Freight Rail
Customer Alliance

November 25, 2019 By Electronic Filing

Cynthia T. Brown
Chief, Section of Administration
Office of Proceedings
Surface Transportation Board
395 E Street, S.W.
Washington, D.C. 20423-0001

Re: EP 761, Hearing on Revenue Adequacy
EP 722, Railroad Revenue Adequacy

Dear Ms. Brown:

The Freight Rail Customer Alliance ("FRCA") submits the following comments in response to the Notice of Public Hearing ("Notice" or "Proposal") that the Surface Transportation Board ("Board" or "STB") served in the above-captioned proceeding on September 12, 2019.

FRCA is an alliance of freight rail shippers impacted by continued unrestrained freight rail market dominance over rail-dependent shippers. FRCA represents large trade associations that in turn represent more than 3,500 electric utility, agriculture, chemical, and alternative fuel companies and their customers.

FRCA previously filed a notice of appearance for its President, Shelley Sahling-Zart, Vice President and General Counsel of FRCA-member Lincoln Electric System ("LES"), to appear at the hearing. This letter constitutes FRCA's written testimony.

1. A straightforward and effective revenue adequacy rate constraint is vitally needed as an alternative to stand-alone cost and the other existing maximum rate reasonableness methodologies.

FRCA very much welcomes the Board's initiative in proposing to develop and implement a meaningful revenue adequacy constraint at this time. FRCA fully agrees with the premise of the Board's Rate Reform Task Force ("RRTF") and its Report ("RRTF Report") that the Board's existing rate reasonableness methodologies need substantial improvement.

With the smallest exceptions, rate cases to date have focused on the stand-alone cost test ("SAC"), with all of the difficulties of having to work with replacement costs. As a result, there has not been, in practice, a meaningful rate constraint for many captive shippers, especially small shippers that otherwise do not have an effective path to rate relief. SAC has worked for just some of the largest shippers, and even then, only those with unit-train movements. Even unit train shippers have found SAC very expensive and time-consuming to pursue, as LES can attest from its own direct experience in the

Western Fuels Association/Basin Electric Power rate case against BNSF that continued for over a decade.

Simplified SAC is also very expensive and has not been invoked since the limit on rate relief was removed. RRTF Report at 42. The Three-Benchmark approach offers limited rate relief, is not inexpensive by any means, exposes shippers to high rates because other, supposedly similarly situated shippers pay high rates, entails considerable uncertainty, and has not attracted significant shipper interest.

For most shippers, the STB simply has not provided an effective means to prevent rate abuse. This reality should change, especially as the carriers have achieved revenue adequacy. There is thus a vital need for a straightforward and effective revenue adequacy rate constraint to serve as an alternative to stand-alone cost and the other existing rate reasonableness methodologies that can apply more broadly and at lower cost.

FRCA thus welcomes the Board's revenue adequacy proposal at this time. However, there are a number of deficiencies in the Board's proposal, particularly as it represents significant steps backwards from the revenue adequacy constraint adopted in *Coal Rate Guidelines*, as compounded by the fact that the Notice and the RRTF Report do not begin to provide any sort of reasonable explanation for those steps backwards.

FRCA also awaits some proposal or further action from the Board regarding the RRTF's proposal for a new rate constraint in the form of Incumbent Network Cost Analysis ("INCA"). While INCA is not fully fleshed out in the RRTF Report (a problem that also applies to revenue adequacy), it has considerable potential, and its development should not be delayed.

2. The Board's proposed method for ascertaining revenue adequacy requires an accurate measurement of the cost of capital and the return on net investment, which are both deficient at this time.

The Board proposes to ascertain revenue adequacy by considering whether a carrier's return on net investment ("ROI") exceeds the railroad industry average cost of capital ("COC") based on a multiple-year average of varying length selected to track the business cycle.

That choice is suspect. Investors normally consider a range of factors in deciding whether an investment provides an adequate return, rather than focus on just one. Moreover, whether a carrier is able to attract sufficient capital is something that should be directly observable. Instead, the Board proposes to rely on the COC, which the Board has repeatedly stated is not directly observable, and therefore subject to uncertain modeling.

Nonetheless, if the Board wishes to rely on just two elements, the COC and the ROI, it should also focus efforts to reconfigure the calculations so that they accurately reflect investor expectations. In particular, the Board determined a railroad industry COC for 2018 of 12.22%, whereas respected Wall Street analysts and even BNSF Executive Chairman Matt Rose, before his departure from the carrier, put the figure at 7%. Using a COC figure that is overstated by 70% grossly distorts the Board's analysis. FRCA hopes that this matter will receive full consideration in the Board's EP 664 (Sub-No. 4) proceeding.

