, the ROIs for
11 BNSF, UP, NS and CSXT all increased significantly
12 over 2007 values. Taken together, the distortion and
13 bias risks, coupled with serious concerns regarding
14 accuracy, argued strongly against the task force's
15 proposed floating study period, and in favor of a
16 fixed period where the ROI, COC test serves as a
17 presumption.

18 But where consistent with Board precedent,
19 the question of an individual railroad's revenue
20 adequacy under the Guidelines, remains a matter of
21 individual evidentiary showings. The Coal Rate
22 Guidelines are clear that once a carrier achieves

1 revenue adequacy, its captive shippers no longer
2 should bear the economic burden of differential
3 pricing.

4 In ex parte number 722, WCTL proposed a
5 straight forward method for implementing this
6 constraint. A revenue adequate railroad would only
7 be permitted to increase a captive shipper's
8 pre-existing rate by a reasonable measure of actual
9 railroad cost inflation. And we proposed the use of
10 the RCAF after adjusted for productivity.

11 The task force report recommends a rate
12 increase limitation as well. However, its limit only
13 would apply to some captive shippers, and its
14 implementation would require a potentially complex
15 and contentious series of calculations that easily
16 could leave deserving captive shippers without
17 meaningful relief.

18 The task force proposes to determine a
19 revenue adequate carrier's present value surplus of
20 net operating revenue, over required returns,
21 measured over varying time periods. Then allocate
22 that surplus over an undetermined, but very large

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1 number of commodity service groups, using the maximum
2 markup methodology, employed under the Stand-Alone
3 Cost constraint.

4 Whether a particular captive shipper's
5 rate would be constrained would depend on the
6 relationship of its rates revenue to variable cost
7 ratio, to the threshold ratio for its commodity
8 service group. In addition to building in multiple
9 layers of easily disputed evidentiary findings, the
10 task force's approach conflicts with the Guidelines
11 focus on the reasonableness of individual rates and
12 is squarely at odds with the only court-approved
13 precedent concerning implementation of the revenue
14 adequacy constraint.

15 The task force would permit continued
16 differential pricing on captive traffic by a revenue
17 adequate carrier. And it would tie a shipper's rate
18 relief, not to the revenue adequate status of its
19 serving railroad, but to the level of rates paid by
20 other non-complaining shippers who happen to fall
21 within the complainant's defined commodity service
22 group.

1 The Coal Rate Guidelines carved out a very
2 specific and limited exception to the rule that
3 revenue adequate railroads would not be permitted to
4 engage in further differential pricing. The
5 railroad had to show the need for additional
6 revenues, the specific harm that it would suffer if
7 it could not raise those revenues, and the reasons
8 why captive shippers were the only available source
9 for those revenues.

10 The task force's proposal ignores this
11 mandate and opens the door to continued differential
12 pricing by revenue adequate carriers. It is
13 inconsistent with the central tenets of the Coal
14 Rate Guidelines and should not be adopted. In
15 contrast, the remedy proposed by the Western Coal
16 Traffic League hues closely to those Guidelines and
17 is both effective and easily administered, and we
18 continue to recommend it to the Board.

19 As an alternative remedy, the task force
20 proposed that the Board relax its bottleneck rate
21 rules where the bottleneck carrier is revenue
22 adequate. As a threshold matter, the League agrees

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1 that this should be an alternative, though
2 non-exclusive remedy worthy of the Board's
3 consideration.

4 We submit that the rate increase
5 constraint, as proposed by the League, should be the
6 principal option for implementing the revenue
7 adequacy constraint. Properly designed, however, the
8 task force's conceptual bottleneck proposal could
9 afford an effective second avenue of relief.

10 The Board's current policy, which the
11 Court of Appeals made clear, was predicated in
12 significant part on balancing the perceived revenue
13 inadequate status of the railroads with a need for
14 rate protection on captive shippers. Requires that
15 in order to compel a railroad with exclusive control
16 over service to a particular destination, to
17 establish a separate rate for use in combination with
18 an upstream competitor.

19 A shipper first must demonstrate that the
20 dominant carrier has engaged in anti-competitive
21 conduct, or failed to provide adequate service under
22 the Board's competitive access rules. This proof

1 burden has amounted to a nearly insurmountable
2 barrier for captive shippers to clear, leading to a
3 perpetuation of closed bottlenecks and corresponding
4 monopoly pricing.

5 While the task force did not suggest
6 specific steps to open up greater opportunities for
7 bottleneck relief, WCTL submits that one effective
8 reform would be to eliminate the competitive access
9 proof requirement in cases where the bottleneck
10 railroad is revenue adequate.

11 It is true that the Board carved out
12 something of an exception to the full competitive
13 access requirements in circumstances where a shipper
14 can secure a contract with an upstream carrier for
15 service from the origin to the bottleneck
16 interchange.

17 However, over the past 20 years, it's been
18 the experience of many WCTL members that the western
19 railroads, in particular, have little interest in
20 negotiating such contracts. Apparently out of a
21 concern that if one did so, it would invite
22 retaliation in markets where that carrier controlled

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1 the bottleneck.

2 Therefore, in addition to liberalizing the
3 evidentiary requirements for bottleneck relief when a
4 railroad is revenue adequate, the Board should
5 consider making separate bottleneck pricing available
6 without regard to whether a shipper has first
7 secured an upstream contract. Such a policy would
8 promote increased competition and streamline the
9 regulatory process in those cases where the
10 bottleneck rate is set at an unreasonably high level.

11 Finally, the task force proposes that the
12 Board restore the simplification convention for
13 calculating road property investment under the
14 Simplified Stand-Alone Cost methodology. According
15 to the task force, this change would make Simplified-
16 SAC more accessible to more shippers.

17 The Western Coal Traffic League does not
18 oppose the task force's recommendation, so long as
19 using the simplification convention is at the option
20 of the complaining shipper. We can easily imagine
21 circumstances where reliance on average RPI costs
22 from previous cases could yield higher stand-alone

1 costs and a specific analysis of the actual route
2 over which the challenged rate applies.

3 So, a complainant might be willing to
4 incur the additional litigation expense to pursue a
5 better outcome. In other cases, of course, the
6 cost-benefit balance could tip the other way. The
7 key is to leave the determination to the individual
8 complaining shipper.

9 In closing, I would like to emphasize
10 again a key point made by the League in its filings
11 in ex parte number 722. The revenue adequacy
12 constraint as proposed by WCTL will only apply to
13 that narrow class of captive shippers who undertake
14 to file formal rate complaints, are able to
15 demonstrate that they are subject to railroad market
16 dominance, and are able to carry the burden that the
17 defendant carrier is revenue adequate.

18 If successful, those shippers also would
19 secure nothing more than an inflation-adjusted limit
20 on further increases to established rates. Despite
21 what was argued by some of the railroads in ex parte
22 722, and what we've already heard a bit of this

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1 morning, the adoption of an efficient, effective and
2 substantive revenue adequacy constraint will not
3 threaten future railroad investment, financial health
4 or service reliability.

5 Instead, it will breathe timely life into
6 a key element of the Coal Rate Guidelines for the
7 deserved benefit of captive shippers and in the case
8 of WCTL, the electric ratepayers that their members
9 serve. We thank the Board for the opportunity to
10 appear today and we would look forward to your
11 questions.

12 BOARD MEMBER OBERMAN: Thank you all.
13 I'll just have to start anyway with a couple of
14 questions. Jill, the -- does BN take the position
15 that the railroad adequacy proposal in the Rate
16 Reform Task Force is prohibited by our statute?

17 MS. MULLIGAN: So, to break that down a
18 little bit. I think that the -- starting with the
19 rate proposal and actually both of the proposals.

20 BOARD MEMBER OBERMAN: Well take the RIC,
21 not the other one.

22 MS. MULLIGAN: Take the RIC, sticking with

1 the RIC first. Okay, so that proposal, I think that
2 it would be inconsistent starting with the statutory
3 focus on allowing competitive markets to determine
4 rates. Because as I understand that proposal, the
5 idea that you are taking a -- you're deciding that a
6 rate is going to -- you're going to iterate a rate, a
7 maximum level rate by a commodity group.

8 And the reality of what you're doing in
9 that practice is you are taking an overage that's run
10 by a railroad across its entire enterprise, which for
11 BNSF is competitive markets, not regulated by the STB
12 in large part. And your taking that overage and then
13 you're allocating it to the subset of captive
14 shippers that may have absolutely no connection
15 whatsoever to that overage that's being allocated.

16 For us, we think that that's just a
17 fundamental misstep in terms of what the Board's
18 appropriate, and I think grounded in the statute what
19 the role is, which is looking at individualized
20 rates, looking at whether that rate, number one,
21 meets the standard of market dominance.

22 And then two, whether a reduction is

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1 appropriate based on where that rate falls in terms
2 of competitive forces. And there are some instances
3 where the Board may look at that and say, there's
4 something that we need to do there, but that should
5 be in reference to what competitive forces would
6 result from in that specific market for that specific
7 rate, which I think for RIC is really disconnected
8 from that.

9 BOARD MEMBER OBERMAN: Is there some
10 specific statutory provision which would bar us from
11 employing that, that's really what I -- I mean
12 there's so much in the statute, that is broad and
13 rhetorical and has policy aspects to it, but I'm
14 trying to figure out if there's something that --

15 MS. MULLIGAN: Yeah.

16 BOARD MEMBER OBERMAN: Because the
17 contention earlier today was that somehow, well the
18 word was untethered, but I don't know if that means
19 we're barred.

20 MS. MULLIGAN: Yeah. And I think there's
21 two ways to think about that. I think number one, if
22 you just went right back to the statute, I do think

1 that the starting premise that appears all through it
2 is the idea that competitive markets should be the
3 starting point. And where those markets are present,
4 that the Board cannot and should not insert
5 themselves into that environment.

6 But I also think, too, you have this
7 statute that's interpreted for decades and decades by
8 the STB in terms of what is an appropriate framework
9 to accomplish what is also I think, a statutory
10 requirement, which is looking at individual rates and
11 determining whether those individual rates are in
12 fact reasonable.

13 And I think that when you start doing
14 something that is enterprise wide, and looking at the
15 return across an entire enterprise, then you are
16 really divorced from that core concept that I think
17 you can support in the statute and in the case law.

18 BOARD MEMBER OBERMAN: Well, it's
19 interesting because the RTP that we've all quoted
20 this morning, subsection 6, about maintaining rates
21 at revenues, you know, which do not exceed the amount
22 necessary to maintain the rail system, would seem to

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1 me to contemplate the overall performance of the
2 railroad, it talks about the system, not just the
3 lane that the shipper is challenging it on, as a way
4 of measuring the rate.

5 And it would seem to actually support
6 the -- Mr. Dowd's point and others, that any shipper
7 who is captive, who proves market dominance, and I --
8 so, by definition it's not a competitive situation,
9 before they're eligible, should have their rates
10 protected, you know, if they're above the level of
11 revenue adequacy.

12 So, I am just trying to figure out why
13 this approach and what's laid out in the Coal Rate
14 Guidelines somehow is barred by our statute. I don't
15 see it. And if it's there, I'd like somebody to
16 point it out to me other than I understand there's a
17 broad policy argument but that's -- first we've got
18 to find out if the statute authorizes it.

19 MS. MULLIGAN: Yeah. I do think you have
20 to consider both of those together. But I also do
21 think that, you know, the -- I don't read section 6
22 the same way that you do. But I also read section 1,

1 2, 3, and 4 before you get to 6 that talk, and you
2 have to imagine there's a reason why you go through 5
3 sections talking about the role of competition, the
4 Congressional directive, in terms of there is really
5 a core principle in terms of what the STB should be
6 doing.

7 And that's a real role for you all too.
8 That's not meant to say there's nothing to be done,
9 nothing to do at all. And that revenue adequacy is
10 something that you should never think about. Of
11 course, it's something that you could consider and
12 think about. I think it's this idea of taking that
13 step beyond and saying there's a core structure that
14 we think is supported by the entirety of ICCTA, and
15 the RTP and other provisions, that talks about the
16 Board's role in regulating individualized rates, and
17 that that is going to somehow be set aside entirely
18 in favor of a constraint that is just really
19 triggered exclusively to an overall revenue, without
20 any reference to the individual shipper, what is
21 their competitive environment and is their rate
22 reasonable for the service that's being provided to

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1 them.

2 BOARD MEMBER OBERMAN: Well, but the
3 individual shipper has to show market dominance, so
4 there is reference to the individual shipper. If
5 they're going to pursue the remedy that's being
6 proposed.

7 MS. MULLIGAN: The -- so, I think there's
8 a couple things there. I think you may have heard in
9 my testimony. I think the NSF does think that the
10 market dominance review that the Board does ignores
11 very large parts of competition that are huge parts
12 of the markets that we're in.

13 So, putting that aside though, I think
14 that there's a -- perhaps a tendency to take a sort
15 of comfort from the fact that we say, okay, we're
16 going to create this draconian, potentially, you
17 know, extremely disruptive methodology, but don't
18 worry, because we're going to do a market dominance,
19 so that no one gets -- so, there's a very large
20 number of people who get in.

21 I think a couple things, going back to
22 what I first said, which is the people who are

1 getting in are not necessarily all related to the
2 thing that you are focused on, which is the overall
3 return of the network. But then also, I think
4 there's a little bit of a notion of okay, there's a
5 small enough group that's potentially impacted by
6 this.

7 The reality is that that may be. I mean I
8 did show our sort of percentages on our network. We
9 do have a very, very large amount of our traffic that
10 is competitive. And so, the issue is though that
11 one, I will say I'm not sure that you get market
12 dominance, right, so putting that aside though.

13 But two, even if you say that it's a small
14 category of folks, those are shippers who are in
15 complex markets and there's implications in terms of
16 our ability -- I think Paul mentioned, our ability
17 then to say okay, how do we engage in investment in
18 their traffic when the message is we cannot earn a
19 market-based return on that traffic.

20 But then also, that is hugely disruptive
21 in terms of the shippers' relationships in their own
22 markets, in terms of creating a shipper who gets the

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1 benefit of a below-market rate, and then is
2 competing with other shippers who may not be on a
3 revenue-adequate railroad, or is on one, one year,
4 and not on the next. I mean I think it's really
5 stepping into a range of interference in a market
6 that the STB has been very cautious about, and I
7 think appropriately so, in terms of policy, but also,
8 I think under the statute too.

9 BOARD MEMBER OBERMAN: By the way, isn't
10 there a court decision some place, or was I just
11 dreaming, that says you can't rank order the 15.
12 Some sections of the RTP that all get equal.

13 MS. MULLIGAN: It is true. Because I say
14 that I was thinking about it. But I'd also say
15 you're not supposed to pluck a single one and say
16 that that tells you what to do, yeah.

17 BOARD MEMBER OBERMAN: No, no, agreed.
18 One final thing. I don't know if you may have
19 already done it, but if you haven't are you going to
20 submit those slides?

21 MS. MULLIGAN: Yes, they are actually in
22 the docket now.

1 BOARD MEMBER OBERMAN: Oh, they are. Oh,
2 okay.

3 MS. MULLIGAN: Yeah, yeah, but if not,
4 feel free to reach out.

5 BOARD MEMBER OBERMAN: Yeah, no I'd like
6 to have them. The one quick question, Zach, your
7 proposal that the Board ought to consider shifting
8 the burden of proof to the railroads, is that limited
9 to railroads which are revenue adequate?
10 Only then?

11 MR. COCCOLI: Yes.

12 BOARD MEMBER OBERMAN: And, do you have
13 any authority, or do you think it's needed, to show
14 that that shift in the burden of proof would be
15 consistent with the Administrative Procedure Act
16 where the plaintiff normally has the burden?

17 MR. COCCOLI: I do not have the specific
18 reference to provide at this time.

19 BOARD MEMBER OBERMAN: Do you think that's
20 a concern if we wanted to do it, what would be our
21 authority to shift that burden of proof?

22 MR. COCCOLI: I think the regulatory

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1 authority overall is to provide for reasonable rates.
2 And equitable access to the rate dispute methodology
3 would provide cover for shifting that burden in the
4 case of the Montana shipper who's already one step
5 removed from the negotiation and the rate setting
6 process. I think more direct engagement by the
7 Surface Transportation Board could be appropriate.

8 BOARD MEMBER OBERMAN: What do you mean,
9 one step removed?

10 MR. COCCOLI: The Ag producers that I
11 represent that I'm referencing, are not per se the
12 shipper.

13 BOARD MEMBER OBERMAN: Oh, I see what you
14 mean. You're talking about removed from the grain
15 elevator or whatever.

16 MR. COCCOLI: Correct.

17 BOARD MEMBER OBERMAN: Yeah, okay. Thank
18 you, that was helpful.

19 VICE CHAIRMAN FUCHS: Jill, AAR's
20 testimony mentioned that the task force is kind of
21 conceptually on the right path by exploring
22 simplifications to simplify SAC. Would you concur

1 that you know, simplifying RPI is a worthy thing to
2 consider?

3 MS. MULLIGAN: Yeah, I don't think we have
4 an issue with that. I think that it doesn't feel
5 like the right framework to say that that's something
6 that would be an appropriate simplification just
7 because of revenue advocacy, but yeah.

8 VICE CHAIRMAN FUCHS: Right, the Board can
9 just do that.

10 MS. MULLIGAN: And I think it's something
11 that could be explored in terms of options to
12 simplify. Where I started a little bit with is the
13 idea that sort of somehow is going to be the penalty
14 for revenue adequacy.

15 VICE CHAIRMAN FUCHS: Right, right, I'm
16 only talking about the concept itself.

17 MS. MULLIGAN: So, I think we're agreeing,
18 yeah.

19 VICE CHAIRMAN FUCHS: Yes. And do you
20 have any issue, maybe Mr. Dowd and Ms. Whalen laid
21 out the possibility of the shipper's discretion about
22 whether or not to use, you know, a simplified RPI.

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1 Do you have any issue with that?

2 MS. MULLIGAN: You know what, I
3 honestly -- we could be okay with that. It's not
4 something I think I've run fully to ground, but could
5 be something worth exploring going forward. I
6 wouldn't close out the opportunity at this point.

7 VICE CHAIRMAN FUCHS: And one thing that I
8 also picked up was you know, in the definition of the
9 timeframe for long-term revenue adequacy, you know,
10 there's one -- a couple, a few different approaches.

11 MS. MULLIGAN: Yes.

12 VICE CHAIRMAN FUCHS: In terms of the
13 number of years, whether or not you include a
14 recession, and then whether or not you have a
15 presumption and allow for other evidence. Is there
16 anything conceptually wrong with allowing for a
17 presumption, assuming Mr. Dowd is describing such
18 that the Board has a standardized definition, but a
19 lot of additional evidence in any adjudication?

20 MS. MULLIGAN: Yeah, I mean I think
21 there's a couple ways to think about that. I think
22 that some of the proposals are that you are revenue

1 adequate if the STB calculation says you are. But
2 then if you're not, then shippers can come in and
3 show the evidence. So, I don't know that it's
4 actually proposed as sort of a two-way street where
5 you can kind of argue both sides of that as proposed.

6 I think there's -- and then I also think
7 the important question is how are we going to use it.
8 If the idea is that you are going to use it as a very
9 sort of you pass this line and therefore, things
10 start happening that you rail, and you shipper have
11 you know, are part of what you are doing in your
12 everyday business, then I think that you do need a
13 significant amount of confidence in the measurement.

14 I think that we've talked about
15 replacement cost, not because we want to launch off
16 on something because we've been told no before on
17 that several times. But launch off on how do we do
18 replacement cost to incorporate it into your revenue
19 adequacy calculation? But because it also helps to
20 understand look, there are things that make this not
21 be absolutely perfect mechanism, which should cause
22 us to pause and say, okay, is it then appropriate to

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1 launch off in a whole other regulatory structure
2 because of what it says?

3 The -- and we would say no, but so I think
4 in terms of what the Board uses it for, of making
5 sure they understand trends of the industry, making
6 sure they understand long-term, what's happening in
7 the current environment. The revenue adequacy
8 calculation is informative in that way and something
9 like the replacement cost amount, would that be a
10 fatal flaw?

11 But if you were going to start using it as
12 a here, you are going to fall off this cliff now and
13 the way that you engage in your business in the
14 competitive environment, what's that?

15 CHAIRMAN BEGEMAN: That's how we would
16 describe it.

17 MS. MULLIGAN: But if that was the case,
18 then I do think that you absolutely would need other
19 factors, including replacement costs as part of that.

20 VICE CHAIRMAN FUCHS: And you know, Mr.
21 Ward referenced kind of the like and I just, you
22 know, I think it's really great that -- and I was

1 talking about SAC and potentially use of comparison
2 groups and streamlining Three-B. And I think both
3 those get at the fact that you know, when you look at
4 our 15 rate review processes, it's difficult to be
5 satisfied.

6 And so, would you concur that you know,
7 putting aside the rhetoric, that we have a problem
8 with our regulatory structure right now?

9 MS. MULLIGAN: I think that there are
10 certain shippers who feel like they are outside of
11 the Board in terms of an option for help. And we
12 understand that, we take that seriously, because we
13 do think that having that backdrop of the Board and
14 having that feel effective to shippers is important.

15 I think for us, it is the most important
16 areas is for small shippers who don't have the same
17 sorts of resources as bigger shippers have, and don't
18 necessarily have the same sort of market presence
19 that bigger shippers have.

20 VICE CHAIRMAN FUCHS: Right.

21 MS. MULLIGAN: So, for us it's really -- I
22 think there is further simplification that the Board

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1 could do. We think it should be appropriately
2 tailored to the issue that you're trying to fix.

3 VICE CHAIRMAN FUCHS: Right, right.

4 MS. MULLIGAN: Which seems to really be,
5 there is a section of shippers who feel like that the
6 Board is not accessible to them because of
7 complexity, because of costs, that sort of thing.

8 VICE CHAIRMAN FUCHS: And turning to
9 Western Call and CTA, you know, you having a
10 presentation of competing with natural gas and you
11 know, I think it was said a number of times how that
12 is really what they would hold up as an example of
13 product competition that's not included in the market
14 dominance test.

15 And I think when the Board made that
16 determination, it's because you know, issues of
17 product and geographic competition are very complex
18 and maybe are outside the Board's typical expertise.
19 And please, someone correct me if I don't -- my
20 shorthand is not the correct interpretation of that.
21 So, what do you say to someone who says, listen, you
22 know, they're saying that they're competing fiercely

1 with natural gas. Isn't that the prototypical
2 example of product competition, and why would the
3 Board ignore that? It could go to either party.

4 MR. WARD: I'm not sure I understand the
5 point of the question exactly.

6 VICE CHAIRMAN FUCHS: So, maybe from
7 western coal, a product competition is something the
8 Board doesn't consider whether or not someone is
9 market dominant, and you know, being a set number of
10 times, that natural gas is an example of product
11 competition and understanding the complexities of
12 considering that and the Board's expertise.
13 Conceptually, is there a problem with that, or you
14 know, is it just a practical issue and are those
15 practical issues insurmountable?

16 MS. WHALEN: I think it's both. For
17 example, I'll speak for LCRA. We have three coal
18 plants. We cannot co-fire gas with them. So, it's
19 not like gas is cheaper than coal this week. We're
20 going to switch to gas.

21 VICE CHAIRMAN FUCHS: Right.

22 MS. WHALEN: And then next week it flips

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1 and we're going to switch to coal. So, I would say
2 from a practical standpoint and conceptually, unit by
3 unit basis, you can't say that they compete. Now if
4 you have capacity in your portfolio and you have gas,
5 then you may shift some of your generation one way or
6 another, but it's not a one for one competition.

7 And then as well, you've got areas where
8 like the central part of the United States up north.
9 I mean they are very heavy coal because you just
10 don't get gas up there. So, I would suggest that
11 gas may have an influence in the overall electric
12 generation market, but as far as causing a shift one
13 way or another with coal shippers and our need to
14 have coal on the ground and burn, I would say no, I
15 think there's -- it's a little bit of a faulty
16 comparison.

17 MR. WARD: I would just add to that, the
18 presence of gas in the market, you know, the
19 transportation is on a completely separate platform.
20 You know, our ability to compete against gas is
21 affected by the reasonableness of the rates that
22 we're able to obtain from many of our members, the

1 only transportation option that's available to them.

2 So, it's important for us to be having
3 rates that are not a penalty to us to enable us to
4 compete against resources that are transported
5 through entirely different mediums.

6 MS. MULLIGAN: Then, maybe if I can just
7 add to that. Because I do think I actually agree
8 with you. Our point is that the gas price does
9 actually limit our ability to charge a rate because
10 even if you're not a utility that has the ability to
11 flex up and down and use gas versus coal, the reality
12 is if we price our transportation too high, we lose
13 out to gas, which doesn't touch our railroad.

14 So, there is a built-in penalty if we do
15 actually get our rate too high in terms of not being
16 able to move the coal because it doesn't move.
17 Because it's like on the same cost curve as gas, and
18 there's complexities to that, I don't mean to make it
19 overly simple, but I do think it's something that's
20 very real for us.

21 VICE CHAIRMAN FUCHS: Sure, but Jill, I
22 maybe, interpreted some of your statements as saying

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1 that the Board ought to consider the role of gas in
2 adjudicating the market dominance.

3 MS. MULLIGAN: Yes, no, I think that's
4 right. And for exactly the reason that I do think it
5 does influence our ability to charge rates, yeah.

6 BOARD MEMBER OBERMAN: On this subject
7 though, is it on, I'm sorry. Aren't there other
8 factors that determine the competitors of gas, such
9 as environmental regulation and --

10 MS. MULLIGAN: Yeah, I mean it's not --

11 BOARD MEMBER OBERMAN: In other words, if
12 there are environmental issues, lowering or raising
13 the price of shipping a ton of coal, it may not have
14 an effect at all, but if somebody is going to invest
15 in a gas plant. I mean that --

16 MS. MULLIGAN: And it's also I don't mean
17 to say that gas is the only thing out there too. I
18 mean you do have wind. You have other types of
19 electricity that falls along the grid that we also
20 potentially compete with. The -- I think the point
21 is that there is actual real forces out there and
22 historically, what the Board has said is that's just

1 going to be irrelevant to what we do. And I think
2 that does mean that when you're talking about a coal
3 environment, or even on the grain side, when you're
4 talking about grain captivity and not thinking about
5 the fact that there is geographic competition there,
6 that really does just mean that you're not -- if
7 you're making decisions, regulatory decisions on that
8 basis, then you're not doing so with a full view of
9 the competition.

10 MR. DOWD: I'd like to add just a little
11 bit of context to the subject. Because what I'm
12 hearing is something that seems to be narrowly
13 focused on this question of whether gas competes with
14 coal in the generation market. And that's not really
15 the issue.

16 When the Agency made the policy decision
17 that it was no longer going to consider geographic
18 and product competition, that was predicated in large
19 part on the complexity and the time and the expense
20 that was associated with what under the regulatory
21 regime is supposed to be a threshold determination.

22 In those areas of the energy market where

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1 gas or wind or renewables or purchased power,
2 directly competes with coal, those are not the coal
3 movements that come before your agency. Because in
4 those circumstances, the parties negotiate their way
5 to a resolution. And the result is some sort of a
6 contract, which is outside the scope of your
7 jurisdiction.

8 The movements that come before your agency
9 are the ones where they have no other recourse,
10 because no one in their right mind signs up for 5, 6,
11 7 million dollars and three years of litigation
12 unless they have no other place to go.

13 So, when you consider it in the context of
14 who's actually bringing the cases before the Board,
15 the agency's prior determination that we're not going
16 to make it even more expensive and more complex by
17 inviting fanciful theories about geographic and
18 product competition makes a lot of sense.

19 VICE CHAIRMAN FUCHS: And I think you're
20 spot on in terms of what the Board said, and I just
21 want to make sure I point it. You said fanciful
22 theories, but it's not necessarily a fanciful theory,

1 its geographic does exist, it's just too complex for
2 the Board to consider and it's not worth it on the
3 threshold determination given the fact that you
4 mentioned, right.

5 But that competition itself does exist in
6 the marketplace.

7 MR. DOWD: In those circumstances where it
8 is not a fanciful theory.

9 VICE CHAIRMAN FUCHS: Right.

10 MR. DOWN: Those customers are never going
11 to be coming before your agency.

12 VICE CHAIRMAN FUCHS: And could -- but
13 here's the one thing, and you know, just play devil's
14 advocate. The same could be said for all forms of
15 competition, right, where if there's barge
16 competition or truck competition, then those are the
17 types of things that wouldn't come before.

18 So, how do you differentiate that type of
19 competition from other types of competition? The
20 complexities at issue, I agree with you entirely that
21 that's what the Board said. But the point about
22 because there's that form of competition those rates

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1 won't come, well then that applies to everything else
2 that we consider under market dominance, doesn't it?

3 MR. DOWD: Well not in the same way.

4 VICE CHAIRMAN FUCHS: Okay.

5 MR. DOWD: Now, I was involved in the
6 Consumers Energy case.

7 VICE CHAIRMAN FUCHS: Sure, right yeah.

8 MR. DOWD: And we had a pretty interesting
9 market dominance argument. In that case it was all
10 about alleged transportation competition.

11 VICE CHAIRMAN FUCHS: Right.

12 MR. DOWD: But usually, usually
13 transportation competition is easier to assess
14 because you have an economic piece and you have a
15 physical piece, and you can pretty much get to the
16 answer fairly easily.

17 VICE CHAIRMAN FUCHS: So, it really boils
18 down to the complexity relative to what it's worth.

19 MR. DOWD: Yes. I think that's a major
20 part of it, yes.

21 MS. MULLIGAN: And if I could just I think
22 the important part of this too is also that I think

1 we started talking about market dominance because of
2 the idea that, you know, we may have these proposals
3 that come, but be comfortable about it because
4 there -- you know, there's going to be a process on
5 the front end that sorts through the traffic and says
6 I am really going to narrowly focus on those where
7 it's appropriate, and those where we should feel
8 comfortable in terms of taking those over edges, and
9 doing something.

10 And I think unfortunately that's just not
11 where the Board is in terms of their current process
12 for market dominance.

13 CHAIRMAN BEGEMAN: Not quite sure where I
14 want to start. Don't worry, I'm not going to go at
15 length. But I think I will just kind of start my
16 commentary based on what you mentioned Mr. Ward, and
17 I'd say maybe Patrick kind of returned as rhetoric,
18 rather, you know, press rhetoric, various things.
19 And so, starting with sort of what you said as you
20 were speaking to us. I'm going to ask all the
21 railroads. I didn't ask this of AAR, but you know,
22 one of the interesting rhetorics I read a bit ago is

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1 that the
2 FCC and the STB are obsolete.

3 And I was kind of happy to be in
4 conjunction with the FCC as far as being grouped with
5 that agency, but I'm curious from BNFS's
6 perspective, is the Board obsolete?

7 MS. MULLIGAN: No. I don't think so at
8 all. And I think, you know, as part of my
9 conclusion, I think I did endorse very much that
10 there is a really valid role for the STB in terms of
11 you know, making sure that where there are instances
12 where the market forces aren't present, that they are
13 there and that they are viable in terms of -- as an
14 option and a path forward for the Board.

15 So, I think absolutely we do think that
16 there is a role for the Board and it's an important
17 one and it needs to be properly shaped, and you know,
18 we are in like I said, a very competitive
19 environment and so I do think it can be a narrow
20 role, but I do think it's an essential one.

21 BOARD MEMBER OBERMAN: As the oldest
22 member of the Board, I didn't take it personally.

1 CHAIRMAN BEGEMAN: Certainly, any other of
2 the panelists are welcome to comment on that, but I
3 don't know that it was generated from a shipper
4 perspective. I'm certainly not saying that BNSF
5 generated the commentary. So, back to you Mr.
6 Ward. You're my focus. Again, based on something
7 you said.

8 So, I'm going to pivot to other panelists.
9 You know, you indicated you're not in a position and
10 your members aren't in a position to hire lawyers and
11 economists, et cetera. And I certainly can
12 understand that. You know one of the reasons that
13 this Board is really trying to find new
14 methodologies, improved approaches, is because you
15 know, the SAC prospects are extraordinarily expensive
16 and time consuming.

17 And you know, this agency has long been
18 trying to find a better approach, specifically, for
19 smaller shippers. I know that a previous Chairman is
20 sitting behind me and he was reading some of his
21 testimony for Congress and he said -- addressing the
22 small rate cases was his top priority.

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1 And so, you know, it was a worthy priority
2 then and it's just as worthy today and I appreciate
3 that my colleagues are -- we're all in agreement that
4 we do want to make meaningful, wise, useful change.
5 We're not looking to turn the clock back, but we are
6 looking to carry out what the statute tells us we are
7 to be doing. So, thank all of you for any effort
8 that you will help us to do that.

9 So, Mr. Dowd, you know, you had mentioned
10 that you thought that the task force got a little bit
11 of it right, but you were pretty unhappy with a
12 number of things, and you wanted to make sure that
13 for example, that there had to be an undertaking to
14 file a formal rate complaint, et cetera.

15 And to me, let's see, and then revenue
16 adequacy wasn't just a snapshot, but you know, sort
17 of -- I would say maybe what you went through as far
18 as your additional evidence with the Consumers
19 case, you wanted that opportunity to really litigate
20 every little aspect.

21 And my concern about that is then you have
22 Mr. Ward who doesn't -- he doesn't want to pay for

1 expensive lawyers and economists. So, how do you --
2 you can't really have it both ways.

3 MR. DOWD: Well, I think.

4 CHAIRMAN BEGEMAN: We've been trying to
5 simplify.

6 MR. DOWD: I think that -- well, our basic
7 positions on the task force is recommendations are
8 predicated on our interpretation of the law, our
9 interpretation of prior precedent. So, you know,
10 when we look at the implementation of the revenue
11 adequacy constraint, that is part of the coal rate
12 guidelines. It's one of the four constraints adopted
13 in the coal rate guidelines.

14 The coal rate guidelines in turn, is a
15 methodology for adjudicating rate complaints which
16 can only be brought upon a showing of market
17 dominance. So, as we see the revenue adequacy
18 constraint, it lives within the context of the
19 complaint process instead of bringing a stand-alone
20 cost presentation, you bring an adequacy
21 presentation.

22 However, just as you've attempted through

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1 Simplified Standards and through 3 Benchmarks to come
2 up with more streamlined and less expensive
3 alternatives to constrained market pricing. In the
4 revenue adequacy context, that's why we advocated
5 presumption. So that, you know, if Mr. Ward has a
6 carrier that fits within the presumption, doesn't
7 have to put on a case that their revenue adequate,
8 it's right there, you know, in their qualification
9 under the presumption.

10 So, it would be a simplifying convention
11 that could be applied by a complainant that did not
12 have the resources or didn't feel the need to make a
13 larger case for the carrier's financial health. So,
14 we don't see them as in conflict and mutually
15 exclusive. They're more -- it's more a question of
16 can you have a simplifying convention that can make a
17 standard and more complex approach simpler in
18 appropriate circumstances.

19 CHAIRMAN BEGEMAN: Did anyone have any
20 views they wanted to offer us regarding ACC's
21 benchmark method at this point?

22 MS. MULLIGAN: I mean I think that AAR

1 covered it in pretty good detail. I think, you know,
2 for us, I think it has a lot of the same issues as
3 the general sort of top-down regulations just
4 generally on overall returns being applied to
5 individual rates.

6 I think the other thing, and I will not
7 claim to understand it. I've now tried to read it
8 twice and listened through it the third time, but I
9 think there's at least a couple things. I do think
10 that one of the things to think about is how they
11 have defined competition in there. The fact that
12 they -- I think one of their charts showed that they
13 think that rail traffic, only 5 percent of it is
14 actually competitive with truck.

15 Which just sort of to me, said we're
16 really kind of often, a world that's not at all, you
17 know, connected to the one that BNSF is in terms of
18 you know, how prolific truck competition is and as
19 evidenced by our intermodal business.

20 I think the other thing too is that what
21 it really -- like I said it's extremely complex, and
22 so the idea that it is sold as something that could

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1 be a simplification just doesn't hold together for
2 me. But I do think there is a concept in there
3 that's fairly simple which is it seems like it's a
4 methodology of averaging, it's more complicated
5 because there's regression in it, but it's a
6 methodology that seems to be taking your traffic
7 below 180 and using it to drive above 180 down to
8 180.

9 So, I mean I think that it does it in a
10 very sophisticated econometric way, but that to me
11 seemed to be the sort of output of it, is that it's
12 really, and I think in fact, a lot of the different
13 areas that it identified, it was either a freeze or a
14 reduction down to 180 for BNSF. So, that would be
15 very concerning.

16 And I think also concerning for the
17 reasons that Paul talked about it in his testimony,
18 it is designed to get a rate. While they talk about
19 it as being a market competitive rate, I don't think
20 that that's really what comes out of it for the
21 reasons that the AAR talked about.

22 But it's also, you know, as we talked

1 about one of the concerns. Where it connects to our
2 business is the fact that if we can't earn a market
3 level return on the business that would be subject to
4 one of these different rate methodologist, then that
5 really connects back to what Paul was talking about
6 in terms of our ability to do forward looking
7 investment.

8 And it materially increases the risk to
9 the investment when it's being done for traffic
10 that's subject to a methodology like that.

11 CHAIRMAN BEGEMAN: The beginning of your
12 testimony you made it clear about less than a third
13 of your traffic in '17 was subject to our
14 jurisdiction, is that what you said?

15 MS. MULLIGAN: So --

16 CHAIRMAN BEGEMAN: They moved up rates
17 above greater --

18 MS. MULLIGAN: So, it's actually, of all
19 of our traffic, one third of it is above 180.

20 CHAIRMAN BEGEMAN: So, the rest --

21 MS. MULLIGAN: The rest below the
22 jurisdictional threshold. And then within that we do

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1 have, you know, intermodals is a category of that
2 too. So, even in the traffic above 180, there is
3 traffic there that is actually competitive and exempt
4 from STB jurisdiction too, so.

5 CHAIRMAN BEGEMAN: And do you happen to
6 know, and it's fine if you don't know it, but of the
7 portion that is not under our jurisdiction, to what
8 extent is it because the Board has exempted those
9 commodities? You know, all of it?

10 MS. MULLIGAN: So, I think I'm not so sure
11 I understand the question. What I would say is that
12 for all of our commodities, we have traffic that is
13 above 180 and below 180. So, we have intermodal
14 traffic that's above and below. We have grain
15 traffic that's above and below. And so, it's a mix
16 and that's in large part because we're in a lot of
17 diverse markets for that traffic, including there's
18 diverse markets within the ag world.

19 So, but I do think there is a lot of
20 distribution in that.

21 CHAIRMAN BEGEMAN: Well, let me ask it.
22 It's not a different way, it's actually a different

1 question. In terms of the commodities that move
2 above 180, so under our jurisdiction is there a
3 predominance of the type of commodity that is? Is it
4 coal and is it grain? It just, is there a certain,
5 like a couple of --

6 MS. MULLIGAN: Yeah, no, I think I get
7 what you're asking. No, no, the reality is we have
8 like I said, intermodal traffic, not regulated.
9 That's also above 180 and there would be grain, there
10 would be coal traffic in there too.

11 And I think part of it when we do the
12 market based pricing so we're not kind of doing cross
13 base pricing, so you know, it's -- you wouldn't have
14 sort of natural clusters in terms of the RVC, so I
15 mean the market means that we have a distribution.
16 It's a distribution that we think is, you know,
17 reflects the competitive nature of our traffic in
18 terms of how much of it is in that below 180
19 category. But I don't want to go too far down that
20 because I do not think that you know, and obviously
21 actually really tells you about the individual market
22 that a customer is.

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1 I think the point that I was trying to
2 make is there's a sort of story of these regulated
3 commodities. We are, you know, taking rates up and
4 up and up. And if that was the case over the 10
5 year, I think you would see a different trend line of
6 what the Board measures. That was the main point
7 there.

8 CHAIRMAN BEGEMAN: And then I guess my
9 last question for you is you had mentioned that you
10 thought, and I may not get this quite right. I was
11 writing it quickly, but you think that the Board can
12 consider and think about revenue adequacy?

13 MS. MULLIGAN: Yeah.

14 CHAIRMAN BEGEMAN: And do what with those
15 thoughts? What does it inform?

16 MS. MULLIGAN: Yeah, I think probably
17 you're getting a lot of answers of what you can't do.

18 CHAIRMAN BEGEMAN: Yeah.

19 MS. MULLIGAN: And I do think there is,
20 you know, I still think that.

21 CHAIRMAN BEGEMAN: I don't think we could
22 do anything based on Mr. -- the AAR's testimony.

1 MS. MULLIGAN: Yeah, I mean I think in
2 terms of a wholesale new rate constraint that comes
3 into existence because the test has shown a certain
4 number of years of an overage versus an underage. I
5 don't think that that's something the Board should
6 do, and I don't think it's consistent with the
7 statute and the case law.

8 I do think that RY and cost of capital, I
9 think those are relevant metrics for the Board to
10 look at to understand the industry. And I could see
11 that if you were getting to a point where you had
12 railroads that had multiples of cost of capital being
13 earned and returns that you would want to understand
14 that.

15 And I think that's -- and also you also
16 frankly, have a directive to ensure that we don't
17 become revenue inadequate, so there's, you know,
18 there's reasons that this is a relevant metric in the
19 industry and in the Board.

20 I think that it's something like it's a
21 data point that I think is fair to be looking at and
22 even when the railroads were revenue adequate, you

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1 guys may even consider doing something along the
2 lines of a new Christianson report, or something like
3 that to say you know, data helps us understand what
4 we should potentially look at and talk about. I
5 don't think it should lead to some very dramatic
6 change in how you regulate, so I think it should be
7 informative in terms of how you approach.

8 And I also understand you would
9 potentially feel a lot of pressure when you have
10 multiple railroads, revenue adequate for prolonged
11 periods of time to make sure that your rate
12 reasonableness mechanisms do work. And so, I do
13 think that's also part of why the Board is
14 appropriately focused on you know, it's existing
15 methodologies to make sure it's accessible to all of
16 the stakeholders.

17 But that doesn't mean that there should be
18 something automatic that takes the Board away from
19 looking at the specific circumstances of that -- of a
20 shipper, of the market that they're in, you know,
21 determining whether it is in fact, a failure of
22 market power and then taking action on the basis of

1 that.

2 CHAIRMAN BEGEMAN: Kelvin, if I could ask
3 you, and I'm asking you this because you know, you've
4 been involved in Board matters for a good long time
5 as Western Coal Traffic League has as well, and
6 you -- you participate in so many of our proceedings
7 and thank you for that.

8 Sort of I guess if you could maybe fill me
9 in on some distant past. So, when constrained market
10 pricing was announced and there's revenue adequacy
11 and there's management efficiencies and SAC. Was
12 it -- did the railroads always say revenue adequacy,
13 that's a ridiculous constraint? I mean for me it was
14 the first time I think I recall hearing that was
15 during the 2015, the proceeding, EP 722 proceeding in
16 the hearing.

17 But that doesn't mean it wasn't -- you
18 know, perhaps I don't know what happened from the
19 previous many years prior to that. So, if you could
20 enlighten me if you happen to know, or of course,
21 revenues weren't -- necessary revenue adequate for
22 such a long time maybe it just didn't come into be a

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1 concern by the industry.

2 MR. DOWD: Well, sadly I can remember that
3 far back. The guidelines, you know, were adopted in
4 1985 as the result of what was a multi-year effort by
5 the then Interstate Commerce Commission to give
6 regulatory effect to certain statutory mandates,
7 revenue adequacy, the command to hold rates to
8 reasonable levels in the absence of effective
9 competition, and also the so-called Long-Cannon
10 Factors, directing the agency to look to see whether
11 the railroads were maximizing their opportunities
12 from competitive business before increasing rates in
13 captive business.

14 And you know, the agency went through a
15 number of years of proceedings and comments and
16 hearings and so forth, trying to come up with a
17 methodology that would give effect to those statutory
18 commands. Constrained market pricing was largely
19 promoted by the railroad side. Professor Baumol, you
20 know, was there, the principle champion in that
21 regard.

22 And the notion of revenue adequacy as the

1 first constraint was non-controversial at the time
2 that it was adopted. Whether that was because none
3 of the railroads were perceived as revenue adequate,
4 or whether it was because it was so obvious that no
5 one wanted to dispute it, it was not contested.

6 What was contested was how are you going
7 to do stand-alone cost and what's the burden of proof
8 going to be and all of that. So, and one interesting
9 and somewhat ironic point in that regard was in those
10 days the carrier's position was the reason why we
11 have to be able to differentially price the captive
12 traffic over here is because we have all this other
13 competitive traffic over there where we can't earn a
14 high enough return.

15 It's worth carrying because it covers its
16 variable cost, and it makes a contribution, but we
17 can't earn enough to be overall adequate, so we have
18 to be permitted to differentially price the captive
19 traffic.

20 And the irony is that what we are hearing
21 today is well, you shouldn't allow the captive
22 shippers to get any benefit from revenue adequacy

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1 that may be a consequence of all this other traffic
2 over here. Because -- the shippers were exposed to
3 differential pricing because of that traffic over
4 there.

5 VICE CHAIRMAN FUCHS: Would you say the
6 contention in the first panel from AAR is that when
7 SAC limits the ROI cost to capital, using replacement
8 costs. Let's say we did revenue adequacy using
9 replacement cost. Their point is that the only way
10 railroads would be ROI over the cost of capital, is
11 because their competitive traffic covers more than
12 the replacement costs. Is that basically, is that
13 your understanding of what AAR was contending in the
14 first panel?

15 MR. DOWD: Well not entirely. I think I
16 did hear them say that when you have a rate set under
17 the stand-alone cost constraint, it is set at exactly
18 the revenue adequate level.

19 VICE CHAIRMAN FUCHS: Right.

20 MR. DOWD: So, if you only had two kinds
21 of traffic, one was SAC and then everything else and
22 you were revenue adequate it must be because you were

1 running more of the other traffic.

2 VICE CHAIRMAN FUCHS: Right, right.

3 MR. DOWD: I'm not sure that life actually
4 works that way, but I think that's what they said.

5 VICE CHAIRMAN FUCHS: And is that what
6 you're referring to when you say that it's kind of
7 switching the argument?

8 MR. DOWD: Well, what I was pointing out
9 was that during the 1980's when differential pricing
10 was being promoted as an essential component of the
11 coal rate guidelines, the argument was the inability
12 to earn satisfactory returns on competitive traffic
13 should justify higher rates and captive traffic. And
14 what we're hearing now is that the fact that there
15 are higher returns on competitive traffic, shouldn't
16 allow the captive traffic to get any benefit, and I
17 just find that to be ironic.

18 VICE CHAIRMAN FUCHS: Very quickly. Mr.
19 Bischler, when BN loses an asset. Are there assets
20 on BNSF's line that if they lost them, they wouldn't
21 replace or if you lost them you wouldn't replace?

22 MR. BISCHLER: I haven't seen that. It's

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1 a network business obviously and so if we lose an
2 asset, we're going to replace it. And so the coal
3 loop is a great example of that example, so in my
4 career I haven't seen it.

5 VICE CHAIRMAN FUCHS: Does anyone have any
6 comments on the deferred taxes issue about including
7 that in the investment base? We haven't talked about
8 it yet at all today, but it came up a few times
9 throughout testimony.

10 CHAIRMAN BEGEMAN: Alright, we're going to
11 conclude the panel so that we can leave before the
12 NASA folks push us out of the room at 6 o'clock.
13 Thank you all very much. Greatly appreciated. We
14 will now go to Panel 3 and begin with the first
15 witness, Mr. Awad.

16 MR. AWAD: Yes. Hello everybody. My name
17 is Hussam Awad. I'm the Senior Vice President of the
18 Procurement and Supply Chain for Indorama Ventures in
19 North and South America. I'm here with Phil Rine who
20 is Indorama's Assistant Vice President for Logistics.