In addition, the Board's ROI calculations ignore the $9 billion of income that the Class I railroads achieved in 2017 due to the tax cut and the associated reduction in their deferred tax liabilities. The Board's decision to exclude that income from the 2017 annual revenue adequacy determination may be, perhaps, understandable insofar as it would have caused the 2017 "snapshot" to depart from those of adjacent years, but that magnitude of income should not be simply ignored for purposes of considering the adequacy of railroad return and income over a multi-year period.

In short, if the Board wishes to ascertain revenue adequacy based on the relationship between the COC and the ROI, it needs to get both right, and it has not done so.

FRCA opposes any effort to ascertain revenue adequacy based on the railroads' replacement cost of assets. Ascertaining replacement costs is inherently problematic and is major reason why SAC and Simplified SAC have been expensive and of very limited effectiveness in practice. The railroads are not entitled to, and should not receive, a return on investments they have not made and may never make. A relevant consideration is their ability to make those investments when they are needed, but the railroads have shown no difficulty in that regard for at least twenty-five years (*e.g.,* all the money went into the merger acquisition premiums could have been spent instead on the monies spent in actual capital and operational investments).

The problem has instead been the railroads' unwillingness to make those investments, particularly when they perceive they can improve their financial performance by reducing capacity and driving rates up. The current infatuation with precision scheduled railroading ("PSR") is merely the latest example. Allowing the railroads to receive a return on the replacement cost of assets they have not replaced will only exacerbate the problems of excessive rates and underinvestment.

3. Use of a varying multi-year time period to measure revenue adequacy is inherently problematic, and the Board should instead use a rolling average of a fixed length.

If the Board is determined to measure revenue adequacy based on the COC and ROI, use of a multiple-year averaging period is useful since any single year's results will vary and may not be representative of longer-term reality. The Board proposes to use a measuring period of varying length in order to track the business cycle.

While the relationship between COC and ROI may vary based on the business cycle, the length of the business cycle cannot be known in advance, the rail business cycle does not necessarily conform to the general business cycle, and railroads can perform well even when their volumes decline (*e.g.,* 2019 to date). In short, trying to capture the business cycle is inherently problematic.

The more practical problem is that lengthening and then truncating the business cycle causes different years to be assigned different weights. If there are five years, each year has a weight of 20%, but if they are eight years, each year as a weight of 12.5%. A year that is added relatively late when the measuring period is expanding, and then removed relatively early when the measuring period is curtailed, will likely receive less weight compared to other years that are included at the beginning of the cycle. The multiple-year average will then be biased because some years will end up having more weight than others.

These are the same problems that caused the Board and its predecessor, the Interstate Commerce Commission, to recognize the folly in trying to capture the business cycle for purposes of measuring productivity for the Rail Cost Adjustment Factor (RCAF) and to adopt the RCAF-5. The Board should learn from its past experience and use a rolling-average of fixed length to measure revenue adequacy. Five years, the period used to measure RCAF productivity, appears adequate, although a longer averaging period may contribute to greater stability.

4. The proposed rate increase constraint should apply fully to all captive rates, as *Coal Rate Guidelines* specifies, and not just selectively, as the RRTF proposes.

The revenue increase constraint adopted in the *Coal Rate Guidelines* applies fully to all captive rates of a revenue adequate carrier. Once a carrier achieves revenue adequacy, a shipper that demonstrates market dominance is protected from rate increases in excess of costs, unless the carrier makes a special showing. The stated justification is that there should not be further differential pricing once a carrier achieves revenue adequacy on a long-term basis; at that point, the carrier is earning sufficient revenue to cover its costs, maintain its system, and attract capital, and further exploitation is not needed. Where there is protection, it applies equally, regardless of the revenues to variable cost ("R/VC") ratio of the individual movement. The revenue increase constraint established in the *Coal Rate Guidelines* is simple and straightforward, especially compared to SAC as it has evolved in practice.

The RRTF Report and Notice complicate and corrupt that basic concept. Rates and movements, at least those above the jurisdictional threshold, for a revenue adequate carrier are broken into an unspecified number of categories based on unspecified criteria by an unspecified entity. A share of the carrier's indexed average revenue adequacy surplus is then assigned to each rate category based on that category's share of total carrier revenues from movements with R/VC ratios exceeding the jurisdictional threshold. The assigned surplus is then allocated to individual movements within each category on a declining R/VC ratio basis using the Maximum Markup Methodology ("MMM") borrowed from SAC. The R/VC ratio at which the category's surplus is exhausted becomes the R/VC cutoff. Rates in that category falling at or above the R/VC cutoff (which varies from category to category) would be protected from further increases in excess of inflation as measured by the RCAF-U. Rates falling below could be increased up to the R/VC cutoff.

The proposal is defective for many reasons, and FRCA will note only a few:

- First, the Notice's proposal allows for additional increases for those rates falling below the cutoff. The proposal thus allows for further exploitation of captive traffic beyond the level needed to achieve and maintain revenue adequacy, in direct contravention of *Coal Rate Guidelines*.