21 I would like to take a minute to sincerely
22 thank the Board for having this hearing on a matter

1 that is extremely important to us and other shippers.
2 Presently Indorama feels it has no recourse when a
3 rate is unreasonable which happens in the majority of
4 the time. We commend the Board for attempting to
5 find better ways to challenge a rate in this
6 proceeding and in the final offer rate review and
7 market dominance streamlined approach proceedings.

8 I will take a few minutes to introduce
9 Indorama and give some background on rail issues
10 we've been experiencing, specifically with the
11 Norfolk Southern. And then Phil will discuss our
12 comments on the matter at hand.

13 Auriga Polymers is an affiliate of
14 Indorama Ventures. Indorama and its affiliated
15 companies, Auriga, Starpet, Alphapet, Indorama
16 Venture Oxides & Glycol, Indorama Ventures Olefins,
17 Indorama Ventures Xylenes & PTA, Enterprise Indorama
18 P.T.A. Montreal and Indorama Ventures Mexico, have
19 active relationships with all the Class I railroads
20 and numerous short line railroads. The following is
21 a brief description of the Indorama operation across
22 the world.

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1 Indorama Ventures Public Company Limited,
2 listed in Thailand stock exchange, is one of the
3 leading petrochemical producers, with a global
4 manufacturing footprint across Africa, Asia, Europe
5 and the Americas. The company's portfolio comprises
6 of PTA, PX, NDC, PIA, PET, fibers, packaging,
7 specialty chemicals and olefins.

8 Indorama products serve major fast-moving
9 consumer goods and automotive sectors, examples are
10 beverages, hygiene, personal care, electronics, tire,
11 and safety segments. Indorama has approximately
12 19,000 employees worldwide and consolidated revenue
13 of almost 11 billion dollars in 2018. The company is
14 also listed in the Dow Jones Sustainability Index.

15 The headquarters of Indorama is in
16 Bangkok, Thailand and it's operating in about 31
17 different countries. Indorama has 15, more
18 specifically the United States, we have 15
19 manufacturing facilities in the U.S., Canada and
20 Mexico, serving over 200 customers in 45 states and
21 18 trans loading sites.

22 Over the past decade, Indorama has

1 invested in greenfields, brownfields and acquisitions
2 in North America with the most recent being the
3 acquisition of custom polymers PET recycling facility
4 in Athens, Alabama.

5 In addition, on August 8th, 2019, Indorama
6 announced the 2.1 billion dollars acquisition of
7 Huntsman's World-Class Integrated Oxides and
8 Derivatives Businesses with large operating sites in
9 the U.S. Golf Coast as well as in India and
10 Australia. The transaction is expected to be
11 completed and closed by first quarter of 2020.

12 Furthermore, on August 4th, just recently
13 we announced acquisition of Green Fibers, which is a
14 recycling facility in California. You can say based
15 on this, Indorama is one of the fastest growing
16 chemical companies in the world and we are ranked
17 28th largest chemical company in the world.

18 As we have testified before the Board
19 previously, Indorama has seen dramatic increases in
20 the cost and difficulty in shipping rail,
21 specifically via the Norfolk Southern, due to changes
22 in tariffs and operations over the past 19 months.

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1 One of our affiliate companies, StarPet, in Asheboro,
2 North Carolina, had significant financial operational
3 impacts.

4 With the October 2018 tariff change from 2
5 free demurrage days to 0 free demurrage days, StarPet
6 has been invoiced over \$392,000 with no end in sight.
7 This demurrage cost covers the last 13 months versus
8 what we have previously \$855.00, yes \$855.00 over 20
9 months, between February 2017 through September 2018.
10 We feel that the NS tariff structure is built with no
11 possible way for shippers like StarPet to completely
12 avoid demurrage. This confirms our thinking that
13 demurrage has become a revenue stream for NS.

14 To be more specific, with zero free days,
15 cars are placed overnight and are on demurrage the
16 same day after placed construct statute.
17 Furthermore, the NS has removed one of the two trains
18 that worked the switch on the service, the StarPet
19 site which builds the train between 5 and 6 a.m. with
20 no changes that can be made once the StarPet group
21 arrives to work.

22 Even if StarPet does request the cars

1 between 3 and 4 a.m. before the train is built, NS
2 cannot guarantee that they will have our cars on the
3 train. There is no time to react before demurrage
4 begins which means NS has effectively build in
5 demurrage charges to our daily operational cost.
6 Even though we just received a new structure for
7 service in the last couple of days, so we're trying
8 to evaluate the new structure that we were just
9 informed about the service to the facility.

10 Transit times continue to be inconsistent,
11 making it impossible for StarPet to make plans that
12 avoid demurrage or embargo. ETAs also change from
13 initial ship date during transit time either from
14 origin or junction, making it a moving target and
15 effecting our demurrage/credit structure in addition
16 to not being able to effectively plan our production
17 schedule.

18 StarPet has sent numerous emails to NS
19 personnel asking about bunching cars by NS only and
20 only on NS track. While NS acknowledged the
21 bunching, there was no explanation or relief due to
22 the bunching which is not caused by StarPet or its'

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1 suppliers, with the most recent bunching issue
2 affecting raw material cars, feedstock coming into
3 the sites as we speak, during this week.

4 The only changes NS has made either added
5 to our cost or were moved to another category, like a
6 SIT yard, storing transit yard. And the cost to move
7 one car equal around 17 days of demurrage charges.
8 This does not offer StarPet any relief. It just
9 moves the expense to a different bucket. NS has
10 recently announced additional changes to NS6004-D
11 effective April 2020, that will likely further
12 increase their demurrage revenue from shippers like
13 StarPet.

14 Furthermore, NS has started acquiring
15 volume commitment with liquidated damages in any 12
16 month contract. We have not experienced this from
17 any other railroad as the time of this writing. With
18 the nature of the PET business, the plastic business
19 that we're in, most of Indorama's customers do not
20 sign 12 month contracts, so we are unable to commit
21 to a specific volume, only that if we maintain the
22 business we will ship on the NS.

1 Unfortunately, NS is unwilling to agree to
2 those terms and has put some of our contracts on 90
3 days renewal with little or no negotiation, which is
4 again, not practiced by any other railroads that we
5 know of. We are basically advised that our rates
6 will be in most cases.

7 During our journey in North America as
8 Indorama, we have grown the most with NS by either
9 greenfields, brownfields or acquisitions, and
10 therefore, Indorama does value our relationship, with
11 NS, past and future and we are hopeful that they will
12 give the Board's policy statement serious
13 consideration that will result in a more fair and
14 reasonable tariff structure.

15 I will now turn it to Phil to go over the
16 subject at hand.

17 MR. RINE: Thank you Hussam. Good
18 afternoon and thank you again to the Board for the
19 time, energy and interest you have invested in
20 working to streamline this process. As you heard in
21 Hussam's testimony, Indorama has been having some
22 difficult conversations with the NS lately, with

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1 little to no result, and has a very strong interest
2 in having the Board establish regulations for revenue
3 adequacy constraint process.

4 And also, in the market dominance
5 streamline approach in EP 756 and in the final offer
6 rate review process in EP 755, as discussed in our
7 comments by Indorama in those proceedings. Indorama
8 commends the Board for taking an interest in
9 promoting policies that remove barriers to accessing
10 regulatory protection remedies, and is extremely
11 pleased that the Board is having this discussion
12 about the revenue adequacy constraint.

13 In the interest of time, I will summarize
14 my written testimony and will be more than happy to
15 answer questions by the Board once the panelists
16 testimonies are complete. On April 25th, 2019, the
17 Regulatory Reform Act issued a report that
18 recommended, among other things, that the Board
19 consider policy changes regarding revenue adequacy.

20 The Board asked interested persons to
21 provide input to the RRTC's recommendations regarding
22 railroad revenue adequacy. The Board specifically

1 asked participants to address the following RTF
2 recommendations in the written testimony at the
3 hearing.

4 Definition of long-term revenue adequacy,
5 rate increase constraint, bottleneck changes,
6 simplified stand-alone costing. I will address each
7 of these points in order presented by the Board.
8 Definition of long-term revenue adequacy. The first
9 recommendation the Board asked Indorama to address is
10 the definition of long-term revenue adequacy.

11 As noted, the RRTF recommended determining
12 long-term revenue adequacy by looking at the annual
13 determinations over the shortest period of time, not
14 less than 5 years. That includes both a year and
15 once the recession began, and the year that follows a
16 year in which a recession began.

17 Generally, Indorama is supportive of this
18 approach, but suggests broadening it to ensure it
19 captures all revenue adequate carriers by adding the
20 right to submit additional verbatim evidence on
21 revenue adequacy in the STB determined range around
22 the cost of capital calculation that would take into

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1 account the inexact nature of the process.

2 In making a decision on long-term revenue
3 and adequacy, the Board should consider that most
4 economists and financial analysts, presently, do not
5 consider any Class I railroad to be revenue
6 adequate. In fact, CSX in May of this year, had a
7 stock price to 80, increasing from a price of 54,
8 excuse me, 14 in December of 2007.

9 Moreover, CSX's operating ratio in 2018
10 reached an all-time low of 58.7 percent. However,
11 the Board recently, in a revenue adequacy constraint
12 rate case, found CSX not to be revenue adequate
13 despite this obvious good health.

14 While CSX was close to being revenue
15 adequate in the Board's annual determination during
16 the present business cycle, it never achieved that
17 standard which resulted in this confusing finding of
18 revenue adequacy -- inadequacy, despite the
19 railroad's skyrocketing stock price and record low
20 operating ratio.

21 Indorama urges the Board to use this
22 proposed test, but it should add in two additional

1 parts. First, Indorama suggests that the Board also
2 permit additional verbatim evidence of revenue
3 adequacy, or inadequacy to be submitted by the
4 parties in these cases. We believe the Board should
5 reevaluate how it could possibly find a company like
6 CSX to be revenue inadequate despite receiving ample
7 additional evidence of its extremely good financial
8 health. Otherwise, the revenue adequacy constraint
9 may lie shallow, like the stand-alone cost constraint
10 penalty does, presently does, excuse me.

11 One way to ensure that railroads are
12 considered to be revenue adequate when they are
13 earning a return just below the cost of capital
14 standard, is to create a range around this number of
15 2 percentage points. Therefore, if the Board
16 determined the cost of capital to be 12 percent over
17 the business cycle, a railroad that earned 10.5
18 percent would still be considered long-term revenue
19 adequate.

20 This approach is justifiable because the
21 cost of capital determination is merely an estimate.
22 Auriga again commends the Board for having this

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1 discussion about a standard for when a railroad is
2 considered to be long-term revenue adequate.
3 However, it urges the Board to consider all provided
4 competent evidence when reaching this result and to
5 provide some flexibility in making this
6 determination by establishing some type of cost of
7 capital range when deciding whether a railroad earned
8 the cost of capital over a business cycle.

9 The rate increase constraint, as noted,
10 the RRTF recommended considering a rate increase
11 constraint for long-term revenue adequate carriers,
12 which would identify a point beyond which further
13 application of differential pricing would be
14 unwarranted. The RRTF reasoned that the purpose of
15 this proposal is to maintain reasonable rates where
16 there is an absence of effective competition and
17 where a rail rate provides revenues which exceed the
18 amount necessary to maintain the rail system and to
19 attract capital.

20 Indorama again asked the Board for this
21 opportunity to -- thanks the Board for this
22 opportunity to discuss this recommendation which

1 provides a form of relief for rail shippers when
2 long-term adequacy is found. The RRTF explained that
3 this constraint is an identification of the point to
4 which the existing application of differential
5 pricing is enough.

6 However, in applying this constraint,
7 excuse me, I see I'm out of time, may I have 5
8 minutes?

9 CHAIRMAN BEGEMAN: Four.

10 MR. RINE: Four. However, in applying
11 this constraint, the Board would not rebate any money
12 to shippers, and would not reduce the rates shippers
13 are currently paying beyond the level identified.
14 Moreover, carriers could continue to charge their
15 existing rates to their existing customers.

16 The constraint would impose no change on
17 their existing rate structure for shippers who's
18 rates exceed the rate increased constraint carriers
19 would be forbidden to raise -- in raising
20 non-contract, non-exempt rates, by more than the rate
21 of inflation measured by the RRTC. Long-term
22 revenue, adequate carriers would be free to raise

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1 their non-contract, non-exempt rates below the
2 threshold, but only up to the threshold, not beyond
3 it.

4 No constraint would be enforced as to
5 commodities or services that are exempt pursuant to a
6 contract. The threshold level would vary based on
7 the category of transportation and would rise and
8 fall each year as the carrier's revenue above the
9 long-term revenue adequacy threshold rises or falls.

10 In other words, the Board would
11 prospectively constraint long-term revenue adequate
12 railroads from raising rates, but would not provide a
13 shipper any relief from an existing, unreasonable
14 rate prospectively or retrospectively.

15 While this constraint would be an
16 extremely useful tool for shippers to help them
17 control the unreasonable rate increases which seem to
18 have to become a matter of course in the rail
19 industry, it would not solve the existing or past
20 problem of unreasonable rates.

21 As a result, Auriga urges the Board to
22 adopt this constraint and also to make competitive

1 access more available to shippers as discussed in the
2 following section. Bottleneck changes -- as noted
3 the RRTC recommended considering suspension of the
4 Board's bottleneck protections as applied in
5 long-term revenue adequate carriers. Indorama
6 applauds this proposal, and only asks the Board to
7 take one further step by also making reciprocal
8 switching available to shippers by using a more
9 lenient standard as applied to long-term revenue
10 carriers.

11 As background, competitive access refers
12 to the inner railroad competitive arrangements under
13 which railroads participate and through routes with
14 other railroads. This offered shippers joint rates
15 on such routes, uses other railroad terminal traffic
16 facilities and switched cars to the service of other
17 railroads to and from track sightings where shippers
18 are located.

19 A thorough route is an arrangement under
20 which a shipment is transported to its ultimate
21 destination by two or more railroads in succession.
22 One means of competitive access is available to a

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1 shipper and is at issue in this recommendation, is
2 through route under 49 USC 10705 which is subject to
3 the bottleneck protections.

4 Indorama believes the RTF's recommendation
5 to make a through route more available when a carrier
6 is found to be long-term revenue adequate is
7 indisputable within the Board's statutory power. We
8 believe the Board should not stop here, changing the
9 standard for bottleneck alone would be a great first
10 step, however, this remedy would not be as useful for
11 shippers as it would be for others.

12 As the Board's noted, if the shippers
13 obtained this access, it would still have to bring a
14 rate case to obtain relief on the shorter captive
15 portion of the route. Of course, the hope would be
16 that shippers would not have more negotiating power
17 due to the availability of this remedy. But as the
18 Board knows and is the point of the RRTF report,
19 bringing a rate case is not a simple matter and might
20 render this proposal less effective.

21 I will jump to my conclusion here.

22 Indorama, once again, thanks the Board for taking

1 this important step to define when a railroad is
2 considered to be long-term revenue adequate, and to
3 determine which regulatory action should then occur.
4 As discussed here, Indorama supports the
5 recommendations RRTF listed in the notice, but also
6 seeks a slight broadening of the proposed long-term
7 revenue adequate standard, and the addition of
8 reciprocal switching changed to bottleneck protective
9 change, with the imposition of these recommendations
10 for a revenue adequate constraint and the rules
11 proposed under the final offer rate review and market
12 dominance streamline approach, Indorama believes the
13 Board will be able to regulate the railroad industry
14 in the manner Congress intended.

15 As a result, Indorama asks the Board to
16 take these next steps to bring back some balance to a
17 regulatory scheme that has been less effective than
18 necessary to protect rail shippers. Thank you for
19 your time today.

20 CHAIRMAN BEGEMAN: Thank you. Next, we'll
21 hear from NS.

22 MR. RINE: Thank you for the extra 4

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1 minutes.

2 MR. FRIEDMANN: Good afternoon. Chairman
3 Begeman, Vice Chairman Fuchs and Member Oberman. My
4 name is John Friedmann. I'm Norfolk Southern's
5 Vice-President Network Planning and Optimization.
6 And I'm responsible for Norfolk Southern's operating
7 plan.

8 Previously, I spent approximately a decade
9 as Norfolk Southern's Vice President of Strategic
10 Planning. My testimony concerns the potential
11 impacts on Norfolk Southern's greater uncertainty
12 with the level -- with the removal of the bottleneck
13 protections. Meaning that future investments may be
14 too risky, even if current traffic levels justified
15 expansion. Even absent traffic diversions, service
16 for all customers in the area would be degraded
17 because Norfolk Southern would lack economic
18 certainty to make investments in the line.

19 Today, the density of the traffic supports
20 six through trains per day to and from Norfolk
21 Southern's hub in Birmingham, and numerous locals
22 provide a daily service to all customers along the

1 line. Diversion of anchor customer traffic would not
2 only rob the line of density and degrade service for
3 other online customers, it also would lessen Norfolk
4 Southern's ability to provide effective interline
5 service from its Birmingham hump yard.

6 You, as Board members, should be concerned
7 with the overall impacts to the rail network of the
8 bottleneck recommendation put forward by the rate
9 reform task force. There will always be individual
10 shippers who advocate for change in hopes of
11 advancing their own parochial interest.

12 But this proposal would have significant
13 consequences for the efficient and effective
14 operation of the rail network as a whole, affecting
15 both the companies represented here and countless
16 other shippers who are not appearing at the hearings.
17 When viewed through this lens, it is clear that the
18 Board should not move forward on changing the
19 bottleneck decisions in a way that will degrade the
20 railway. Thank you.

21 MR. SAPPINGTON: Good afternoon and thank
22 you for the privilege of speaking before the Board

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1 today. My name is David Sappington. I'm Professor
2 of Economics and Director of the Public Policy
3 Research Center at the University of Florida. I've
4 also served as the Chief Economist at the Federal
5 Communications Commission and my research over the
6 past 40 years has focused on the design and
7 implementation of incentive regulation.

8 My primary message today is a straight
9 forward one. I respectfully urge the Board to
10 refrain from imposing explicit earnings regulation in
11 the freight rail industry. Such regulation would be
12 contrary to trends in other industries around the
13 world to the Board's current progressive regulatory
14 policy and to basic principles of regulatory policy
15 design.

16 A key principle of regulatory policy
17 design is that regulations should only be imposed
18 where competition fails to adequately discipline
19 suppliers. This is the case because regulation is
20 unavoidably costly and imperfect. Consequently,
21 competition is the preferred form of industry
22 governance whenever competition can discipline

1 industry suppliers effectively.

2 A related principle is the mimic
3 competition principle that Professor Kalt talked
4 about this morning. Namely, that in settings where
5 regulation is, in fact, needed to substitute for
6 competition, regulatory policy typically should be
7 designed to replicate the disciplinary forces of
8 competition.

9 In the Board's current policy, encompasses
10 both of these important principles. In particular,
11 the policy allows competition to discipline suppliers
12 of freight rail services where it can do so
13 effectively. As when railroads and shippers
14 voluntarily negotiate mutually advantageous
15 contracts, or when rates are less than 180 percent of
16 measured variable cost.

17 The Board's current policy also replicates
18 competitive discipline appropriately where regulatory
19 intervention is deemed to be necessary. In
20 particular, the policy protects shippers that lack
21 effective competition by restricting rates below the
22 stand-alone costs of an efficient supplier of the

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1 relevant rail services.

2 This policy replicates competitive forces,
3 which typically compel the supplier to set prices at
4 or below the level of its rival's costs. And by
5 comparing rates to the cost of an efficient
6 supplier, the Board's policy can implement even more
7 stringent requirements and challenges that a railroad
8 would face in an actual industry setting.

9 By employing the stand-alone cost test,
10 rather than explicit earnings regulation to protect
11 shippers, the Board's policy avoids a fundamental
12 drawback to explicit earnings regulation. The draw
13 back is that such regulation limits a supplier's
14 incentive to innovate and to reduce its cost.

15 The diminished incentive, of course,
16 arises because cost reductions increase earnings,
17 which trigger more stringent price constraints.
18 Consequently, under explicit earnings regulation, the
19 regulated supplier is penalized for reducing its cost
20 and so cannot reasonably be expected to focus its
21 efforts on doing so.

22 But this is only one of many drawbacks to

1 explicit earnings regulation. Additional drawbacks
2 include the following three: First, in addition to
3 limiting incentives to reduce cost, explicit
4 earnings regulation also limits incentives to
5 innovate and to engage in new product innovation
6 coming up with new and better quality services.

7 Again, the reason is exactly the same when
8 you're near or at your so-called adequate level of
9 earnings, your opportunity to earn greater earnings
10 is limited, regardless of how valuable a new service
11 you might be able to create for shippers, so that's
12 another important drawback to explicit earnings
13 regulation.

14 Another important drawback is that because
15 cost and earnings are difficult to measure
16 accurately, and there's certainly a lot of
17 contentions, as we've heard this morning, about
18 exactly how you measure costs. Because of these
19 difficulties in measuring costs, there's always the
20 risk when you do adequate revenue adequacy type
21 regulations, that you've not pinpointed exactly what
22 costs, and therefore earnings are exactly.

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1 But if you err on the side of over --
2 under estimating costs, or overstating earnings, you
3 run the risk of the firm not being able to attract
4 the capital it needs to continue to invest and serve
5 its shippers well.

6 A third drawback to explicit earnings
7 regulation is that because these costs and earnings
8 are difficult to measure accurately, particularly
9 when only a portion of the firm's services are
10 subject to regulation, the implementation of earnings
11 regulation would be complex, time-consuming and
12 contentious.

13 Earnings regulation is particularly
14 pernicious when it is applied in asymmetric fashion.
15 When regulation limits earnings to a so-called
16 reasonable level, but entails no provisions to allow
17 earnings to increase when they fall below this level,
18 then a regulated railroad has very little incentive
19 to undertake ventures that involve even a small
20 amount of risk.

21 Under asymmetric earnings regulation, a
22 successful venture provides no financial reward and

1 an unsuccessful venture imposes financial penalties
2 on the railroad. In essence, the railroad is placed
3 in a head's you don't win, tails you lose situation.

4 And when a railroad cannot gain, but only
5 lose from risky ventures, it will naturally decline
6 to undertake them, regardless of the perspective
7 value that these ventures might hold for shippers.
8 By limiting a railroad's incentive to pursue
9 promising, yet risky ventures, asymmetric earnings
10 regulation would introduce incentives that depart
11 radically from those that prevail in competitive
12 markets where successful innovation typically
13 generates large financial rewards.

14 In light of the many well-known drawbacks
15 to explicit earnings regulation, regulators in other
16 industries around the world have been turning away
17 from such regulation for many years now. In the
18 electricity sector for example, regulators have
19 adopted various forms of what's known as
20 performance-based regulation under which a firm that
21 delivers exceptional performance in the marketplace
22 is rewarded financially for doing so, precisely as it

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1 would be in a competitive market.

2 It is important to note that the Board's
3 current regulatory policy encompasses the key
4 features of practices that are viewed as innovative
5 and progressive in other industries. For example,
6 the stand-alone cost tests avoid linking authorized
7 prices to a railroad's own cost, thereby providing
8 strong incentives for cost reduction.

9 The Board's current policy also avoids
10 explicit earnings regulation, and so allows a
11 railroad's financial returns to vary with its
12 performance in the marketplace, just as under
13 performance-based regulation. The Board's current
14 policy thereby provides incentives for railroads to
15 promising, yet risky, innovative activities that can
16 be of substantial benefit to shippers.

17 Consequently, the Board's current policy
18 can reasonably be viewed as being on the frontier of
19 innovative regulatory policy design. Additional
20 earnings regulation would move the Board's policy
21 away from the frontier precisely in the opposite
22 direction that regulatory policy has been proceeding

1 in other industries.

2 The movement away from earnings regulation
3 in other industries, reflects a growing recognition
4 of the fallacy of a common myth about earnings
5 regulation. The myth is that a regulator serves
6 customers well by systematically precluding a
7 regulated supplier from securing anything more than
8 what might be deemed an adequate level of earnings.

9 The corollary of this myth is that
10 regulators have failed to protect customers
11 adequately if the regulated firm secures more than
12 adequate earnings. Fortunately, there is a growing
13 recognition among regulators around the world that
14 this myth, and its corollary are not only false, but
15 fundamentally misguided.

16 All parties can gain. Regulated suppliers
17 and their customers alike when suppliers are
18 motivated by the prospect of financial reward,
19 discover innovative ways to operate more efficiently
20 and to better serve their customers.

21 Healthy financial returns can be a sign of
22 effective regulation that has induced innovation

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1 which in turn has delivered highly valued benefits to
2 customers.

3 In closing, I again respectfully urge the
4 Board to refrain from imposing earnings regulation in
5 the freight rail industry. Explicit earnings
6 regulation entails many well-known drawbacks. Its
7 implementation would stifle innovation in the
8 industry and would threaten to reverse the
9 substantial progress the industry has experienced
10 since the passage of the Staggers Act.

11 The Board's current policy constitutes
12 enlightened, progressive regulation that embodies the
13 key principles of sound regulatory policy design, and
14 that reflects trends in other industries. My sincere
15 hope is that the Board's future regulatory policy
16 will continue to be so enlightened, and that the
17 Board may resist any pressures it may face to return
18 to the largely discredited regulatory policies of the
19 past. Thank you.

20 CHAIRMAN BEGEMAN: Thank you. Olin?

21 MR. CHIRUMBOLE: Chairman Begeman, Vice
22 Chairman Fuchs, Member Oberman. My name is Frank

1 Chirumbole and I'm the Vice President of Integrated
2 Supply Chain for Olin Corporation. I am accompanied
3 today by our outside counsel, Peter Pfohl.

4 Olin thanks the Board for holding a public
5 hearing on this important topic. As the Board moves
6 forward with revisions to its rate-making processes,
7 we urge you to recognize the challenges that face
8 captive carload shippers such as Olin, and that you
9 will use this opportunity to devise a meaningful, but
10 practical, revenue adequacy constraint that will
11 restore some balance between captive shippers and
12 their carriers.

13 Olin is the world's largest chlorine
14 company and the world's largest epoxy manufacturer.
15 We ship over 47,000 railcars annual in North America.
16 You encounter our products every day, mainly
17 chlorine and caustic soda, as they are used in a
18 variety of applications, including water treatment,
19 aluminum manufacturing, wind energy application and
20 many others.

21 Olin's manufacturing sites are all captive
22 to their respective carriers. As a result, we have

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1 seen rail rates continually escalate at levels above
2 inflation with negligible improvements in service.
3 The current state of rail regulation encourages
4 monopolistic behavior that has negative ramifications
5 for Olin and our customers.

6 Reasonable regulation changes will benefit
7 the long-term health of the rail industry, as well as
8 all rail reliant U.S. manufacturing. In order for
9 railroads to grow, they also need their customers to
10 be successful and many of their pricing strategies
11 are limiting the growth of their customers
12 businesses, including Olin.

13 Before getting into the details of this
14 proceeding, I want to share Olin's experience in
15 challenging unreasonable rates. As you know, Olin
16 subsidiary, Sunbelt, pursued a stand-alone cost rate
17 case, which the Board decided in 2014 and
18 reconsidered in 2016.

19 Sunbelt narrowly lost its case, despite
20 demonstrating that the revenue over variable cost
21 ratio for the movement was nearly 500 percent.
22 Chairman Begeman, in that 2014 decision, you said --

1 and I'm paraphrasing, "The Board has a duty to ensure
2 that shippers have a viable means to challenge a
3 rate, and that the Board should ask whether the SAC
4 process can provide a meaningful gauge of rate
5 reasonableness for carload shippers."

6 It's Olin's view, that that is not a
7 viable process for us, or any other carload shipper.
8 This is supported by the fact that no carload shipper
9 has ever obtained rate relief under the SAC process.
10 Given this history, Olin is pleased to see that the
11 Board is seeking comments on the rate reform task
12 force proposal to implement a revenue adequacy
13 constraint.

14 Olin's written comments provide more
15 detail -- a more detailed explanation on our
16 position, but the critical points are as follows:
17 One -- the Board should rely on a usually
18 ascertainable 5 year analysis to establish a
19 presumption that a railroad is revenue adequate.

20 Trying to sort out so-called business
21 cycles is difficult, and the assumption that the
22 cycle is indicative of revenue adequacy has not been

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1 proven out by the task force. From Olin's point of
2 view, knowing that there is one clear standard,
3 provides a degree of certainty that is valuable to us
4 and other shippers.

5 Two -- the revenue adequacy constraint
6 should protect shippers, rather than invite
7 complexity. The task force proposal will lead to
8 costly and complex filings, covering topics such as
9 the net surplus operating revenues, which shippers
10 should be clustered together, and how to apportion
11 those revenues using the maximum mark-up methodology
12 process.

13 We encourage a simple application that
14 assumes a revenue adequate carrier is earning
15 adequate revenues, unless the railroad can prove
16 otherwise. Assuming the carrier is revenue adequate,
17 future rate increases should be limited to actual
18 productivity adjusted railroad costs.

19 Three -- Olin urges the Board to allow a
20 shipper to provide additional evidence to demonstrate
21 that a carrier is revenue adequate. Given the
22 Board's annual revenue adequacy determination is

1 somewhat mechanical, it lacks qualitative and
2 additional quantitative elements.

3 Four -- a key issue with the proposed
4 revenue adequacy constraint is that it provides no
5 means for rate reduction or reparations. A shipper
6 would need to pursue a rate case separately, and that
7 is why Olin strongly supports a simplified approach,
8 such as the final operate review proposed by the task
9 force.

10 I want to draw the Board's attention to
11 two other issues that greatly impact the
12 effectiveness of any potential revenue adequacy
13 constraint. First, the Board's view of revenue
14 adequacy relies almost exclusively on its
15 determination of the railroad industry cost of
16 capital. Olin believes that the Board's cost of
17 capital procedures produces inflated numbers, versus
18 how the railroads and Wall Street view the industry's
19 cost of capital.

20 For example, the Board's 2018 cost of
21 capital determination was 12.22 percent. BNSF's
22 Executive Chairman, Matt Rose, speaking at the

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1 Railroad Financial Corporation's 2019 Conference, put
2 today's real world cost of capital at about 7
3 percent.

4 The Board's cost of capital calculation is
5 70 percent greater than the industry's and Wall
6 Street's view of the figure. Olin urges the Board to
7 modify its procedures to better reflect the real
8 cost of capital for railroads.

9 Second, the Board needs to address the
10 fact that many lanes are bundled in private
11 agreements and the railroads make it essentially
12 impossible to challenge a single lane in that
13 situation. This is because the railroads require
14 that all lanes under a bundled private contract, be
15 taken to tariff in order for a shipper to bring any
16 case before the STB.

17 Olin urges the Board to incorporate
18 protections against these unreasonable rate bundling
19 practices, as well as rate gaming by the carriers.
20 We provide further details on our position in the
21 comments we filed in the Board's final offer rate
22 review proceeding.

1 I want to touch briefly on the comments
2 submitted by other parties in this proceeding. Not
3 surprisingly, the railroads have adopted a "Just Say
4 No" strategy here. And I won't begin to argue the
5 details of their theories. But I will say that the
6 rate issues driven by a lack of the competitive
7 market are real and tangible.

8 The revenue adequacy constraint is not a
9 blunt instrument meant to pound down the future
10 earnings of the industry. Instead, it provides an
11 additional means to check the rate increases of
12 market dominant carriers. Under the task force
13 proposal, the constraint is only available if a
14 shipper files a case and proves that the carrier has
15 market dominance. Even then, the carrier still has
16 to be long-term revenue adequate before any
17 constraint would even begin to apply.

18 Olin supports a robust and highly
19 functional rail network. But there must be some
20 reasonable limits. Chlorine car rates of more than
21 \$30,000 per railcar and R over VC's of over 1,000
22 percent are not reasonable. We hope the Board finds

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1 a fair equilibrium as it implements this constraint.

2 As for other shippers, there are obviously
3 a mix of views on the specifics, but one thing that's
4 clear -- the board must do more. The American
5 Chemistry Council has proposed implementing a
6 competitive benchmarking methodology as essentially a
7 substitute for a revenue adequacy constraint. It may
8 be a useful, additional tool, but we understand that
9 even if the Board were to consider it, it may take
10 far longer to implement than the revenue adequacy
11 constraint.

12 Thus, Olin urges the Board to proceed here
13 first. So, in summary, Olin's key recommendations
14 and issues are: One -- use of simplified approach
15 for the determination of revenue adequacy, which
16 would include a five-year analysis period. B -- the
17 ability for shippers to submit other supporting
18 evidence to demonstrate the carrier is revenue
19 adequate, and the use of a standard that provides for
20 limited cost base increases and avoids complicated
21 surplus revenue and MMM type analysis.

22 Number two -- the Board should modify its

1 cost of capital determination to better reflect the
2 real cost of capital for railroads.

3 Number three -- the task force provides no
4 path for rate reductions, or reparations through the
5 revenue adequacy test. And those need to be included
6 as part of the Board's ongoing rate review
7 proceedings.

8 And four -- the Board needs to address the
9 rate bundling issues and the fact that moving from a
10 private contract to tariff, is a strong deterrent to
11 bringing a case before the STB. Thank you again for
12 the opportunity to appear before you today.

13 CHAIRMAN BEGEMAN: Thank you very much.
14 Patrick?

15 VICE CHAIRMAN FUCHS: Maybe starting with
16 NS. The period by which long-term revenue adequacy
17 is defined. Not asking you to weigh in on whether or
18 not that revenue adequacy should be used as a
19 constraint or just a measure of the economic health
20 of the railroads, but just in terms of the period.
21 What do you all think and what does the academic
22 literature support as the most relevant and justified

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1 time period?

2 MR. SAPPINGTON: I wish that I could be of
3 help on that, but I really can't. Very, extremely
4 good question. It's just one that's not my area of
5 expertise. Norfolk Southern just asked me to talk
6 about earnings regulation and the rate increase
7 constraint.

8 VICE CHAIRMAN FUCHS: Let's go there.

9 MR. SAPPINGTON: Okay.

10 VICE CHAIRMAN FUCHS: So, I had the
11 opportunity to review a lot of your research and it
12 was enlightening to say the least. One thing that
13 you put forward and is -- on price cap regulation,
14 generally. You know, you said such a price cap
15 regulation plan can provide a substantial incentive
16 to innovate and reduce operating cost with low risk,
17 allowing the firm excess profit or forcing the firm
18 to suffer financial distress.

19 And you compare it -- and I notice in your
20 remarks today you compared some things in the
21 electricity industry, but then you kind of compared
22 that to the telecom in which you said, you know,

1 price-cap regulation is often considered a superior
2 form of economic regulation generally, rather than a
3 superior form of regulation in selected settings, and
4 you were talking about why it hasn't been adopted in
5 the electricity sector.

6 So, I guess I kind of pose the same
7 question. Stepping away from the issue of rate of
8 return aspect within revenue adequacy, just price cap
9 regulation generally, does it have a role in the
10 railroad industry? What do you see as the trade-offs
11 there?

12 MR. SAPPINGTON: The benefit of price-cap
13 regulation comes about because it doesn't link the
14 firms, because it doesn't directly regulate earnings.
15 What it says to the firm is here's a reasonable price
16 trajectory, and as long as you can live with that
17 price trajectory, we're not going to change it when
18 we see your earnings being relatively high or
19 relatively low. So, it provides all the right
20 incentives for the firm to minimize its costs and to
21 innovate.

22 Now, in the railroad sector, that is

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1 essentially what the SAC test does. The SAC test
2 says the price, and what's really nice about the SAC
3 test, is it does it on a customer by customer basis.
4 Here is the price cap on the amount you can charge to
5 that particular customer. And what that cap is, is
6 based upon not your cost, but the cost of an
7 efficient supplier.

8 So, I view the SAC test very much as a
9 price-cap constraint, but one that's different from
10 the typical one in the telecom or the electricity
11 sector, primarily because it focuses on the right
12 price for an individual customer, whereas in more
13 generally what we tend to do with a price cap
14 constraint is to say okay, as long as on average your
15 prices aren't going up too rapidly, everything's
16 fine.

17 I don't think individual shippers would
18 like that very much because that allows the firm a
19 tremendous amount of flexibility to raise some prices
20 and lower others, as long as on average, prices
21 aren't rising too rapidly. And that's more amenable
22 to an industry where you've got lots of homogeneity

1 among customers.

2 But when you've got rate variation among
3 customer's cost and needs, the price targeted to the
4 individual customer makes more sense.

5 VICE CHAIRMAN FUCHS: Thank you. And Mr.
6 Friedmann, can we turn to kind of bottleneck versus
7 reciprocal switching? And there's a Christianson
8 report, not that I'm asking you to be familiar with
9 it. It was cited a couple times earlier, are you,
10 okay.

11 So, but one of the things that that report
12 said was that you know, when evaluating the, "suite
13 of open access," their words, they said that, "The
14 reciprocal switching in terminal agreements, you
15 know, will be the least costly in terms of a loss of
16 economic efficiency and most likely to promote a
17 competitive response among railroads." And they
18 said, "To the extent the competitive responses result
19 in traffic increases, static efficiency launches may
20 be overcome.

21 There could be a gain in economies of
22 densities if volumes increase." And they're

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1 comparing that to bottleneck. So, it was meant as a
2 basis of comparison where reciprocal switching was
3 actually better from an economist perspective
4 compared to bottleneck. What is your view on that?
5 Understanding you're fiercely opposed to both, but
6 choosing or looking at the two, what do you see as
7 more economically harmful to NS from your
8 perspective?

9 MR. FRIEDMANN: Well, I think what you
10 have to think of in both cases is they introduce a
11 level of inefficiency and risk into the system that's
12 not present now. And both provide a disincentive to
13 investment, a likelihood of causing congestion or
14 other operational disruption.

15 So, I think that both, from an operational
16 perspective, can look very similar. But they each
17 bring in a level of network deterioration, in terms
18 of efficiency and operation, as well as a lack of
19 incentive to invest.

20 VICE CHAIRMAN FUCHS: Do you view
21 switching as Christianson did? As some of those
22 negative effects that you're describing, do you view

1 that as a little bit more attenuated or lower with
2 reciprocal switching relative to bottleneck?

3 MR. FRIEDMANN: Well if you take
4 reciprocal switching, and I will use reciprocal
5 switching in the contest in which its used today,
6 which are generally long-term arrangements between
7 carriers, most of which have constrained geography
8 and a history behind them.

9 Those tend to be fairly stable
10 arrangements. I would not say that reciprocal
11 switching, in terms of being proposed as a solution
12 to perceive competitive problems necessarily mirrors
13 the practice that's here today. But in terms of if
14 the Board were to take action on either, I'm not
15 suggestion a position, I know that you are against
16 both. I just -- you don't perceive that NS would --
17 there'd be any difference in the cost to NS or the
18 effects on NS between a bottleneck thing as
19 contemplated by the RLTF, or say reciprocal switching
20 is contemplated by the Board's proposed rule in the
21 matter?

22 MR. FRIEDMANN: I'm not qualified to talk

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1 in terms of the whatever it's called, the revenue
2 impacts of it for example.

3 VICE CHAIRMAN FUCHS: From an operational
4 standpoint, yes.

5 MR. FRIEDMANN: Never have to meet a rate.
6 But from an operational impact, they would both have
7 the potential to -- and likelihood, to cause similar
8 disruption congestion and loss of efficiency.

9 VICE CHAIRMAN FUCHS: Do you have a view
10 on that directly? Anything, yes?

11 MR. CHIRUMBOLE: No, in my view of that is
12 I just look at it this way. Whether that's a real
13 reason or not, it eliminates an opportunity to look
14 for a competitive rate when you cannot go to a
15 different destination because of that excused. Now,
16 I don't mean that to mean it's not a valid one, but I
17 don't have competition. And so, I'm looking for
18 anything that will give us some ability to get lower
19 rates.

20 VICE CHAIRMAN FUCHS: Right.

21 MR. CHIRUMBOLE: And that just doesn't
22 happen. I'm prohibited from doing it.

1 VICE CHAIRMAN FUCHS: I hear you. And
2 sir, you mentioned that SAC's just doesn't work
3 for --

4 MR. CHIRUMBOLE: Yes.

5 VICE CHAIRMAN FUCHS: And, you know, the
6 Board's out to put out a proposal. You know, we have
7 an alternative with 3B, AAR put forward some
8 indication of a willingness to work on a comparison
9 group approach. Obviously, ACC has put forward a
10 competitive rate benchmarking, which setting aside
11 the competitive threshold issues, when you actually
12 look at controlling for different things, it's
13 starting to look like a little bit of a comparison
14 group in a sense, right?

15 The regression of being, you know, a
16 sophisticated comparison group. I guess I'm
17 wondering if you all have any thoughts on whether or
18 not you know, a comparison group approach as you
19 know, has the potential as a mechanism for potential
20 rate relief, either improvements to 3B or entirely
21 new comparison group approach.

22 MR. CHIRUMBOLE: Well, relative to where

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1 we stand today, any of these hold some promise. One
2 concern we have with the comparison group is what if
3 the whole group is out of line already?

4 VICE CHAIRMAN FUCHS: Right.

5 MR. CHIRUMBOLE: And so, now you're
6 limiting increases on an already high rate.

7 VICE CHAIRMAN FUCHS: So, what do we do
8 about that?

9 MR. CHIRUMBOLE: Final offer rate review.
10 We need a rate -- a new simplified rate case
11 approach. That's why we mentioned that in our
12 testimony.

13 BOARD MEMBER OBERMAN: Let me pick up on
14 that. I have more than a three second delay.

15 CHAIRMAN BEGEMAN: The railroads do.

16 BOARD MEMBER OBERMAN: Could be they're
17 handling the whole system, here right? Frank, what
18 in the final-offer procedure, if you -- if the
19 comparison group are all high, then what -- you have
20 to use some mechanism to prove your -- to be
21 convincing in the final offer you make. Well, what
22 approach would be workable? The one that ACC has

1 proposed, because that's a comparison group.

2 MR. CHIRUMBOLE: I'm trying, it's been a
3 while since I've read that thorough, the task force
4 report. But there is an ability to present
5 evidence -- I think it's broader than just the
6 comparison group. You're not limited by it. It's
7 literally a negotiation, if I recall. Is that right?

8 BOARD MEMBER OBERMAN: Well, you have to
9 have been making your offer the way this is designed.
10 You have to back it up.

11 MR. CHIRUMBOLE: Right.

12 BOARD MEMBER OBERMAN: You can back it up
13 any way you want. We didn't -- at least in the
14 proposal, we didn't say you must choose one mechanism
15 or another. So, what I'm wondering is what mechanism
16 would you choose to persuade the Board to pick your
17 final offer as opposed to the railroad's if it isn't
18 a comparison group?

19 MR. CHIRUMBOLE: No, we haven't thought
20 through that to that point, but we -- the concept, we
21 want to pursue it because anything that simplifies
22 the approach is going to be --

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1 BOARD MEMBER OBERMAN: Mr. Friedmann, I
2 have a -- I wanted to follow-up with a few questions
3 for you. On the Mobile line that you spoke about,
4 you said there are 65 customers. I can't read my own
5 writing. 3 of the customer's account for 80 percent
6 of all of the traffic on that 250 miles, is that
7 right?

8 MR. FRIEDMANN: Approximately 70 percent.

9 BOARD MEMBER OBERMAN: I'm sorry. Well I
10 wrote down that 15 - some number of customers account
11 for 15 percent of something. Could you?

12 MR. FRIEDMANN: One, I just can walk
13 through it again quickly, if it would be helpful.

14 BOARD MEMBER OBERMAN: Okay, please do,
15 yeah.

16 MR. FRIEDMANN: Okay. The Mobile line is
17 250 miles long, 71 percent of the line's carloads are
18 handled on the last 15 percent of the miles. And on
19 that segment, 3 anchor customers account for 80
20 percent of the traffic.

21 BOARD MEMBER OBERMAN: On that 15 percent
22 of the --

1 MR. FRIEDMANN: The miles, yes.

2 BOARD MEMBER OBERMAN: Okay, that's -- you
3 were going so fast I was taking notes and then I
4 couldn't figure out what I was writing.

5 MR. FRIEDMANN: So, I was trying to be
6 respectful of the time.

7 BOARD MEMBER OBERMAN: No, no, I
8 appreciate that. Listen, I've learned to listen to
9 Patrick, so I should be able to listen fast. Of the
10 65 customers on that line, how many of them are in a
11 market dominant situation?

12 MR. FRIEDMANN: I don't know. I would say
13 that of the 65 customers, the vast majority are
14 solely served by Norfolk Southern.

15 BOARD MEMBER OBERMAN: And the 3 customers
16 that account for 80 percent of the last 15 percent of
17 the miles, are those are market dominant? I assume
18 one of them is Olin.

19 MR. FRIEDMANN: All 3 customers are solely
20 served by Norfolk Southern in terms of rail, although
21 all of them make use of water as well.

22 BOARD MEMBER OBERMAN: Is one of those the

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1 Olin plant that we visited in McIntosh?

2 MR. FRIEDMANN: I wasn't with you when you
3 came to McIntosh.

4 BOARD MEMBER OBERMAN: Well, you know
5 where McIntosh is. I'm just trying to picture
6 because I have a concrete picture of how many -- what
7 they ship out. That is the Mobile line, right?

8 MR. FRIEDMANN: It is, yes. They are.

9 BOARD MEMBER OBERMAN: I mean I'm just
10 going to guess there isn't anybody. They must be one
11 of the 3 biggest. If you've got bigger ones than
12 Olin, then it seems to be that's a pretty big
13 customer.

14 MR. FRIEDMANN: There are larger customers
15 on.

16 BOARD MEMBER OBERMAN: Okay. Let me
17 switch to Professor Sappington for a minute and then
18 I'm going to come back to you, Mr. Friedmann. I
19 don't mean to be flip about this, but you said in
20 your testimony, that the proposed rate revenue
21 adequacy methodology is bad for both sides and that
22 your idea of incentive regulation benefits both

1 shippers and railroads.

2 And I'm really wondering why, if that's
3 really correct, all of these shippers are in here
4 saying they don't agree. I mean, do they need to
5 take your course? I mean what's?

6 MR. SAPPINGTON: There are many possible
7 reasons. I believe Mr. Atkins brought one up this
8 morning. The shippers clear have an obligation to
9 pursue the best interests of their shareholders.
10 That includes finding ways to keep the rates that
11 they pay for rail services and other inputs as low as
12 possible.

13 One way to do that is to come to the
14 Board, who has the power to set those rates. Another
15 would be to challenge, according to the SAC test, for
16 example, this particular venue may be cheaper for
17 them to do that. And I certainly don't condemn them
18 in any way for doing so. They're pursuing the best
19 interests of their shareholders, but it's what you
20 would expect to have happen, even if they were
21 actually quite pleased with the rates they're
22 getting, it doesn't hurt to ask for lower rates

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1 still.

2 BOARD MEMBER OBERMAN: No, but if you were
3 correct that the overall system would ultimately
4 benefit shippers, it would be better for their
5 shareholders too, if they perceived accurate -- if
6 they agreed with what your argument is, wouldn't it?
7 I just don't understand, there's a disconnect here.

8 MR. SAPPINGTON: Okay.

9 BOARD MEMBER OBERMAN: You're saying the
10 methodology you're urging is better for everybody,
11 including the shippers.

12 MR. SAPPINGTON: Right.

13 BOARD MEMBER OBERMAN: Which would mean it
14 would be better for the shipper shareholders. They
15 don't see it that way. So, I mean why do we have
16 this disconnect?

17 MR. SAPPINGTON: Well, maybe I would just
18 respectfully ask that you ask that same question to
19 them, and ask whether they do believe in fact that
20 the best way to regulate is to say to the railroads
21 that no matter what you do to serve our interest,
22 that you're going to be held to exactly a fair rate

1 of return.