- Second, no justification is given for this substantial reduction in the level of protection established in *Coal Rate Guidelines*. While a MMM-type approach might make, perhaps, some sense for allocating rate reductions, the rate increase constraint does not entail affirmative reductions, only protection from further increases and additional exploitation.

- Third, URCS and the resulting R/VC ratios are too crude and arbitrary a tool to be applied in this manner, as explained in the 2015 Transportation Research Board Report, *Modernizing Freight Rail Regulation,* and reaffirmed by its authors in their October 29, 2019 comments submitted to this Docket and to Docket Nos. EP 755 and EP 756 on October 17, 2019. Movements may appear to have the same variable costs, when their actual variable costs are very different, and vice versa. Fourth, there are numerous problematic boundary area issues, such as how categories are defined, and why issue traffic belongs in one category and not another. For example, a movement of 999 miles might have a relatively low R/VC ratio compared to an otherwise identical movement of 500 miles, but a relatively high R/VC ratio compared to one of 1,000 miles, creating conflict over where seemingly arbitrary lines are drawn. Fifth, the R/VC cutoff is apt to vary year-by-year, carrying the risk that rates will be allowed to increase to a higher R/VC in one year, but not required to decrease in a following year, enabling the carriers to lock-in excessive rate increases that would not have been permitted in the first place.

In contrast, the *Coal Rate Guidelines* approach is simple, fair, established, and justified. It should be retained, especially as it is now apparent that the Class I railroad industry, or nearly all of it, has achieved revenue adequacy. Furthermore, permissible rate increases should be governed by cost index such as the RCAF-A or RCAF-5, and not an input price index such as the RCAF-U, which is apt to enable rates to increase above the R/VC cutoff.

Also, it should be recognized that the revenue adequacy rate constraint in the *Coal Rate Guidelines* is not a cap on railroad rates, revenues, or earnings, and will not discourage investment. Increased investment will equate to higher costs, all other things being equal.

5. FRCA supports the suspension of the Bottleneck Rate protections for revenue-adequate carriers.

Currently, obtaining a rate for a bottleneck segment generally requires that a shipper obtain a contract rate for the competitive segment of the movement or undertake a "competitive access" case, which usually entails showing that the bottleneck carrier has engaged in anticompetitive conduct. Contract rates for the competitive segment are seldom obtainable, apparently because carriers fear the retaliation from competitors that would result elsewhere, and both carriers perceive that they better off limiting the competition between themselves. Competitive access cases are very difficult and rare.

The Board's proposal is that a shipper would be able to proceed with a bottleneck rate case against a revenue adequate carrier. The rationale is that since the carrier has already achieved revenue adequacy, there is an opportunity to harness the benefits of competition.

FRCA supports the Board's proposal. The Board's limitations on bottleneck rates are overly restrictive to begin with, and rate relief should be more readily available from a revenue adequate carrier than a revenue inadequate one. The revenue adequate carrier with a bottleneck segment will still have more than adequate protection available, *e.g.*, the market dominance requirement, the SAC test, etc. Furthermore, allowing bottleneck rate relief may resolve many of the elements that have made the Board's competitive switching proceeding so problematic.

However, the Board's proposal will be of little practical significance if the carriers on the so-called competitive segment do not actually compete. The presence of a second carrier, *i.e.,* a duopoly, is hardly sufficient to ensure competition.

6. FRCA supports allowing a shipper to reinstate the simplified road property investment analysis in a Simplified SAC rate case against a revenue-adequate carrier, but the simplification should be at the shipper's option.

The RRTF Report observed that one reason Simplified SAC has not been invoked is because of the need to make a full showing of Road Property Investment ("RPI"). A simplified RPI showing was previously part of the Simplified SAC test, but was removed when the $5 million limit on rate relief was removed. RRTF Report at 42. The Board proposes to reinstate the RPI simplification for revenue adequate carriers.

FRCA supports the proposal, but submits that the use of the RPI simplification should be at a shipper's option, and not compelled by the Board. A shipper might reasonably conclude that it would prefer to make a full RPI showing, and it should have that choice, especially since the purpose of Simplified SAC is, as with SAC, to identify the *lowest* cost at which a hypothetical least-cost, most-efficient competitor could provide replacement service. The RPI simplification could result in a higher rate than a full RPI showing, and a shipper should not have to pay a higher rate because a carrier has achieved revenue adequacy.

FRCA recognizes that the RRTF Report proposed eliminating Simplified SAC for non-revenue adequate defendants in favor of INCA, but the Board has not issued any notice for INCA, nor has it proposed to eliminate Simplified SAC where a carrier is revenue inadequate.

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To conclude, FRCA thanks the Board for issuing its Notice. The Board's revenue adequacy proposals represent good steps, but they need significant improvement, as explained in FRCA's comments. FRCA looks forward to appearing at the Board's hearing.

Respectfully submitted,

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