2 In other industries, regulators have
3 exactly that same question and I don't know why they
4 changed their mind explicitly, whether all
5 constituents came together and argued the same point
6 of view. But what they have found, and it's been
7 demonstrated empirically, is that when you do depart
8 from that strict standard, everyone does end up being
9 better off.

10 There are gains in the industry, many of
11 which accrue to the customers and some accrue to the
12 suppliers also.

13 BOARD MEMBER OBERMAN: Alright, I think
14 part of the problem, Professor, maybe that I don't
15 understand the task force revenue adequacy proposal
16 to be one which says to the railroads no matter what
17 you do, you're going to be held to this rate of
18 return. So, maybe they don't see it that way either.
19 Let me ask you this question.

20 You referred to the SAC test in a way that
21 sounded to me like the SAC test is utilized by
22 others, for regulating other industries, I gather it

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1 does apply to telecommunications in some ways?

2 MR. SAPPINGTON: Not that I'm aware of. I
3 don't believe the SAC test itself is used in
4 telecommunications.

5 BOARD MEMBER OBERMAN: Is it used anywhere
6 other than railroads?

7 MR. SAPPINGTON: I'm not aware of it, no.
8 Partly because we -- again, the point is the nature
9 of the customers. As I understand it in the rail
10 industry, there are relatively few large customers
11 and so, you need to specify, target your regulation
12 to the idiosyncratic needs of that relatively small
13 number of customers. In other industries there are
14 thousands, if not millions, of customers roughly
15 similar, and so sort of a blanket regulation applying
16 to all of them makes more sense.

17 BOARD MEMBER OBERMAN: Well, I understand.
18 I took it -- maybe by inference the way you spoke
19 about it that maybe there were some other industries
20 in which we could compare the results of the SAC
21 test. But it doesn't -- I didn't think it was being
22 used anywhere else.

1 MR. SAPPINGTON: Not explicitly in that
2 form, but in related forms in which you do try to
3 use, as your standard, the activity of an efficient
4 firm as opposed to measuring the cost of the firms
5 that you're actually regulating directly.

6 BOARD MEMBER OBERMAN: Well, okay, but
7 that doesn't necessarily involve, in other settings,
8 the rebuilding of an entire firm, does it, with
9 engineering studies and so forth, that's the problem.

10 MR. SAPPINGTON: Well, what you are trying
11 to do in all these different forms of regulations is
12 to figure out what relevant costs are and, ideally,
13 efficient costs and hold the regulated suppliers to
14 that standard. They have to meet, they have to
15 perform as an efficient firm would, or they're going
16 to suffer financially. So, we're having that same
17 basic standard imposed across the board, but exactly
18 how we do it varies across industries.

19 BOARD MEMBER OBERMAN: Well, you could use
20 that same description really of a utility-style
21 regulation too. And that isn't something that
22 anybody's proposing. So, I mean in terms of

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1 efficiency and holding a firm to efficient costs,
2 that underlies a utility concept as well.

3 MR. SAPPINGTON: Right, but then there's
4 also on top of that, usually there's the rate of
5 return constraint which says that not only do you
6 have to operate efficiently, but if you do, or
7 operate even if they operate extremely efficiently,
8 you can't make more than what we deem to be an
9 adequate level of earnings. And that's the source of
10 the -- what empirical research has demonstrated is
11 really what constrains industry performance.

12 BOARD MEMBER OBERMAN: Let me switch over.
13 I want to get to this cost of capital that you
14 mentioned Frank. I took a look at -- I don't know if
15 it was your -- somebody actually cited the most
16 recent article that captured Matt Rose's talk, was
17 that I think it was in yours.

18 So, I took a look at it. It only tells us
19 7 percent and I don't know where that came from, or
20 what he bases it on. Do you have any understanding
21 of how -- at least whatever you think of our
22 formula, there was a formula, so everybody knows how

1 we got to 12 percent. How do you get to 7?

2 MR. CHIRUMBOLE: Yeah, and again, I'm only
3 quoting the fact that they're talking in front of
4 Wall Street people about a different number than the
5 number that the Board all calculates. And I'm just
6 saying we ought to resolve that. Because it would
7 obviously, unfairly would limit the revenue adequacy
8 constraint if we're using an inflated number.

9 BOARD MEMBER OBERMAN: Well, I mean we're
10 calculating a high number pursuant to a regulatory
11 setting in which, you know, we have to conform our
12 activities within our statute. What business people
13 and stock traders on Wall Street come up with is at
14 least in that sense of it, that's just their
15 perception from a rate of return.

16 I'm just wondering how this 7 percent, is
17 it based on actual performance in the market or where
18 it came from.

19 MR. CHIRUMBOLE: And I don't know the
20 answer to that. I don't. You know, that's something
21 we can get our financial people to look at and if we
22 need to talk about that, that's fine.

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1 BOARD MEMBER OBERMAN: Well, they're doing
2 it. So, this leaves me to, and I want to ask.

3 MR. SAPPINGTON: Mr. Oberman, can I
4 address it?

5 BOARD MEMBER OBERMAN: Yeah, go ahead.

6 MR. SAPPINGTON: I just want to follow-up
7 on the important question you asked before about the
8 SAC test being used elsewhere. Again, I'm not sure
9 if that exact terminology is used, but I have been
10 thinking more about the telecommunications industry.
11 And it seems to me they faced a problem similar to
12 the one you're facing here, which is that they needed
13 to decide how costly it was to provide service in
14 rural regions where there weren't many suppliers who
15 wanted to supply the service.

16 And so, they had contentious hearings
17 about exactly what it would cost to supply this
18 service in rural regions where no one really wanted
19 to supply the service because the regulations were in
20 place that you had to keep rates low. And the costs
21 were just much, well above those regulated rates.
22 So, no one wanted to serve those regions, so the

1 question was, well how much do you have to pay
2 someone to provide the service at those artificially
3 low rates.

4 And so, what the industry did over time,
5 they came together and essentially built a model that
6 both the regulatory staff and the industry
7 participants agreed upon was sort of a reasonable way
8 to look at the cost of supplying this service. And I
9 don't think they used the word SAC or stand-alone
10 costs, but they distinguished between greenfield
11 operations and brownfield operations, basically if
12 you're starting from scratch to build your network to
13 serve these customers, that's what they talked about
14 with greenfield.

15 Brownfield was like it had some of the
16 network structure in place, but you needed to extend
17 it. So, the concepts are very similar, even if they
18 don't use exactly the same terminology. And I would
19 just recommend perhaps, to have your staff take a
20 look, if they're not already familiar with what the
21 FCC did there. It's called the hybrid proxy cost
22 model. And I was very impressed to watch this

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1 process go on where the parties from the industry all
2 came together and essentially worked together over
3 time to develop a model of what it would cost to
4 provide this service.

5 And I'm wondering if the same type of
6 exercise might not be beneficial in the rail
7 industry. I think that would reduce the cost to all
8 of understanding what goes into these models, and if
9 you can come up with some general guidelines and
10 what's a reasonable model that could facilitate the
11 regulatory process and bring down these costs that
12 I'm hearing about being so observant in an actual SAC
13 hearing.

14 BOARD MEMBER OBERMAN: I'm hardly an
15 expert, but it strikes me that the fundamental
16 infrastructure building of the railroad is so vastly
17 different from stream, you know, fundamentally you're
18 doing a telecommunications set-up. I don't know if
19 that comparison is going to be that instructive,
20 other than the fact that the industry and its
21 customers -- and the regulators work together, that's
22 always good.

1 But other than that, I don't know what
2 there is to learn, but maybe our economists will help
3 us out.

4 MR. SAPPINGTON: I agree. I wouldn't want
5 to suggest that model is one you could just import
6 here by any means. But it's more of a process that I
7 was suggesting might be useful to follow-up on.

8 BOARD MEMBER OBERMAN: I'd like to ask
9 both John and Frank if you would comment on this in
10 any order. I have been very much puzzled by the --
11 on the cost of capital measurements. That's why I
12 asked -- questioned Frank about how close to the real
13 world our ability to calculate cost of capital is,
14 and I know there are complaints about the
15 inaccuracies of it.

16 But there's an aspect of this in the
17 railroad industry in particular, that has confused
18 me. And so, I want to raise this with each of the
19 railroads other than BN, which is -- doesn't have
20 public shareholders. As I look at NS's performance
21 in the last 6 years, and I'm looking at some numbers
22 that were compiled from your public disclosures,

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1 John.

2 Just going in 2018, you have a gross
3 operating revenue of 11 and a half billion, and net
4 revenues of just under 4 billion, and just under 2
5 billion of CapEx, and 2.7 billion dollars of stock
6 buyback. And that pattern was very similar over the
7 5 years before that.

8 So, you had almost, not quite twice as
9 much, net revenue as you actually spent on CapEx.
10 And then you used the rest of it, and I gather
11 with -- had these stock buybacks. So, as I
12 understand our standards under revenue adequacy, the
13 rates are supposed to be set to make sure you have
14 enough capital and that you can attract capital. And
15 I don't see NS having difficulty attracting capital,
16 since you have way more net revenue than you needed
17 for your actual capital expenditures, at least over
18 the last 6 years, and you were able to use a lot of
19 it for stock buybacks.

20 So, without getting into the debate about
21 whether stock buybacks in general are a good or a bad
22 thing, gathered years ago, they weren't allowed at

1 all and now the rage on Wall Street. In our
2 setting -- in the captive shipper's setting, under
3 our statute, to me a shipper is supposed to pay a
4 rate that allows you to cover your capital and make a
5 reasonable return, at least that's what the revenue
6 adequacy standard is about under the coal rate
7 guidelines.

8 But I don't see anywhere in the statute
9 that a shipper is also supposed to pay you enough for
10 stock buybacks. And ultimately, that would -- if
11 that were not allowed, that would affect cost of
12 capital and it would go into the whole calculation of
13 who's revenue adequate.

14 So, can you enlighten me on why you need
15 to charge rates to shippers above what you need for
16 your capital expenditures at a reasonable return,
17 trying to get you also into the billions of dollars
18 of stock buybacks? And then, and Frank, I'd like
19 your observations on that as well, but whoever wants
20 to go first.

21 MR. FRIEDMANN: Well unfortunately, my
22 answer is going to be fairly short. Aside from the

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1 fact that I'm aware of very few, if any, industries
2 that are as capital intensive as railroads or any
3 that are asked to take their entire net revenue and
4 put it back into a year's worth of CapEx, I'm neither
5 a financial expert, nor an expert on the statute.

6 So, I'm probably the wrong guy to even guess at that.

7 BOARD MEMBER OBERMAN: Alright. We'll
8 have to find somebody who is. Frank, do you want to?

9 MR. CHIRUMBOLE: And I can't say that I've
10 studied NS's annual report deeply recently, but my
11 comment would be if they have that kind of money or
12 are able to get that kind of money to invest in the
13 network, that their cash flow has to be pretty
14 healthy. And I realize we can debate what the right
15 cost of capital number is.

16 My only statement would be they seem to be
17 financially healthy to me. Railroad stock price has
18 been up. They're buying it. They're buying it back.
19 I understand they have cash to do that. It's just
20 that, you know, almost a layman's observation.

21 But back to what the right cost of capital
22 is. I only brought up that quote from Matt Rose to

1 say there's a disconnect. Frankly, any application
2 of a cost of capital number as part of this revenue
3 adequacy is going to be better than what we have now.
4 So, I mean I'm not going to make that a major point
5 in our mind over whether or not we would support
6 this. But we just wanted to point that out.

7 I will also add that our cost of capital
8 is not 12 percent, it's lower than that. It's not as
9 low as theirs, but it's lower than that.

10 BOARD MEMBER OBERMAN: Well, it just has
11 struck me that the better performing the railroads
12 are, and the higher their stock prices, the higher --
13 under our formula, the higher the cost of capital,
14 but the irony is if the purpose of a cost of capital
15 measurement, in our regulated setting, I don't mean
16 in other industries, is to make sure that the
17 railroads have enough capital to be financially
18 sound, the irony is that the more sound they are, the
19 more difficult it is for a captive shipper to
20 challenge their rates under our -- and so there's
21 something inversed, unless I just don't fully
22 comprehend how this capital market works, and that's

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1 entirely possible.

2 MR. CHIRUMBOLE: I'm not familiar enough
3 with that calculation to answer, so.

4 BOARD MEMBER OBERMAN: Yep. Go ahead
5 Patrick.

6 VICE CHAIRMAN FUCHS: A question for Mr.
7 Rine's lot. You know, thinking about the bottleneck
8 proposal. I think you mentioned reciprocal switching
9 in your testimony as well. Say the Board acted on
10 either of those, what do you expect could be the
11 specific competitive response, you know, from
12 railroads? How would that change in your view? You
13 can say in general terms or specific terms, anything
14 with your rate or service.

15 MR. RINE: That's the connection also with
16 our comments about -- that's also in conjunction with
17 our additional request for competitive switching?

18 VICE CHAIRMAN FUCHS: Yes, either
19 switching a bottleneck if there were facilities that
20 the Board were to mandate, you know, one of those two
21 competitive access remedies, I guess. You know, what
22 do you think that would do for your rates or for your

1 service, and wherever it would be.

2 MR. RINE: Well, we have facilities in
3 Canada.

4 VICE CHAIRMAN FUCHS: Yeah.

5 MR. RINE: And we enjoy the opportunity
6 there to negotiate with both Canadian carriers. And
7 that's not some comments made that specific
8 switching, for example, is a long-term proposition.
9 We've not seen that. We've had some short-term,
10 one-year, two-year contracts, and we could go back
11 and forth.

12 And there is leverage there for us as we
13 negotiate to enjoy lower rates. And one thing I
14 might mention too, the term head to head competition
15 hadn't been used today while I've been here, but
16 that's the focus that we see that's missing. And we
17 talk about competition, the lack of competition.

18 I'm one of those elderly men in the
19 audience. I've been around for a number of years,
20 and I was here before deregulation. I was here for
21 Staggers. I've appeared before the Board a number
22 of times, and I recall back when Conrail was being

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1 divided up between NS and CSX. I served on the
2 Conrail transaction team and appeared before the
3 Board.

4 And I was asked a question by the Chairman
5 at that time, if it was true what the railroads would
6 say if the Board did what the shippers were asking,
7 and that was not to break-up Conrail. But the
8 railroad said they were going to go broke, or if they
9 didn't get a merger approved, the railroad would go
10 broke. And it's part of the public record that
11 Conrail officials stated at the time, the last two
12 years Conrail, were the best revenue years in the
13 history of Conrail.

14 And where there were three competitors
15 competing for business, that the shippers were
16 enjoying rates around 20 percent less. And where
17 there were two competitors, the rates were somewhere
18 between 12 to 14 percent. And I testified that we
19 saw that, we saw those numbers. So, if you have
20 someone like Conrail, that had two of the best years,
21 and they were revenue. I don't know if they were
22 considered revenue adequate. I think they were

1 considered to have two of the best years, and they
2 had head to head competition.

3 That we struggled with understanding why
4 the railroads would say that they would go out of
5 business, you know, they could compete, and they
6 competed vigorously. And so, back in those days we
7 had four railroads in the south. We had three in the
8 north. We had Conrail, CSX, NS, we had BNSF, Santa
9 Fe, UP & SP, and a lot of combinations there, okay.

10 So, when we drive out competition, that
11 head to head competition, what we have left is what
12 we have today. And anything you do that will drive
13 competition, and that's a struggle for a shipper.
14 What we're looking for is a competitive rate that we
15 can include into a competitive selling price.

16 We compete with our customers, you know,
17 because we have competitors on the other side. We're
18 shipping customers we're shipping to. But on this
19 side, when we're captive to railroads, we have one
20 dictating rates to us. There's virtually no
21 competition. There are no negotiations. That's
22 where we're at today, very little negotiations.

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1 And when you look at Indorama, one of the
2 fastest growing companies in the world, and the
3 contribution that we are making. As we mentioned 2.1
4 billion dollar acquisition. We've bought multiple
5 facilities around the world and it's a struggle and
6 you hear response as well.

7 When we look at their shipments, their
8 shipments are not affected. Our bottom line is
9 affected though. You know, because just because they
10 keep passing on rates to us, doesn't not mean that
11 we're not absorbing that, taking less profit, less
12 profit, less profit. Ultimately, it affects our
13 business.

14 VICE CHAIRMAN FUCHS: And I guess maybe
15 the proper term is the task force performing
16 protections. Do you have any view on that if there
17 were either the bottleneck changes proposed by ROTF
18 or you know, reciprocal switching as contemplated by
19 711, do you have any, you know, perspective on what
20 you would expect to see when it comes to written
21 service?

22 MR. CHIRUMBOLE: Our view is it might be

1 helpful, but it requires the railroads to compete and
2 they haven't shown that they want to.

3 CHAIRMAN BEGEMAN: Okay, it's my turn.
4 It's my turn, it's my turn. It will be profound, I
5 assure you. John, the submissions of the other
6 carriers, or at least one other carrier, cover
7 bottlenecks to quite an extent, such as what you did,
8 and one of the things that I have found missing from
9 the testimony that I've read or that I've heard so
10 far, is I'm hearing why it -- losing your long haul,
11 your full route to another carrier, why that is not
12 a good thing from your perspective.

13 But I'm not hearing anything about the
14 fact that you also could be receiving, you know,
15 service, or you know, customers from the other
16 bottleneck carriers that might be in the same
17 situation where someone wants to go to you and leave
18 them. So, could you help fill in some of those
19 blanks? It's not -- it wouldn't be, you know, a
20 one-way street, or it seems like it would be an
21 opportunity should a carrier want to take it and as
22 Frank just said, and actually do some competition.

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1 Again, it's not for the entire route, so I
2 understand there would be trade-offs, but we've been
3 in a few settings where we've kind of been left with
4 an impression that the railroads don't want to
5 compete, so here's your opportunity to tell us
6 something different.

7 MR. FRIEDMANN: I think one of the things
8 the railroads work hard at is trying to maximize the
9 efficiency of the network. And whether that's
10 something that's just moving over Norfolk Southern's
11 lines, or a shipment that we have to work with
12 another railroad to get to its destination. And in
13 sometimes, we will short haul ourselves because that
14 is the most efficient route.

15 There are shipments for example, from
16 around the Mobile area that are headed to the
17 panhandle of Florida, alright. It doesn't make a lot
18 of sense to drag those up all the way to Birmingham
19 and bring them back. You know, we will work that,
20 but --

21 CHAIRMAN BEGEMAN: But that's at your
22 choice, not at the shipper's choice, right?

1 MR. FRIEDMANN: Yeah, and what we're
2 trying to do is maximize the efficiency of the
3 network so that we can in essence, provide a viable
4 efficient quality service for all of the shippers.

5 And the concern we have is that what may
6 be good for one particular shipper is bad for the
7 network. It may be good for us, for example, as a
8 particular carrier if we are the receiver of that.
9 But one thing I have seen is that interchanges are
10 the weak link in the transportation network.

11 So, adding more interchange events
12 naturally degrades efficiency. And the quickest way
13 into a service crisis is wild unpredictable swings of
14 volume. And so, from an operating perspective, which
15 is what I'm here talking about today, those are the
16 things that we try in the case of interchanges, to
17 carefully manage. Or in volumes, do our best to
18 predict and minimize the risk with.

19 MR. CHIRUMBOLE: Can I make a comment
20 about that? In a scenario where the bottleneck
21 protections were eliminated, and a lower price was
22 available to a shipper, causing the original fare to

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1 short haul themselves, the originating carrier can
2 remedy that by lowering their price to keep it on the
3 long haul route. That doesn't happen.

4 The excuse is put up there well, it's
5 going to mess up our network. Well, if you lower the
6 price and keep it on your network, the network should
7 be fine. That's what's not happening.

8 BOARD MEMBER OBERMAN: I would just like
9 to follow-up on this question. All day we've been
10 hearing from Professor Sappington and Professor Kalt
11 mimic competition. Considering mimicking
12 competition, which is that allows deficiencies in the
13 SAC test, or whatever other mechanism we're trying to
14 mimic competition.

15 Isn't loosening up the bottleneck and
16 competitive switching rules, a way to get actual
17 competition? I mean everybody says the best way to
18 control rates is not for us to set them, but for the
19 market to set them through competition -- a sentiment
20 with which I agree. So, I understand you're saying
21 that there's a cost of the efficiency in the network
22 if you have to have an interchange, although as Frank

1 points out, you can avoid the interchange by just
2 having competitive price.

3 So, we're talking about two competing
4 interests. But it seems to be difficult for us --
5 for the railroads to come in here and say let
6 competition set the rates, but where there's a chance
7 to have more competition, don't make us do it. And I
8 share Ann's sentiment, we've seen at least two
9 concrete situations that I'm aware of where
10 railroads, there's some evidence that they have a
11 chance for competition and are consciously avoiding
12 it.

13 So, we're getting really mixed signals on
14 this, and I find it very troubling. So, I don't know
15 if you want to comment on that or just let it be, yes
16 sir.

17 CHAIRMAN BEGEMAN: Patrick, comment on
18 this.

19 BOARD MEMBER OBERMAN: I'll ask Patrick.

20 VICE CHAIRMAN FUCHS: No, no, isn't the
21 difference, and please correct me. But isn't the
22 difference the way SAC mimics competition, it brings

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1 the rate down to the stand-alone cost, which is what
2 would be the competitive rate in a contestable market
3 where a hypothetical entrant can come in and take the
4 traffic. But if you have actual competition, that is
5 forced by the Board, it lowers the price down to
6 incremental costs for long-run marginal cost.

7 So, the difference is when you impose
8 actual competition, you take the carrier, and the
9 carrier can't make a contribution to the fixed cost,
10 whereas which is what the SAC fills in and allows for
11 those fixed costs. Isn't that the difference?

12 MR. FRIEDMANN: Well, I would also say
13 that one, the SAC test is really a test, if I
14 interpret this right, designed to constrain pricing,
15 alright, that in the end has no operational impact.

16 At the same time, if you adopt any of the
17 operational remedies that you've discussed,
18 especially in a capacity-constrained environment like
19 we've got on the Mobile line, there is that
20 inefficiency that you're introducing, not only to the
21 shipper that benefits, but the shippers who are
22 basically the casualties.

1 VICE CHAIRMAN FUCHS: But I think to
2 Frank's point, it would be that you would lower the
3 rate in that situation to avoid that inefficiency,
4 but it's just that if you wanted to keep that
5 traffic, you would lower the rate probably, below
6 stand-alone costs, and that's the difference.

7 MR. FRIEDMANN: Well, either way the
8 network is more soft, okay. You could say, you know,
9 I don't want to -- if we lowered the rate because I
10 want to avoid it, that means there's less chance of
11 investment there, less new capacity, less solution
12 for operational issues.

13 VICE CHAIRMAN FUCHS: Right.

14 BOARD MEMBER OBERMAN: I'm really having
15 trouble with this. You are arguing for monopolistic
16 pricing, so you could have more money. I mean you're
17 either going to have competition set the rates or
18 you're not. I'm really getting kind of -- and Frank,
19 do you want to weigh in on this?

20 MR. CHIRUMBOLE: I might have said I guess
21 in that scenario if the rates weren't going up 5
22 percent every year, then I might believe you, but why

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1 does it need to go up 5 percent every year if the
2 original rate was what you needed to support your
3 network. Are your costs going up 5 percent a year?
4 Mine don't go up 5 percent a year, so.

5 VICE CHAIRMAN FUCHS: I think the
6 difference is -- and I'm not saying I feel one way or
7 the other about the policies that we're discussing.
8 I think that the difference is that, you know, when
9 you have economies of scope and density, and you have
10 you know, an average cost that falls with more
11 production, sometimes the most efficient outcome is
12 for one firm to serve that particular plant and they
13 differentially price to cover their fixed costs.

14 And that's going to be above what you
15 would see in a purely competitive market. And
16 that's, I think, the difference, is that if we had
17 forced competition everywhere the argument is -- and
18 I'm not weighing in on any particular policy, but I
19 think the argument is that carriers wouldn't be able
20 to differentially price enough to cover their fixed
21 costs.

22 And so, you know, our regulatory framework

1 absolutely allows currently for carriers to
2 differentially price when they have market power to
3 cover their fixed costs.

4 BOARD MEMBER OBERMAN: Well, but maybe so,
5 but then let's not engage in the facade that what
6 we're doing is mimicking true competition. We're
7 doing something else. You know, as I understand the
8 history of this industry, which I'm just getting
9 into, we were overbuilt, and so in 1980, the Congress
10 said we've got to have rationalization, and a great
11 deal of that has gone on to everybody's benefit. I
12 don't think there's any doubt about that.

13 So, nobody's quarreling with the general
14 benefits of the Staggers deregulation. But now we're
15 at a point where there's so much rationalization,
16 there's very little, from what I understand, and Mr.
17 Rine talked about it, and other shippers, actual
18 competition and I think you're almost conceding it on
19 the 250 mile Mobile line, John. And now you're
20 saying don't go any further, or we won't be able to
21 have enough capital.

22 And if you're right, then we have to have

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1 some other mechanism, but let's not call it
2 competition. Because you're saying if you have too
3 much competition, your prices will be too low and you
4 won't be able to have enough for capital, so let's
5 call it something else.

6 That's sort of the problem I'm having with
7 it. I listen to all this mimicking competition.
8 That's just a facade. If there's a difference
9 between mimicking competition and real competition,
10 then the mimic is not a very good mimic. So, let's
11 deal with some other concept and maybe we'll make
12 more progress.

13 MR. FRIEDMANN: Perhaps the distinction
14 that you're trying to make, Commissioner Oberman, is
15 a difference between short-term and long-term
16 competition. They are both forms of competition, but
17 in the short run you may gain some more competition
18 by the bottleneck change that is being considered.

19 But I think the point that's being made is
20 that in the long-term though, that opportunity to
21 have that competition may disappear entirely, because
22 it will no longer be profitable to invest the

1 resources that are currently there, but may not be
2 there long-term.

3 BOARD MEMBER OBERMAN: That may be so, but
4 I'm sort of responding to Patrick, who is way more
5 knowledgeable about this than I am, if the
6 stand-alone test is building in some ability for
7 beating capital costs that wouldn't be there if there
8 was actual competition, then let's just not pretend
9 that we're trying to have rates set according to some
10 competition concept to the SAC test, because we're
11 doing something else.

12 I don't know what it is, but it can't be
13 if it's different than actual competition, then it
14 isn't mimicking it. That's all I'm saying. And
15 it's -- I don't think productive to pretend that
16 we're doing something that we're not. It may lead to
17 a different way of making sure railroads have enough
18 funds, but I just find it frustrating, particularly,
19 since throughout our statutes, our mandates from
20 Congress, they have as much competition as possible.

21 But here, I'm being told not to have too
22 much competition, or we won't have enough money, so.

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1 MR. FRIEDMANN: I think the answer may
2 come down to the point that Professor Kalt made this
3 morning about the way in which competition works in
4 different ways in different situations. So, in a
5 situation where it really is only efficient to have a
6 single supplier, what you're competing for is for the
7 right to be the sole provider of that service.

8 Whereas, the other type of competition I
9 think we're talking about now, is where you already
10 have two railroads situated to supply service to the
11 same shipper.

12 CHAIRMAN BEGEMAN: Okay, so we actually
13 could keep talking past 6 o'clock. But I don't want
14 to short change the last panel. I just have two
15 things. How ironic, I'm going to ask at this point.
16 So, NS, is the Board obsolete in your view?

17 MR. FRIEDMANN: I don't believe so.

18 CHAIRMAN BEGEMAN: Alright, that will give
19 a lot to add to my talking points in my letter, thank
20 you. And finally, to Mr. Awad and to Phil, thank
21 you. I do have questions that I'm not going to be
22 able to ask you. Same for you, Frank, and also you,

1 Pete. But I just want to make a comment to all of
2 you in the audience.

3 All you railroads that are listening, but
4 although this is not a demurrage hearing, and at
5 first, I thought maybe you were confused that it was
6 May again. I appreciate the fact that you came and
7 told us it was going on from your perspective with
8 demurrage since we had that period in May and since
9 we've made -- there's proposals. Just a very short
10 time ago, we received replies on our proposals, and I
11 will say, I was pretty troubled by some of the things
12 that I have read that are similar to what you just
13 said to us. And I hope that the railroads are
14 reading all of the different replies and, you know,
15 maybe we'll have to have one more round of commentary
16 of he said, she said, he said, she said, they said,
17 because there are some real extreme allegations that
18 a couple of the filers have said on behalf of their
19 members. And I also want to acknowledge as what the
20 Board has said in some of their proposals, I mean,
21 some of the railroads really have heard concerns and
22 have acted on them, I mean, NS, you got rid of that

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1 congestion fee. You've done various things that we
2 cited, but again, I think there is a lot more work to
3 be done. And so I hope you all take that as being
4 duly noted and we'll go to the fourth panel.

5 MS. GAINNEY: Thank you, Chairman Begeman, Vice
6 Chairman Fuchs and Member Oberman. My name is Kathy
7 Gainey and I'm counsel at CN. With me today is CN's
8 Vice President and Treasurer, Bernd Beyer and CN's
9 outside counsel Matt Warren. CN appreciates the
10 opportunity to testify today as to the importance of
11 predictable regulatory framework that supports CN's
12 ability to invest in its network, equipment and
13 technology, to provide safe and reliable service to
14 our rail customers.

15 CN's network is unique in that it touches
16 three coasts of North America. We move a wide
17 variety of commodities across Canada and the United
18 States and to ports that reach markets across the
19 globe, maintaining and expanding our 19,500-mile
20 network requires significant ongoing investment. Mr.
21 Beyer is going to chair how CN's invests her safety
22 and rail customers. These investments maintain CN's

1 current network and improve network fluidity,
2 increase capacity and build resiliency. He will
3 testify about our concern that the revenue adequacy
4 proposals in the Surface Transportation Board's Rate
5 Reform Task Force report would increase regulatory
6 uncertainty.

7 Such increased regulatory risk could make
8 it harder for CN to compete with other industries for
9 capital and financial markets and to make the rail
10 industry -- and will make the rail industry a
11 riskier investment and much less attractive to
12 investors.

13 Such increased regulatory uncertainty
14 could also increase the risk for CN to pursue new
15 investments in its network and equipment. And with
16 that I'll turn it over to Bernd.

17 MR. BEYER: Thank you Kathy. Good
18 afternoon Chairman Begeman, Vice Chairman Fuchs and
19 Member Oberman. As Treasurer of CN, I work daily to
20 ensure that CN's capital investments benefit our
21 network and our customers and that they make sense
22 from a financial standpoint.

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1 CN invests heavily in its network and
2 equipment. Those investments are vital to providing
3 freight rail service to our customers, to promoting
4 network fluidity, and to building resiliency. Unlike
5 many other transportation modes, a railroad must
6 build, maintain and expand its private network at its
7 own cost.

8 CN's investment decisions are driven by
9 safety and customer service. Our ability to make
10 smart, long-term investments in our network and
11 equipment is critical to our ability to provide good
12 service for our freight rail customers.

13 In 2018, CN invested 52 percent of its
14 operating income into capital investments. Viewed
15 differently, approximately 72 percent of CN's net
16 income was reinvested into the business. CN is on
17 track to outpace those numbers for 2019 with an
18 expected capital investment envelop of 3.9 billion
19 Canadian dollars across the network.

20 As you can see, more than 40 percent of
21 that investment has been in CN's network in the
22 United States. CN's investments are good for safety

1 and rail customers as they tend to reduce cost
2 cycles, increase asset utilization, increase capacity
3 and network fluidity and drive service and growth.

4 We also invest to maintain and rebuild
5 existing infrastructure, fulfill federal regulatory
6 requirements and expand the company footprint. In
7 2019 alone, CN has invested in each of those areas.
8 CN has improved network fluidity by constructing new
9 sidings and siding extensions.

10 Such sidings expand mainline capacity,
11 eliminating key pinch points, improving fluidity and
12 build resiliency. Sidings facilitate efficient train
13 operations by allowing a train to cross another in a
14 rolling meet in CN's mostly single track network in
15 the United States.

16 Key investments include new siding
17 projects at the international border in Rainia,
18 Minnesota and double track in northern Wisconsin,
19 outside Superior. CN is also investing capacity and
20 facilities to respond to customer demand in
21 Tennessee, Illinois, Wisconsin and Minnesota.

22 CN also expanded its fleet of railcars.

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1 In 2018, we added nearly 1,000 cars to our center
2 beam fleet, and over 600 boxcars to rejuvenate as a
3 fleet starting our first product in metal customers.
4 CN is also acquiring 1,000 new generation
5 high-capacity grain copper cars over the next two
6 years to replace aging equipment and meet the growing
7 needs of our grain customers.

8 And by the end of 2019, we will have
9 accepted delivery of 140 new, high-efficiency
10 locomotives for a total investment of approximately
11 500 million. This was CN's largest locomotive
12 purchase since 2012. This improves the reliability
13 of our locomotive fleet.

14 CN's acquisitions of cars and locomotives
15 supports CN's rail service for our customers. CN has
16 also made investments to comply with federal
17 regulatory requirements. Our continued investment in
18 positive train control, or PTC, will result in a
19 planned investment of a total of 1.5 billion.

20 As of November 2019, CN has met the
21 regulatory requirement to operate PTC on all 35 of
22 its U.S. subdivisions required to be equipped with

1 PTC. This PTC mandate has required CN to make a
2 massive commitment of capital resources that are not
3 available for other important investments in its
4 network or equipment.

5 CN has a long history of investing in the
6 United States by expanding its footprint. We are
7 celebrating the 10 year anniversary of our
8 acquisition of EJ&E. To purchase and integrate EJ&E,
9 CN invested hundreds of millions of dollars in
10 infrastructure improvements. This acquisition
11 allowed CN to reduce overall delivery times by
12 approximately 24 hours and directly benefit
13 customers whose freight moves via the Chicago
14 terminal.

15 Since the acquisition of EJ&E, CN's trains
16 now move twice as fast through Chicago. CN also
17 invests in technology to innovate for safety and
18 customer service. CN is excited about a number of
19 technological innovations driven by our research and
20 development that has the potential to enhance the
21 safety and environmental impact of railroad
22 operations.

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1 For example, in 2018, CN unveiled a new
2 design for central beam cars, which reduces undesired
3 train separations by 67 percent, enhancing safety for
4 all customers and our crews. CN has a patent on this
5 technology and has shared the design with the
6 industry.

7 CN is also partnering with -- CN has also
8 partnered with a company to develop CanaPux, an
9 innovative and safe way to transport extra heavy
10 crude. The extra heavy crude is blended with polymer
11 to form a solid pellet that can be transported to
12 global markets using the same infrastructure as coal
13 or petroleum coke. At the end of the journey, the
14 pellet can be re-liquefied, and the polymer can be
15 separated and reused.

16 CanaPux pellets are not volatile, do not
17 burn, do not pose a risk if involved in a derailment.
18 CN is also investing to improve safety and
19 reliability of investing in autonomous track
20 inspection program, and automatic car inspection
21 portals. Over time, these investments will allow for
22 earlier detection of track and car defects to

1 increase safety and enable repairs to be scheduled
2 proactively before an urgent defect arises that
3 requires track or cars to be taken out of service for
4 repairs.

5 Performing track and car inspections at
6 track speed will enable CN to detect defects without
7 impacting network fluidity, meaning that CN will be
8 able to get product to our customers more safety and
9 more efficiently.

10 CN is excited about the opportunities
11 these and other advanced technologies offer. These
12 investments use strong operating metrics which
13 reflect the strong service CN offers to its
14 customers. CN's investments improved dwell, car
15 velocity and network speed.

16 The proposals that are being discussed
17 today are coming at a time when demand for freight
18 rail transportation has decreased. There's also
19 uncertainty regarding trade, tariffs, and the
20 contracting of the North American manufacturing
21 sector. Increased regulatory uncertainty would
22 further increase risk. It is incumbent upon the

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1 Board to develop policies that mitigate, rather than
2 exacerbate the risks that a railroad confronts in
3 making decisions about investment in its network and
4 equipment that will benefit freight rail customers.

5 Added regulatory uncertainty could
6 heighten the risk of investment in the railroad, by
7 also increasing the risk for the railroads in
8 pursuing new investment in its network and equipment.
9 This could result in fewer capital projects. In the
10 long term, regulatory uncertainty could negatively
11 impact network fluidity, customer service, and the
12 overall competitiveness of freight rail as a
13 transportation option in the United States.

14 CN is particularly concerned that the
15 revenue adequacy suggestions in the Rate Reform Task
16 Force report, being considered by the Board, could
17 make a railroad like CN a riskier investment and thus
18 less attractive to investors.

19 Changes that increase regulatory
20 uncertainty and risk, including proposals that could
21 affect a railroad's ability to earn a return on its
22 investment, could discourage such investment and

1 make it harder for CN to compete with other
2 industries to raise necessary capital in financial
3 markets. That capital is necessary for CN to invest
4 in its network and equipment, to provide rates for a
5 service for its customers, and CN is concerned that
6 the effects would deteriorate CN's ability to invest.
7 Thank you.

8 CHAIRMAN BEGEMAN: Alright, CP?

9 MR. WITTEBROOD: Good afternoon Chairman
10 Begeman and Vice Chair Patrick Fuchs and Commissioner
11 Oberman. My name is Tyme Wittebrood, and I am the
12 Director of Regulatory Finance for Canadian Pacific.

13 I'll just give you a little bit of
14 context. The Regulatory Finance team for Canadian
15 Pacific acts as the primary interface between our
16 business and our regulators. We provide guidance and
17 analysis to our regulator, or sorry, to our business
18 in order to -- I should take my glasses off.

19 We provide guidance to the business and to
20 the regulators to ensure that we operate effectively
21 within the regulatory framework and we provide data
22 and analysis to our regulators in order to allow them

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1 to develop and implement the regulations.

2 We are not research economists, rather we
3 deal with regulatory environments from a practical
4 perspective. Similar to the experience in the United
5 States, the Canadian regulatory environment for
6 railroads began to move towards deregulation in the
7 late 1960s with the passage of a new National
8 Transportation Act. With this legislation, the
9 industry moved towards market based rates and the
10 legislation prohibited setting of rates that do not
11 adequately cover a railroad's costs.

12 As in the United States, the results were
13 overwhelmingly positive for railroads and shippers
14 alike. While there are many similarities between the
15 regulatory environment in Canada and in the United
16 States, the Canadian experience has been somewhat
17 different. And I wanted to come here today to
18 provide some observations from the Canadian
19 environment from the Canadian perspective, which may
20 inform these proceedings.

21 But first, I would like to illustrate
22 fundamental flaws in the existing methodology with

1 revenue adequacy that renders it inappropriate as a
2 tool for implementing a top down rate constraint.

3 The use of book values for calculating
4 return on investment, is itself improper. Book
5 values do not represent an accurate view of the
6 replacement cost, or the current market value of an
7 asset. This is especially true of long lived assets
8 such as railway track, and ballast, locomotives,
9 bridges and buildings. These assets may have been
10 purchased decades ago in a time when prices were much
11 lower.

12 Land, which does not depreciate at all,
13 may have been acquired more than a century ago.
14 Prior to CP's acquisition of the DM&E in 2008, CP's
15 U.S. operating companies showed less than 7 million
16 dollars of land assets due to that book value.

17 At that time, we operated just over 4,500
18 miles of track in the U.S. In the following year,
19 when the DM&E acquisition was added to the books, the
20 U.S. track mileage increased by nearly 80 percent, to
21 just over 8,000 miles, but concurrently, the book
22 value of the land increased by nearly 10,000 percent,

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1 to 664 million dollars.

2 Of course, the reason that the newly
3 acquired land represents approximately 100 times
4 greater book value per mile is because they were
5 stated to their modern values when they were
6 acquired. Let us say hypothetically, that CP
7 generated 7 million dollars of income, strictly from
8 its land assets in both the year before the DM&E
9 acquisition and again in the year after.

10 So, in the first year that would represent
11 approximately a 100 percent return on its investment.
12 But in the second year that represents slightly more
13 than 1 percent return and so this state of affairs
14 demonstrates the distorting effect of using book
15 values when attempting to use them in an economic
16 study.

17 The true value of a company's assets to
18 the business is the value that these assets would
19 fetch on the open market today relative to their
20 income generating potential. So, for example, if
21 the liquidation value of an asset exceeds its income
22 generating potential, then a prudent business manager

1 would be expected to sell that asset.

2 And therefore, if a regulator constrains
3 an industry's return on investment according to the
4 book value of that investment, this will likely lead
5 to chronic under investment. New capital will be
6 deployed in non-regulated demands where it is likely
7 to generate returns based on its true value.

8 This is not mere economic theory. And in
9 Canada, the railroad industry has recent experience
10 with this phenomenon. The Canadian railroad industry
11 is subject to a regulatory rate constraint called
12 the maximum revenue entitlement which sets an average
13 price ceiling for the export of grain traffic.

14 The regulator determines the price ceiling
15 annually according to a price inflation index. And
16 this approach does a particularly poor job of
17 reflecting the investment and certain long-lived
18 assets such as the covered hopper cars that are
19 predominantly used to transport grain products.

20 Therefore, an unintended consequence of
21 the MRE has been to prevent the railways from being
22 able to recover adequately the cost of investing in

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1 hopper cars. As a result, Canada's hopper car fleet
2 continues to age and suffer from underinvestment.

3 Finally, in May of 2018, recognizing that
4 Canada's hopper car fleet was becoming unreliable and
5 inefficient, the government passed new legislation
6 that allowed the Canadian regulator to recognize
7 specifically the cost of investing in new hopper cars
8 as an adjustment to the index.

9 And within a few weeks, both CP and CN,
10 sorry, CP and CN announced hopper car purchase
11 programs totaling more than 600 million dollars
12 Canadian. So, this experience clearly demonstrates
13 the broad-based regulatory constraints on revenue
14 will lead to under investment.

15 The RRTF proposal for the rate increase
16 constraint promises that the effect of the regulation
17 will be limited. However, when one walks through the
18 practical implications of managing such a program,
19 from the perspective of both the shipper and the
20 railway, it quickly becomes apparent that the
21 ultimate effect of the program will be far reaching.

22 For example, customers who are under

1 contract will know whether or not their rates will be
2 subject to the RIC if and when their contracts
3 expire, and we would expect them to use that
4 information during negotiations in order to insist on
5 rate increases that fall short of the RRTF
6 requirement. If not, then a customer could threaten
7 to go off contract in order to make use of the RIC
8 protections.

9 And that's simply to say that contract
10 rates will be subject to the RSC practice, even if
11 not in theory. From a railroad's perspective, once
12 the railroad is subject to the RSC, then every
13 action it takes to improve its earnings will
14 contribute to the next year's surplus.

15 This in turn, will lead to a tightening of
16 the RSC's grip. And every time that the railroad
17 considers making an investment or an operational
18 change that would lead to greater efficiency, this
19 should be expected to generate higher earnings, which
20 would lead to subsequent years' overages and
21 surpluses, and therefore every investment opportunity
22 will be evaluated as to its ultimate impact under the

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1 RIC.

2 We see a similar effect in Canada under
3 the MRE regulations. Under the MRE, there is no
4 direct way for a railway to increase the amount of
5 revenue that it may earn for a given volume of
6 traffic. But the railroad may recoup over time,
7 certain investments made in grain handling
8 facilities.

9 Therefore, every potential investment that
10 affects the grain network is evaluated as to its
11 impacts under the MRE. Investments that can be
12 recovered through pricing under the MRE are likely to
13 go forward and those that cannot are not likely to go
14 forward because there is no way for the railroad,
15 sorry -- the railroad to adequately recoup its costs.

16 The RIC proposal does not appear to offer
17 any way for the railroad to recoup the costs of its
18 investments. Arguably, anything that the railway
19 does to improve its earnings under the RSE
20 constraint, will eventually be returned to shippers
21 by way of ever-tightening rate constraints.

22 In conclusion, revenue adequate test is

1 not robust enough to use as the basis for applying
2 sweeping economic regulations that attempt to manage
3 the economic health of an industry that is crucial to
4 the North American economy.

5 Further, as testified by others at this
6 proceeding, such economic regulations would be
7 contrary to the STB's mandate and would have
8 unintended consequences, including distorting a
9 railroad's ability to attract and invest capital.
10 Thank you very much.

11 MS. SAHLING-ZART: Good afternoon. Chair
12 Begeman, Vice Chair Fuchs and Member Oberman. I am
13 Shelley Sahling-Zart, Vice President and General
14 Counsel of Lincoln Electric System, the municipal
15 electric utility in Lincoln, Nebraska. And I
16 currently serve as President of the Freight Rail
17 Customer Alliance or FRCA.

18 FRCA is an alliance of trade associations
19 that in turn represents a diverse group of more than
20 3,500 electric utility, agriculture, chemical and
21 alternative fuel shippers. In addition, I'd note
22 that I had the honor of serving on the Railroad

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1 Shipper Transportation Advisory Council of the STB
2 for 6 years.

3 FRCA thanks the Board for holding this
4 hearing on revenue adequacy and for providing the
5 opportunity for us to address the related proposals
6 in the Rate Reform Task Force report. We'd also
7 like to thank the staff who served on the task force.
8 While there may not be unanimity regarding the
9 recommendations, FRCA certainly appreciates the work
10 to advance the ideas and provide the framework for
11 additional discussion.

12 In the 31 years that I've been
13 participating in these kinds of discussions, we've
14 been discussing pretty much the same topics and the
15 same issues for 31 years, and it's nice to have some
16 concrete ideas on the table to perhaps talk about
17 something different for the next 31, though I won't
18 be here that long.

19 FRCA supports most of the proposals in
20 concept, but believes there are some much needed
21 improvements. FRCA strongly believes that there
22 needs to be a viable and effective revenue adequacy

1 constraint as part of the Board's oversight, by
2 statute rates, as we've discussed today, are required
3 for captive shippers to be reasonable.

4 The Board's only partially effective rate
5 constraint to date has been SAC. SAC works for only
6 a small group of shippers as has been discussed at
7 length. I can attest, from personal experience in
8 the Western Fuel's case, that even where SAC is
9 utilized, it is slow. It is expensive.

10 For most shippers, SAC and the existing
11 alternatives don't work at all. FRCA recognizes that
12 railroads need differential pricing to cover their
13 cost and serve as many shippers as possible. But
14 once railroads recover their cost and achieve revenue
15 adequacy, allowing further unrestrained rate
16 increases does not guarantee further infrastructure
17 investment, but rather, in our opinion, punishes
18 captive shippers.

19 The ICC recognized and established this
20 principal in 1985. Measuring revenue adequacy based
21 on whether a railroad's return on that investment
22 exceeds the cost of capital, can be a reasonable

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1 approach, but other measures should be considered.
2 But to the extent that the Board relies on return on
3 investment and the cost of capital, both must be
4 measured accurately.

5 For instance, return is not measured
6 accurately when it ignores railroad tax savings in
7 2017, 9 billion dollars. And, as you heard earlier,
8 accuracy is also compromised when the Board measures
9 the cost of capital at 12 percent and Burlington
10 Northern's own Executive Chairman says the needed
11 return is only 7 percent.

12 FRCA believes the measurement period
13 should be a fixed length, and that 5 years is
14 sufficient. Trying to capture the business cycle is
15 an exercise in futility, as illustrated by the
16 experience with the RCA of productivity adjustment.
17 Varying the length of the measuring period causes
18 different years to receive different weights and
19 produces distortion.

20 5 years is long enough to smooth out most
21 troughs, and an even longer averaging period makes
22 the constraint less reflective of current and recent

1 conditions. FRCA agrees that a rate increase
2 constraint should be a key element of revenue
3 adequacy constraint.

4 Once a carrier achieves revenue adequacy,
5 the carrier does not generally need to impose further
6 rate increases on its captive traffic, in excess of
7 changes in its costs in order to remain revenue
8 adequate. Unfortunately, the Board's proposed rate
9 protection would apply only to some captive rates;
10 that's a pretty big step backwards from the
11 protection adopted in the coal rate guidelines that
12 applies to all captive rates to a revenue adequate
13 carrier.

14 MMM is a useful mechanism for allocating
15 rate reductions, but the revenue increase constraint
16 does not reduce rates, it merely limits future
17 increases. The protection should apply to all
18 movements where a carrier has market dominance,
19 unless the carrier makes a specific showing that the
20 higher rates should apply to an individual movement.

21 The Board's proposal is also unduly
22 complicated in that it relies on system average URCS

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1 cost, which are inherently imprecise as was also
2 discussed today and explained previously by the TRB.

3 FRCA also supports the proposed suspension
4 of the bottleneck rate protections for revenue
5 adequate carriers. Bottleneck relief may solve most
6 of the issues with competitive access. A carrier
7 that is revenue adequate should be expected to
8 compete. Also, a carrier subject to bottleneck rate
9 relief will still have other protections, such as
10 market dominance and SAC.

11 FRCA also supports allowing a shipper to
12 use the simplified road property investment analysis
13 in a simplified SAC case against a revenue adequate
14 carrier. However, as was also discussed earlier,
15 that should be at the shipper's option and the
16 shipper should be allowed to make a full road
17 property investment showing if it so chooses.

18 A shipper should not have less protection
19 because it's served by a revenue adequate carrier.
20 The Rate Reform Task Force indicated that for revenue
21 adequate carriers, simplified SAC should be replaced
22 by incumbent network cost analysis, or INCA,

1 something we haven't discussed much today.

2 At this time, FRCA does not support
3 elimination of simplified SAC for revenue adequate
4 carriers, but FRCA does look forward to learning more
5 about INCA. It's an interesting concept. Unlike the
6 revenue increase constraint, INCA appears to have the
7 potential to reduce rates, while avoiding an
8 expensive replacement cost analysis.

9 So, that's one we'd like to have more
10 discussion about and pursue a little further. To
11 conclude, the proposals are significant and helpful
12 and FRCA greatly appreciates the attention that the
13 STB is giving these issues, but modifications are
14 needed to the recommendations, but it's a good
15 framework for that start. I look forward to
16 responding to any questions you may have.

17 CHAIRMAN BEGEMAN: Thank you Shelley,
18 Kent?

19 MR. AVERY: Good afternoon. I'm Kent
20 Avery. I'm VP of Commercial for PBF Energy. PBF is
21 an independent refiner. We operate 5 refineries in
22 the U.S., 4 of them are on the east coast, 1 is on

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1 the west coast. I'm going to be brief today, because
2 I don't think there's anything, I can say that hasn't
3 already been said.

4 And frankly, I'd like to -- what's that?
5 Frankly, I want to get to the questions because you
6 know, these two Canadian roads up here, they're the
7 darlings of Wall Street and they've had some form of
8 regulation up there as far as competition is
9 concerned. So, I'd really like to hear from them
10 about what's working and what's not.

11 Also, we're a member of AFPM and AFPM's
12 going to talk tomorrow and a lot of the points are
13 going to be covered there. So, I don't want to stand
14 in between us and a cold beer. So, we'll get to the
15 questions here in a second. I do want to just say a
16 couple things.

17 My testimony was originally about
18 bottlenecking, okay, but again there's been enough
19 said today, and I don't care what you call it,
20 whether you call it reciprocal switching, haulage
21 rights, trackage rights, call it what you want. The
22 gentleman that was up here -- this gentleman right

1 here, that testified before me said it best. We just
2 need head to head competition. This isn't
3 complicated. We just need competition, that's it.

4 As a matter of fact, I am not in favor of
5 rate constraints if there is competition in
6 significant bottlenecking revisions. And, as Mr.
7 Oberman said here earlier, I do encourage the
8 Commissioners to look at the stock buybacks that
9 these railroads have done, versus the capital they
10 spend.

11 I'm not sure why you would buy stock back
12 in a company that's not revenue adequate. So, it
13 just doesn't make sense to me. I do want to tell you
14 what it's like to be a captive shipper though. I'm
15 going to give you two examples. In the east we have
16 4 refineries. The NS railroad serves all 4.

17 2 of those 4 refineries are open, the
18 other two are closed just to the NS. But really,
19 they're all closed to the NS. The leverage the NS
20 has at the two captive facilities, makes the two
21 open facilities almost closed. They're de facto
22 closed because of all the leverage they have.

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1 In the west, I'm captive to the BNSF
2 railroad. And you know, I've been working for over 2
3 years with the BNSF railroad on trying to build
4 storage out there. Today, PVF Energy, I don't want
5 to tell you how much we pay in demurrage, it would be
6 a safety issue. Everyone would fall out of their
7 chairs. But it's a lot of money. And so, we've been
8 working with the BNSF for 2 years and said hey,
9 we'll build. We'll build. We don't want to pay
10 demurrage. We know you don't want us in your serving
11 yard. We'll build, let's go look for a place.

12 We have found 6 to 10 spots, and PVS is
13 willing to build. Okay? The BNSF won't serve it.
14 They're saying that their operating department
15 doesn't like it. They either don't want to switch on
16 the main line, they either can't commit to service
17 within 48 hours of our operation, so what are they
18 doing? I do have a demurrage agreement in place
19 right now.

20 And that demurrage agreement, Miss
21 Mulligan here, is going to cancel it the first of the
22 year. That demurrage agreement only accounts for

1 about 20 percent of the cars that we handle through
2 there, but it is something. But that's going to be
3 cancelled now.

4 I just want to point out that we're
5 willing to build. We're willing to do something.
6 We're a captive shipper. I don't have the ability to
7 go to another railroad and say hey, help me with
8 demurrage or storage, and I'll give you business.
9 So, that's what it's like to be a captive shipper.

10 At any rate, thank you for all the hard
11 work. Thanks for all the work the STB is doing and
12 all their staff. I appreciate the opportunity and I
13 just hope we can come to a happier spot than we are
14 now as a shipping community, thank you.

15 BOARD MEMBER OBERMAN: Thank you Kent.
16 Kathy, I wanted to ask you this question has come up
17 a few times with others too, but I didn't ask it. Or
18 maybe it was Mr. Beyer. One of the two of you talked
19 about the new proposal the RIC idea and the task
20 force report will bring uncertainty to the rail
21 world, and uncertainty is not good.

22 Could either of you tell me what would be

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1 uncertain about it? Why would there be uncertainty?

2 MS. GAINNEY: And so, to clarify, we were
3 actually not speaking specifically about the RIC or
4 the rate increase complaint. We were speaking
5 generally about the Rate Reform Task Force's revenue
6 adequacy proposal to also include the bottleneck
7 proposal.

8 But generally, if the STB is going to
9 engage in something that fundamentally changes the
10 regulatory framework in the United States, it's a
11 two-fold concern. First, for CN, in our internal
12 decision-making about what investments on our network
13 are appropriate to pursue based on our expected rate
14 of return, it has additional uncertainty that makes
15 it unlikely in any particular investment that it
16 would be likely to be funded as it is now.

17 And then our second concern is that the
18 Board's proposals by increasing regulatory
19 uncertainty in the United States with potential for
20 serious implications that would happen, the knife
21 edge, was the phrase used this morning, for
22 potentially long-term, carriers that were deemed

1 long-term revenue adequate.

2 But that would discourage investors from
3 viewing the rail industry as an attractive
4 investment. And we at CN compete in financial
5 markets for capital with other industries, and we
6 view that as a potentially adverse consequence of the
7 rate reform task force proposal.

8 BOARD MEMBER OBERMAN: Here's what I don't
9 understand. If a rule was proposed to enact what the
10 Rate Reform Task Force suggests, in terms of the
11 revenue adequacy measurement plus the RIC and so
12 forth. At that point, what would be uncertain?
13 That's all I'm trying to figure out. As compared to
14 the rate relief mechanisms we have now. You'd know
15 what it was, and there'd be an arithmetical formula
16 to determine if you're revenue adequate, so you may
17 not like it for other reasons, but why would it be
18 uncertain? That's what I'm trying to get at.

19 MR. BEYER: Well, I don't think it's a
20 question whether or not the regulation itself is
21 uncertain. It's more two people have made the point
22 when we make, you know, large investments, we make

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1 them on day one based on a number of assumptions
2 about the future. What the future would look like,
3 what revenues might earn under different scenarios
4 and all that stuff.

5 And as somebody pointed out earlier, it
6 takes you know, it's decayed off return, they have to
7 justify that investment. In a world where you know,
8 we cannot strive to exceed our cost of capital, which
9 is really a requirement to create value for the
10 shareholder, it is much harder to justify such an
11 investment than it is that, you know, if and I think
12 somebody earlier today used an example of an
13 isometric failed curve.

14 If things go bad, I bear -- would have
15 answered the downside risk. If things go well, well
16 then, I'm revenue adequate and cannot you know,
17 harvest debt if you like, those rewards, but we
18 meant, I think, but we said uncertainty.

19 BOARD MEMBER OBERMAN: You mean as to
20 whether your investment will pay off?

21 MR. BEYER: Whether or not the investment
22 will pay off, or that there will be a limited pay-off

1 in an upside, but a full downside if things don't pan
2 out the way anticipated.

3 CHAIRMAN BEGEMAN: Is there any role at
4 the moment that the Board is playing that is coming
5 into, across I guess your decision-making on a daily,
6 or monthly or yearly basis for your investment. So,
7 right now it's all certain because of all the other
8 regulations we have, it's completely crystal clear,
9 but theirs is -- just with respect to revenue
10 adequacy, that's going to impose uncertainty or
11 things like the examples from what's going on with
12 the Canadian regulators.

13 There's probably a lot more uncertainty in
14 that sphere than there is here.

15 MS. GAINNEY: We would think the same
16 thing. We would say the same thing with respect to
17 the Canadian regime, when it creates uncertainty in
18 the long haul.

19 CHAIRMAN BEGEMAN: And yet your operating
20 ratios are the envy of Wall Street and American
21 railroads or U.S. railroads are emulating them,
22 almost all of them, or working to. So, it's kind of

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1 hard to grasp what you're trying to tell us.

2 MS. GAINEY: The increased uncertainty
3 from regulations that make it uncertain whether CN,
4 when we're making a decision whether to invest in an
5 asset like track, that we're going to be depreciating
6 over a 40 year timeframe. If we're not certain that
7 we're going to be able to earn a reasonable rate of
8 return on that investment, it makes CN less likely to
9 invest in that particular asset.

10 CHAIRMAN BEGEMAN: Wouldn't that apply to
11 any investor?

12 BOARD MEMBER OBERMAN: Yeah, I mean, isn't
13 that how any type of business makes an investment.
14 You don't know if it's going to work. There's always
15 an element, that's the whole nature of being a
16 capitalist.

17 MR. BEYER: No, that's fine. But I think
18 an investment is entitled to earn a return above the
19 cost of capital.

20 BOARD MEMBER OBERMAN: Well listen, I
21 understand that you may not like the mechanism. I'm
22 just trying to figure out why you say it's uncertain.

1 Because if it's uncertain, and we're trying to
2 consider devising something, then we should try to
3 make it certain. And that's what I'm missing.

4 If somebody brings a SAC case, that's
5 uncertain because you don't know how we're going to
6 rule on it. So, that's uncertain as well. So,
7 what's the difference? That's all I'm trying to get
8 at. And a number of witnesses have said we're
9 bringing uncertainty into the system. We may be
10 bringing -- I mean if we did it, a mechanism that you
11 don't like, or that you think is harmful, but it
12 would be certain, wouldn't it?

13 MS. GAINEY: It's -- I'll answer and then
14 Bernd will answer. So, in an individual rate case,
15 whatever the rate case methodology would be, it would
16 just be an individual rate that would be at issue and
17 might be found to be unreasonable. But the rate
18 performance half course proposal has a much broader
19 potential impact, that is uncertain and will not be
20 known until things play out in the future and indeed
21 could change on an annual basis and involve factors
22 like lag.

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1 And change fundamentally, in the United
2 States at least, the carrier's expectation that they
3 would be able to be entitled to the long haul on the
4 freight rail move when it's making a decision about
5 an investment and then I'll pass to Bernd to give his
6 perspective as well.

7 MR. BEYER: And I don't have much to add
8 to that Kathy. I mean maybe it's -- what I meant by
9 uncertainty, I guess is risk, which maybe can be used
10 interchangeably. And all else being equal, an
11 investment -- two identical investments, one with a
12 revenue adequacy clause and the other one without, is
13 more risky, or more uncertain because I don't know
14 under different scenarios.

15 BOARD MEMBER OBERMAN: What is it you
16 don't know under the revenue adequacy?

17 MR. BEYER: Okay, so maybe the better way
18 to put it is the investment is more risky and I'm
19 less likely to do that investment because of the
20 presence of the possibility that if I achieve certain
21 revenue threshold, then I need to share that with my
22 customer, those returns.

1 MR. WARREN: I think I might be able to
2 help Member Oberman. What revenue adequacy would do
3 is it would take away the up side. So, it's true
4 that all investments have risk. But now, you have a
5 potential investment. It may not work out. You
6 know, the traffic you think is going to be there, may
7 not develop. So, it may turn out that you didn't
8 earn the return on your investment you were
9 expecting.

10 But maybe you're right. And it will pay
11 off and you will actually earn more on this new
12 intermodal facility that you had, you said you had
13 imagined and now, but what revenue adequacy does --
14 if you've done that investment and you realize the up
15 side, it's taken away. So, all you have is the risk.

16 BOARD MEMBER OBERMAN: But that would be
17 certain. It wouldn't be uncertain. You just don't
18 like the outcome, but that wouldn't be uncertain.
19 That's all I'm trying to get at it, is there
20 something wrong with the predictability maybe we
21 could remedy it, but all you're telling me is it just
22 changes the risk measurement.

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1 MR. WARREN: Yeah, I think you're right.
2 Uncertainty may have been the wrong word. It's more
3 certain that it would be bad.

4 CHAIRMAN BEGEMAN: Are you referring --

5 BOARD MEMBER OBERMAN: I understand that
6 that's what you think, but at least it's certain.

7 CHAIRMAN BEGEMAN: Are you referring
8 mostly to the bottleneck portion of the
9 recommendations?

10 MR. WARREN: I think to both. I think RIC
11 has the same, you know, basic effect, because I think
12 anything that --

13 CHAIRMAN BEGEMAN: The fact that we call
14 it RIC is really a shock to me.

15 MR. WARREN: RIC, yeah, I think any
16 methodology that is based on looking at -- oh,
17 certainly. Any methodology that is based on looking
18 at system-wide revenues and system-wide earnings, and
19 using that to decide you know, where the rate cap is
20 going to be, is ultimately you know, one that is
21 going to discourage investment.

22 Why would you build? Why would you invest

1 in, you know, a new intermodal facility? You know.

2 BOARD MEMBER OBERMAN: 75 percent of your
3 traffic is not limited. That's one reason. As I
4 understand it, only 24 percent, we were told, is
5 captive and all the rest of it is not regulated.
6 So, the one reason you'd invest in a new facility is
7 that most of your traffic you're going to make --
8 you're not restricted as to what you can earn. I
9 mean what am I missing here?

10 MR. WARREN: But well, I think if you've
11 done something on the 75 percent to become more
12 efficient, that's -- you haven't gained anything,
13 because all that is just going to immediately go
14 except the 24 percent.

15 BOARD MEMBER OBERMAN: Just on an
16 individual rate case. What I'm hearing from the
17 railroads is if this revenue adequacy measure was
18 enacted, you would cut off your noses to spite your
19 face. You would cut off your ability to make profits
20 on the 76 percent of the traffic because one or more
21 of the shippers in the 26 percent might bring a RIC
22 case, so to speak. It doesn't make any sense to me.

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1 MR. WARREN: But I think as it was
2 discussed on some of the earlier panels, the
3 decisions that the Board makes are public decisions
4 that you set the market. So, when the Board issues a
5 decision, I think a lot of railroads could speak to
6 the fact that, you know, it's common for someone to
7 come and say, you know, there's a fact case, you
8 know, and the Board gave 180 percent prescription. I
9 want 180 percent.

10 And every contract negotiation is based on
11 that, you know, underlying regulatory view.

12 BOARD MEMBER OBERMAN: Matt, just one
13 thing. But the people who aren't regulated by us are
14 not affected by what we do. So, those market forces
15 wouldn't change, would they?

16 MR. WARREN: Well, I think that they are
17 affecting every stakeholder in the network is
18 affected by what you do. That discourages
19 investment. It's going to hurt those 76 percent that
20 you know, may not have rates that they're complaining
21 about, but certainly have service that they're very
22 concerned with.

1 VICE CHAIRMAN FUCHS: With respect to the
2 investment. If some of what's at the effect that
3 you're referring to is some of it because if
4 investment was successful, and bottleneck was opened
5 up, there's the possibility for a lower return than
6 you could get -- what you're saying, there's a
7 possibility just a lower return.

8 So, such that you wouldn't necessarily,
9 you know, cover the full fixed cost like you would if
10 that person were guaranteed to be captive over the
11 long term.

12 MR. WARREN: Yeah, I think that's right.
13 You're looking system-wide, but I think railroads, as
14 any business, evaluates a potential individual
15 investment, it's going to be looking at, you know,
16 what's our potential return there. And if you're
17 doing things that are cutting or taking away some of
18 the upside, then that's --

19 VICE CHAIRMAN FUCHS: Right, so kind of to
20 Kent's point about the Canadian situation with
21 inter-switching. So, I remember reading this article
22 a few years ago, it was an interview with Hunter

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1 Harrison. And so, maybe you can apply that to both
2 railroads, when he was accepting the 2015 Railroader
3 of the Year Award.

4 And the question that was posed to him
5 was, you know, there's a regulatory situation in
6 Canada. There's some form of open access to a
7 limited extent. You don't seem to have a problem
8 with that. Some of the U.S. railroads are fighting
9 tooth and nail. What's the difference? How's it
10 work?

11 And he said, it's called inter-switching,
12 to some degree the U.S. is old reciprocal switching
13 pre-Staggers, it's one of the regs that are in place.
14 People don't take advantage of it. People really
15 don't take advantage of it because there's really no
16 need to if individual carriers do their job.

17 It's kind of something that can be called
18 a lever that you have over here if you need to be
19 used. My view is for years, a lot of railroaders
20 have been scared of the term open access, and I
21 don't know why. What it says to me is all we're
22 going to do is open up more competition with a

1 limited number of players in North America. It's
2 important to keep the competitive balance.

3 So, where was he wrong?

4 MS. GAINEY: And I'll chime in and say
5 that we're the U.S. regulatory lawyers, but our
6 understanding is, and to draw a distinction between
7 the two kinds of inter-switching in Canada, there's
8 regulated inter-switching that is in the 30 kilometer
9 zone. And that's been in effect since 1908. It was
10 originally adopted in Canada as a land use policy
11 because Canada did not want to have duplicative rail
12 lines being built in urban areas.

13 The other kind of inter-switching was
14 recently adopted, I believe in 2016, long haul
15 inter-switching and contracts to regulate
16 inter-switching that has a cost based rate. Long
17 haul inter-switching, the rate is supposed to be
18 based on a market rate or an average of comparable
19 rates.

20 VICE CHAIRMAN FUCHS: Right.

21 MS. GAINEY: I understand that there has
22 not been any cases under long haul inter-switching

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1 since that's been adopted.

2 VICE CHAIRMAN FUCHS: Why do you think
3 that is?

4 MS. GAINNEY: I won't speculate as to why
5 that is. I'm just aware that there have not been
6 any.

7 VICE CHAIRMAN FUCHS: CP, do you?

8 MR. WITTEBROOD: Specifically, the second
9 question?

10 VICE CHAIRMAN FUCHS: To Miss Gainey's
11 point about why do you think there hasn't been any
12 kind of long haul inter-switching. Why is that the
13 case?

14 MR. WITTEBROOD: Well, again I would be
15 speculating. We haven't been -- we haven't been
16 presented with any requests or from shippers that I'm
17 aware of for movements under long haul
18 inter-switching and the CTA recently said that they
19 haven't been presented either with any requests.

20 I would suspect that the reason is that
21 when shippers and the receiving railroads that they
22 would be negotiating with, when they look at the

1 move, at the end of the day it's the length of haul
2 and the efficiency of the route that drives the
3 decision.

4 So, they probably look at it and they
5 realize that the rate that they're going to get from
6 the receiving carrier plus whatever inter-switching
7 rate they're going to receive from the CTA, isn't
8 going to be very beneficial compared to the rate
9 they're receiving now, and they're also going to be
10 in court incurring delays due to.

11 VICE CHAIRMAN FUCHS: Do you think that
12 there's any mechanism or any reason for the incumbent
13 carrier in that type of regime to lower their rate?
14 So, in other words, to make sure that the incumbent
15 carrier rate stays lower than whatever that
16 alternative regime is that you're describing? If for
17 the new carrier, plus the inter-switching rate?

18 MR. WITTEBROOD: In order to maintain that
19 rate?

20 VICE CHAIRMAN FUCHS: Yeah. Do you think
21 that effect has taken place since 2016?

22 MR. WITTEBROOD: I know one instance where

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1 we had a negotiation where the shipper brought up the
2 idea of long haul inter-switching. And in that case,
3 we managed to negotiate an agreement that suited all
4 parties by taking over. We took over the long haul
5 portion of that.

6 VICE CHAIRMAN FUCHS: And can you
7 contrast, compare and contrast, long haul
8 inter-switching relative to bottleneck and relative
9 to reciprocal switching?

10 MR. WITTEBROOD: Well, the bottleneck
11 proposal, I think it's still fairly vague as to what
12 that means.

13 VICE CHAIRMAN FUCHS: Right.

14 MR. WITTEBROOD: So, I kind of interpret
15 that as all inter-switching. Reciprocal
16 inter-switching, I think it's been discussed.

17 VICE CHAIRMAN FUCHS: A little too graphic
18 in strength, right?

19 MR. WITTEBROOD: Yeah, it's in the -- the
20 way I think of reciprocal inter-switching, it's short
21 movement. And that's predominantly what we have in
22 Canada. The reciprocal inter-switching that we have

1 in Canada is limited to a 30 kilometer radius, so
2 just under 20 miles.

3 VICE CHAIRMAN FUCHS: So, to your eye,
4 does long haul inter-switching look much different
5 than bottleneck?

6 MR. WITTEBROOD: I mean operationally it
7 will probably be similar. In Canada, the regulator
8 has a specific methodology for determining.

9 VICE CHAIRMAN FUCHS: The access price,
10 right versus relative to the carrier setting the rate
11 and the Board then reviewing it.

12 MR. WITTEBROOD: Yes.

13 VICE CHAIRMAN FUCHS: But I guess I'm
14 wondering if Canada can -- and you know, there are
15 some differences in the Canadian/U.S. network, but
16 you know, I would say that Canada looks the most like
17 the U.S. of any country in the world when it comes to
18 the similarities of the rail network.

19 If Canada can implement a long haul
20 inter-switching that looks like bottleneck to your
21 eyes, then what you make of -- and there have been no
22 cases. What do you make of some of the testimony

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1 about the large scale operational effects?

2 MR. WITTEBROOD: It's very early to say
3 because I'll correct Ms. Gainey. It's actually only
4 since May of 2018, that we've had long haul
5 inter-switching.

6 VICE CHAIRMAN FUCHS: Yeah.

7 MR. WITTEBROOD: And so, since we haven't
8 had any cases, we're kind of waiting for that first
9 shoe to drop. And if it does, when it does, we're
10 wondering if that's going to open the flood gates or
11 not, for more cases. So, if that does happen, that
12 could have profound impacts for the network in
13 Canada.

14 At this point, there's no real evidence
15 one way or the other.

16 MS. GAINNEY: And the regulatory regime in
17 Canada is very different. They don't have a
18 statutory provision that gives the originating
19 carrier a right to the long haul.

20 VICE CHAIRMAN FUCHS: I'm only asking from
21 an operational, not a legal standpoint. But I take
22 your point.

1 BOARD MEMBER OBERMAN: I'd like to ask
2 both railroads to comment on the questions I asked
3 earlier about the stock buybacks, and Mr. Beyer, you
4 said you're in the capital markets trying to raise
5 capital. According to the numbers that we have from
6 your public filings for the last few years, just the
7 U.S. portion.

8 In the last three years you've spent 2
9 billion dollars on stock buybacks, and you spent 1
10 billion, roughly, averaging out over the last 3 years
11 per year in CapEx in the United States. So, you
12 spent twice as much on stock buy backs. So, where --
13 when you say you're in the capital markets, are you
14 out borrowing money to make stock buybacks? And if
15 so, why should rate payers be paying for that in a
16 regulated -- if a captive?

17 If you're not captive, you can invest as
18 much money as you want, but.

19 MR. BEYER: Okay. Maybe, if you permit, I
20 can just explain how we think about capital
21 allocation and then I can sort of, from that the
22 answer would flow. I'm not really -- I don't, I

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1 can't really think about buybacks in a geographic
2 way. Because if you go to the New York Stock
3 Exchange, or the TFX, it's neither here nor there.

4 Just to make the point that our buyback
5 budget is significantly smaller than our CapEx budget
6 on a sort of system-wide basis. But regardless, you
7 know, CN is generating operating cash flow,
8 obviously. And then there are three possible uses.
9 What the company can do with that cash flow.

10 One is to invest it in terms of capital
11 investment or M&A, or so grow the company. The other
12 is to repay debt, or build cash, so kind of manage
13 the balance sheet. And the third one is to return it
14 to the shareholders by way of dividends or share
15 buybacks.

16 So, the way we go about it every year, is
17 we say okay, what are all the investment projects
18 that the business is proposing, and do they
19 efficiently exceed what we believe the cost of
20 capital is that we require to satisfy the returns of
21 our, you know, debt holder and equity holder?

22 And once we've exhausted that list, and

1 that was 3.9 billion, for example, in 2019, a number
2 sufficiently larger than last year, and therefore we
3 actually reduced our total buyback in '19 compared to
4 last year, just as a side note.

5 So, once we've exhausted that list, well
6 then we say okay, so do I need to borrow, or do I,
7 you know, I want to maintain a certain debt ratio in
8 terms of -- and debt to capital and so forth, to
9 maintain a credit rating that we want to maintain,
10 and that determines how much I borrow or how much I
11 repay debt. And what is left over and returning to
12 my equity shareholder by way of dividends and share
13 buybacks.

14 Now, I believe that the fact that we are
15 paying a return to our owners is not an indicator of
16 whether or not we are revenue adequate or not. I
17 think our owners invest in us for that to be the
18 case. So, for instance, if we devised an objection
19 off of what the regulation was that whatever cash
20 flow is left over, just exactly covers the CapEx
21 numbers, that was possible. And investor in CN would
22 never receive one dollar, because it would always

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1 just be reinvested and therefore it wouldn't be an
2 investment that people would want to make.

3 And on that basis, we feel that share
4 buyback is a normal part of the business. It's
5 prevalent on the Class I railroads. It's also
6 prevalent among other industries. It's just a
7 mechanism to sort of pay, if you like, the return to
8 the equity holder.

9 Then there's the question of the
10 dividends, you know, why don't we just only pay
11 dividends? In the end, economically it's the same
12 thing. I'm returning capital to my shareholders.

13 In the railroad industry, we tend to have
14 a relatively low dividend because we are very capital
15 intensive. So that year after year I can size my
16 share buyback program to accommodate, you know, the
17 economic cycle, but also CapEx needs. Our CapEx
18 program went from, I think, \$3.4 billion to \$3.9
19 billion and we reduced the share buyback program to
20 enable those larger investments that we felt were
21 worth doing for the benefit of our shareholders, as
22 well.

1 BOARD MEMBER OBERMAN: But none of this
2 relates to having you attract new capital.

3 MR. BEYER: Yeah, I mean we are --

4 BOARD MEMBER OBERMAN: You don't need to
5 attract new capital?

6 MR. BEYER: Yes, we are in the fortunate
7 position at this moment that we generate cash, we
8 don't need to fund cash also.

9 BOARD MEMBER OBERMAN: And that's true,
10 actually, of all of the railroads right now, and it
11 has been for several years. My only question, and
12 this approach that you describe -- and I'm not a
13 business person. But in a non-regulated,
14 non-monopolistic setting, seems to me an appropriate
15 way to run a business.

16 Our statute gives us standards for what
17 captive shippers should be charged, and they don't,
18 it seems to me, include stock buybacks. It does
19 include allowing you to charge enough that you can
20 run your business and attract capital and make a
21 reasonable return.

22 But I don't see anything in here when you

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1 have the captive shipper situation. I'm not talking
2 about that 76 percent that everybody says is fine.
3 I'm talking about these folks over here or Olin, for
4 example, why should they be subject to a rate
5 increase that is essentially being used to fund a
6 stock buyback that's not making a capital investment?
7 I'm having trouble fitting that program you describe
8 into the statute.

9 MR. WARREN: Respectfully, Member Oberman,
10 I think that talking about the statute I feel like
11 it's sort of my purview. I mean I think the statute
12 pretty clearly says that you have a duty to assist
13 every railroad in becoming revenue adequate and
14 define revenue adequate in part, among many other
15 things, that where funds are supposed to fund being
16 able to attract or retain capital in amounts adequate
17 to provide a sound transportation system. And I
18 would submit that part of being able to attract and
19 retain capital means being able to provide a return
20 to shareholders that is on the same footing as the
21 companies with which railroads compete for capital.
22 Share buybacks are not just a railroad thing. It is

1 a very common way of returning value to shareholders.
2 And I think it's something that's consistent with the
3 statute. I think giving railroads the freedom to be
4 able to do that is required by the statute.

5 BOARD MEMBER OBERMAN: I'm sorry, go
6 ahead. No, please.

7 MR. BEYER: If I may, it's also the
8 concept of covering your cost of capital implies that
9 there is a return that is -- must be available for
10 the equity holders of the company.

11 BOARD MEMBER OBERMAN: One of the --

12 MS. GAINEY: And it's not just covering
13 your cost of capital. It's not just earning to the
14 0.001 percent your cost of capital, it's the
15 potential to exceed the cost of capital. That's what
16 it is that makes CN and any other publicly traded
17 company a good investment for equity and debt
18 investors.

19 MR. BEYER: And I think the fundamental
20 point is that even if I am not revenue adequate, I
21 could still have share buybacks because it is the
22 concept is that the equity, the return on equity,

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1 the -- can't remember now what number it is that the
2 STB is using.

3 It implies that that somehow has to be
4 crystalized by the shareholder. And the share
5 buyback is one mechanism to do that.

6 BOARD MEMBER OBERMAN: Well one of the
7 things that makes your investment attractive, is that
8 your stock has been going up through the roof. All
9 of them have in recent years, generally speaking.
10 And again, I'm not asking about a situation in which
11 there would be no stock buybacks.

12 We're only talking about measuring the
13 rate of increase for captive shippers for that
14 component of what you used for share buybacks,
15 because Coal Rate Guidelines suggest otherwise. And
16 to me, the statute, the RTP suggests otherwise. So,
17 you talk as though I'm asking about whether we should
18 have a system which eliminates all of your revenue
19 beyond your capital expenditure. I made no such
20 suggestion.

21 I'm suggesting that when we have a -- I'm
22 asking the question of when we have a cost of capital

1 figure that goes into a rate regulatory system, a
2 formula that affects captive shippers, I want you to
3 mark it down in situations, why should they be paying
4 that extra part because they're captive.

5 In a competitive situation, make as much
6 money as you can, and you will. You are. So, that's
7 what I'm trying to figure out how it relates to our
8 regulatory.

9 MR. WARREN: I think those captive
10 shippers have got -- have options with individualized
11 cases. And in fact, if they bring a SAC or a
12 simplified SAC case, they will not have to pay any
13 more than the cost of capital, because that's what
14 SAC and simplified SACs do, is they take that unit of
15 the network that's being replicated for the case, and
16 they, you know, take the, you know, appropriate
17 traffic group, in fact the shipper gets to select it,
18 and simplified SAC is easier because you just take
19 everything on the line.

20 And ultimately, the reasonableness of the
21 rate is judged on whether or not that rate produces
22 revenues that would be above the cost of capital for

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1 the replacement cost. It's that -- I think that that
2 may -- that actually may be coming around to SAC and
3 simplified SAC may be the more limited revenue
4 adequacy test that you're looking for, because that's
5 the one that actually makes somebody come in,
6 actually demonstrate that the railroad is earning
7 more than their cost of capital on the replacement
8 cost required to serve them. And if so, provides
9 targeted relief.

10 BOARD MEMBER OBERMAN: Well, I'm actually
11 not sure what I'm looking for something that complies
12 with our mandates with the Congress and I'm not sure
13 I know what that answer is yet. That's really the
14 purpose of my pointed questions. But two things,
15 Matt, that assumes that the shipper can bring a SAC
16 case practically. Of course, most can't. And two,
17 how do we measure the cost of capital, which is what
18 this discussion is about, directly goes in to what
19 that number comes out to be.

20 And so, to me the cost of capital under
21 the current formula includes the cost of the share
22 buybacks. And the question in my mind, as it's

1 applied to a captive shipper, is that really the
2 right way to do it given the statutory language.
3 And I barely understand the cost of capital, to be
4 honest with you, but as I understand it, it -- the
5 formula takes into account what's happening in the
6 market.

7 And just one final thing for Shelley. I
8 don't know that you have any more information than I
9 asked of Frank Chirumbole about Matt Rose's arrival
10 at 7 percent. Do you have any other insight into
11 that number?

12 MS. SAHLING-ZART: No, I just understand
13 it's a statement he made at a shareholder meeting.

14 BOARD MEMBER OBERMAN: Thank you. Unless
15 you want to add something more.

16 VICE CHAIRMAN FUCHS: Matt, could you
17 circle back to a question on the -- in the discussion
18 in the first panel. I just want to make sure I'm
19 fully understanding how you all expect the dynamics
20 to work under a replacement cost approach for revenue
21 adequacy. So, as you pointed out in your SAC test,
22 if the -- using replacement costs exceed the cost of

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1 capital the Board just takes it away and gives it out
2 to shippers, is that accurate?

3 MR. WARREN: Yes, more or less, yeah.

4 VICE CHAIRMAN FUCHS: And then I asked the
5 question, "well then how can a railroad ever have an
6 ROI over cost of capital," and it was conveyed to me
7 that it's making that on competitive traffic and
8 that's the way I took the response. And correct
9 me -- stop me if I'm wrong. Sorry?

10 MR. WARREN: No, I think that's right.

11 VICE CHAIRMAN FUCHS: Yeah, so I guess my
12 question is any time there's somebody who can make a
13 market dominant showing, anybody on that segment.
14 Let's say its 95 percent competitive traffic and
15 that's why the railroad is getting ROI over cost of
16 capital. If there's one -- the 5 percent is in a
17 market dominant situation. They can come in, do a
18 SAC test if it's accurate, and take all the ROI. All
19 the earnings in excess of the investment base, right?

20 MR. WARREN: Well, they wouldn't take all
21 of them because you know, under -- we skipped in MMM,
22 which --

1 VICE CHAIRMAN FUCHS: Yes, you know, but
2 they wouldn't get all of it.

3 MR. WARREN: They would just take part of
4 it to there.

5 VICE CHAIRMAN FUCHS: They would just take
6 their pro rata share, so whatever, the way it is
7 envisioned is whatever that railroad's earnings over
8 the investment base at a replacement cost is just for
9 the non-market-dominant traffic that was not taken
10 away, right, through MMM where the captive shipper
11 gets whatever their share is based on the R/VC ratio
12 pay-off and exhaustion rates.

13 So, the point is if we went to a
14 replacement cost basis for revenue adequacy,
15 everything over that threshold would necessarily be
16 all from non-market-dominant carriers, is that kind
17 of the logic behind the position?

18 MR. WARREN: Well, I mean I --

19 VICE CHAIRMAN FUCHS: Is that the right
20 way to look at it even?

21 MR. WARREN: Yeah. I mean I don't know if
22 this is a response exactly to your question, but I

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1 think one of the reasons that I don't know that the
2 analogy works perfectly, is that you have
3 cross-subsidy issues.

4 VICE CHAIRMAN FUCHS: Right.

5 MR. WARREN: That you have to worry about
6 that aren't just based on competitive versus
7 non-competitive, but are based on segments of the
8 network.

9 VICE CHAIRMAN FUCHS: Sure.

10 MR. WARREN: So, you could imagine if, you
11 know, if somebody had, you know, it was a relatively
12 short, you know, movement between a you know, a coal
13 plant and a mine, and you know, on it's own you
14 couldn't have -- you know, on it's own, but the SAC
15 test would support if the rate is reasonable. That
16 shipper then couldn't say well actually, you know,
17 over here there's a -- you know, really high density
18 intermodal line and I want to take it.

19 And if that's part of my stand-alone
20 railroad too, now all of a sudden like I'm going to
21 you know, have a reasonable rate. The Board has said
22 you can't do that, that's a cross subsidy.

1 VICE CHAIRMAN FUCHS: Right.

2 MR. WARREN: So, I think that's one reason
3 why you can't necessarily analogize exactly to what
4 replacement cost system-wide SAC would look like and
5 the outcomes of the individual SAC cases, because you
6 know, SAC is -- it is complicated.

7 And that's one of the reasons that the
8 Board worked so hard to develop Simplified SAC, which
9 is substantially simpler in many ways, and that's one
10 of the reasons the Board developed 3 benchmark, which
11 is designed to, in some ways, reflect
12 revenue-adequacy principles. It's ultimately not a
13 particularly accurate methodology, we think, but it's
14 certainly simpler.

15 VICE CHAIRMAN FUCHS: And I guess what I'm
16 driving at is the crux of -- so you have the legal
17 argument as to why revenue adequacy shouldn't be a
18 constraint, and the crux of the economic argument is
19 that because if you have replacement costs in both
20 areas, understanding that there's some issues on the
21 segment basis, the overwhelming amount of earnings
22 that exceed the replacement cost investment base on a

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1 system-wide basis, are going to be earnings that are
2 achieved from competitive traffic, not market
3 dominant traffic.

4 MR. WARREN: I think there's no -- you
5 can't tell. I mean I think you don't know. You've
6 got to do a more targeted inquiry to understand. And
7 I think the other thing, and we'll save this for the
8 first panel tomorrow morning, is I think that there
9 are pretty significant measurement errors in the way
10 that the Board is doing revenue adequacy right now.

11 And if you actually look at where
12 railroads are standing in the marketplace, I think
13 that leads to some different conclusions about RIC,
14 whether carriers are actually so close to revenue
15 adequacy now.

16 VICE CHAIRMAN FUCHS: Right, right, right,
17 okay. Thank you.

18 MS. GAINES: Patrick, you asked a deferred
19 taxes question of the last panel. Would you like us
20 to --

21 VICE CHAIRMAN FUCHS: Yeah, that'd be
22 great, that'd be great.

1 CHAIRMAN BEGEMAN: And then I have a
2 question or two, please.

3 MR. WARREN: So, we'll talk about this. I
4 mean I do think that, you know, one of the things as
5 you're thinking about you know, your methodology, one
6 of the things you do in the revenue-adequacy annual
7 determinations is that you take all deferred taxes
8 and you subtract them out of the investment base.

9 VICE CHAIRMAN FUCHS: Right, right.

10 MR. WARREN: Which is a methodology that I
11 think has been described in some of the comments as
12 one that we don't think is appropriate.

13 VICE CHAIRMAN FUCHS: Right.

14 MR. WARREN: Did that answer your
15 question?

16 VICE CHAIRMAN FUCHS: Yes.

17 CHAIRMAN BEGEMAN: So, to continue the
18 focus on the railroads instead of the shippers,
19 please excuse us, but you know, it's a real, I guess,
20 kind of benefit or an opportunity for us to ask you
21 questions since you have a different regime in Canada
22 and how things work.

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1 And as you know, there is a pending
2 competitive switching proposal that's -- I'll just
3 say it's pending, and I'd like to get a sense of how,
4 not actually how it works in Canada, but how often
5 are -- do shippers switch? Do they take, and it's
6 not the long haul question. You guys already
7 clarified that that has not been utilized yet.

8 But do the switches occur hundreds of
9 times a day? Do they occur almost never? It's just
10 that there is leverage that if someone wanted to,
11 they could. And also, in my question, I'd also like
12 to understand how many working interchanges are
13 there?

14 MR. WITTEBROOD: Yeah, the zonal
15 inter-switching, the reciprocal end switching is a
16 daily activity in Canada. In terms of actual car
17 numbers, I don't have that information. I don't
18 involve myself in the actual operational aspects of
19 it, but it's more than hundreds a day I would say.

20 However, my understanding is that most of
21 that is more related to physical access than it is to
22 competition in any way. And what I mean by that is

1 because we've had inter-switching since the early
2 1900's, that has impacted how we developed our
3 networks over the years and so, CN's and CP's
4 networks are largely parallel and for example, in
5 Vancouver, which is where I understand most of the
6 inter-switching occurs. Well, when I say most, it's
7 the definitely the biggest zone, somewhere between 25
8 and 50 percent I think of the zonal inter-switching
9 activity occurs in the Vancouver area. That's
10 largely because CN has operational access to the
11 north shore of the inlet and CP has access to the
12 south shore. So, what happens is CN and CP
13 respectively carry their line haul traffic into the
14 Vancouver area, and then we interchange it off with
15 our partner/competitor in Vancouver, in order to
16 finish off that -- what we call the last line of
17 access.

18 In terms of how many interchanges there
19 are, I don't actually have a number. I think it's
20 somewhere in the 10 -- the dozens range, a few dozen.
21 Is that fair do you think?

22 CHAIRMAN BEGEMAN: You could provide it

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1 for the record, that would be fine.

2 MR. WARREN: I do think, I don't want to
3 go from memory, but I believe in the Ex Parte 711
4 record there was some data on the number of
5 inter-switching points in Canada versus the United
6 States. And I think in Canada it was less than 100.
7 Whereas, in the U.S. potentially it would be
8 thousands, which it really was the difference.

9 CHAIRMAN BEGEMAN: And not to continue on
10 this charge longer because the clock is ticking, but
11 when the competitive switch, I'm sorry, the
12 reciprocal switches, is it at the request of the
13 shipper, or is it that part of this is just how
14 you're getting, I guess, you're almost completing
15 your long haul, if you will, for the shipper.

16 MR. WARREN: I'm stuck in -- I believe
17 that under the Canadian system the shippers have the
18 right under the statute, which they have had for a
19 few years.

20 CHAIRMAN BEGEMAN: Really, what I'm trying
21 to ask you and I'm not doing a good job of it, but is
22 it today they want the switch, or is it you know a

1 long time in advance?

2 MR. WITTEBROOD: It's much more the
3 latter. For most of our customers, obviously they're
4 recurring business. We just understand that this is
5 the origin, this is their destination, they require a
6 switch in Vancouver or under where it happens to be,
7 so, it's much more the latter.

8 CHAIRMAN BEGEMAN: So, just one last
9 question for and I guess I'll direct it to Kathy,
10 but -- and I'm not trying to gin anything up on the
11 uncertainty, but it was related to that discussion.
12 Did you have the opportunity to meet with the
13 Canadian regulators before they did various things
14 such as their long haul switching proposal, I assume?
15 And did you tell them it would be uncertain?

16 Or, maybe you're not provided that
17 opportunity. I'm just curious.

18 MS. GAINEY: We did, and we did. Yes, to
19 both questions.

20 CHAIRMAN BEGEMAN: Okay, Shelley?

21 MS. SAHLING-ZART: Can I comment on the
22 uncertainty issue because I spent the day

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1 listening --

2 CHAIRMAN BEGEMAN: I didn't mean to bring
3 that up, sorry.

4 MS. SAHLING-ZART: Listening to the
5 railroads talk a lot about uncertainty and they're
6 concerned about their profitability and their ability
7 to invest. And I think it needs to be said that
8 captive shippers have those same concerns about their
9 businesses. That's why we're here.

10 So, what we're asking you for is to
11 provide some balance and to provide us a mechanism
12 where captive shippers, more uniformly, will have a
13 process that they feel they can affordably access
14 that won't take 5 to 10 years, won't take 5 to 15
15 million dollars to find that certainty. So,
16 certainty cuts across the board.

17 CHAIRMAN BEGEMAN: So, just I guess I'll
18 have to speed my last question, I hope, and it will
19 be both Team Shelley and Team Kent. You know, the
20 Board has a number of regulatory proceedings pending,
21 a lot of -- some new ones, some old ones, the
22 demurrage stuff matters a lot to me, to us.

1 The rate reform proposals matter a lot to
2 me, to us. Some, you know, a number of them are
3 pending at this point or proposed and getting
4 comments and replies, and we are also exploring other
5 things such as the you know, what we're talking
6 about today, which again, has nothing -- although the
7 task force has these areas options in their report,
8 none of them are actually Board proposals.

9 So, I do want to make sure that's clear to
10 everyone. And we're just trying to really get a
11 better understanding of the various different
12 viewpoints, and you all have valid points, or at
13 least most of you do. And I'm not really just
14 referring to this panel, of course.

15 But you know, if you had to ask the Board
16 for like the one issue that you would wish that we
17 would tackle. You know, my days are numbered. I'm
18 not going to impose and see some type of revenue
19 adequacy constraint implemented and challenged and
20 upheld during my time as a member, and I care a lot
21 about the small shipper case improvements, et cetera,
22 but I'd be -- I'd like to know what your thoughts

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1 are.

2 MR. AVERY: Well, I believe that if you
3 allow -- if you create competition by having each
4 industry the ability to have a choice in carriers, to
5 be able to choose and to be able to negotiate, I
6 think that's going to be more powerful and more
7 impactful and it's going to greatly reduce the need
8 for rate cases, it's going to greatly reduce the need
9 for demurrage and accessorial issues, so.

10 CHAIRMAN BEGEMAN: I probably should have
11 cabined my question to things that I did not dissent
12 on.

13 MS. SAHLING-ZART: Yeah, and that's tough
14 without conferring with our membership, but I would
15 say my perception right now is that there are some
16 issues that are going to take a little longer to
17 figure out. I think the most immediate one you can
18 have the biggest impact on would probably be the
19 demurrage and the accessorial charges, and fixing
20 that, especially in light of PSR, but probably close
21 behind that would be the rates.

22 BOARD MEMBER OBERMAN: When you say the

1 rates, you mean the final --

2 MS. SAHLING-ZART: Without looking at the
3 simplified SAC, there's probably several things
4 because different size shippers are going to access
5 different methodologies, right?

6 MS. GAINNEY: Can we answer the question as
7 well?

8 CHAIRMAN BEGEMAN: No, of course. Doing
9 nothing, I believe, was going to be the answer.

10 MS. GAINNEY: No, actually, it's not. Our
11 view is that the Board should concentrate its efforts
12 in, given your limited time left, on reforming the
13 rate reasonableness methodologies to make sure that
14 small shippers have a way and an avenue for their
15 cases to be heard.

16 And whether that's through revising the
17 ADR regulations that the Board has, or revising the 3
18 benchmark methodology.

19 BOARD MEMBER OBERMAN: I didn't hear a
20 final offer in that list.

21 MS. GAINNEY: We've submitted our comments
22 on final offer.

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1 CHAIRMAN BEGEMAN: Look, thank you so much
2 really, even though you were the last panel, you were
3 just as informative as the first and we really
4 appreciate your input and your participation, thank
5 you.

6 We'll see you tomorrow at 9:30.

7 (Whereupon the meeting was adjourned at 5:58
8 p.m. to reconvene tomorrow at 9:30 a.m.)

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