

BEFORE THE  
SURFACE TRANSPORTATION BOARD

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Ex Parte No. 705  
*COMPETITION IN THE RAILROAD INDUSTRY*

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SUPPLEMENTAL COMMENTS  
of the  
INTERESTED PARTIES

The Interested Parties<sup>1</sup> appreciate the Board's keeping the record open in this proceeding and will use this opportunity to respond to some of the questions posed by the Board at the hearings on June 22 and 23, 2011, and to summarize specifically what the Interested Parties believe the Board should do in response to the comments and hearing testimony.

The Interested Parties also wish to respond briefly to a few of the main themes expressed by rail witnesses at the hearing, because we believe those remarks fundamentally misconstrue the nature of competitive access remedies, and misstate the likely economic consequences of a more pro-active policy on rail competition.

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<sup>1</sup> The Interested Parties include the following organizations: Alliance For Rail Competition, The American Chemistry Council, American Forest And Paper Association, American Public Power Association, The Chlorine Institute, Colorado Wheat Administrative Committee, Consumers United For Rail Equity, Edison Electric Institute, Glass Producers Transportation Council, Idaho Barley Commission, Idaho Wheat Commission, Kansas Wheat Commission, Large Public Power Council, Montana Farmers Union, Montana Wheat & Barley Committee, National Association Of Wheat Growers, National Grain And Feed Association, The National Industrial Transportation League, National Rural Electric Cooperative Association, Nebraska Wheat Board, Oklahoma Wheat Commission, Portland Cement Association, South Dakota Wheat Commission, Texas Wheat Producers Board, The Fertilizer Institute, U.S. Clay Producers Traffic Association, and Washington Grain Commission.

**I. Response to Railroad Contentions at June 22-23, 2011 Hearings**

**A. Competition Will Benefit the Entire US Economy, Not Just Shippers**

The remarks of the railroad witnesses at the hearing repeatedly returned to the theme that increased competition sought by proponents of competitive access was simply "a matter of price" and that "only a few shippers" would benefit from the more competitive rates that would result, effectively amounting to a one-time transfer of money from the pockets of the railroads to the pockets of shippers.

In actuality, the entire US economy would benefit from easing the stranglehold that the big four railroads have over the shipment of the basic commodities on which our economy depends – the products of agriculture, forestry, mining and industry. The reason that the United States enforces its antitrust laws is to preserve competition so that market forces can price goods in accordance with demand and, in the words of economists, "allocate resources most efficiently." Real and vigorous competition leads to the highest levels of investment, innovation, service and consumer welfare and, yes, it leads to competitive pricing as well. Competition does not involve a zero-sum game in which there are winners and losers, but rather expanding the economic pie so that everyone can have a bigger piece. As Commissioner Mulvey pointed out at the hearing, Mr. Buffett of Berkshire Hathaway, in acquiring BNSF, was "betting on America." The Interested Parties, representing a broad cross-section of American businesses, are convinced that the American economy can flourish as never before if they are able to transport their goods at reasonable and competitive rates. And that will benefit the railroads as well.

## **B. Increasing Competition Will Not Undermine Railroad Investment**

Another theme of the railroad witnesses was that, while railroads face and deal with intense competition every day, a small amount of "artificial competition" created by the exercise of the Board's statutory powers would quickly bring them to financial ruin. In truth, there is no way to differentiate between different types of competition, or to call one "natural" and another "artificial." Shippers might, with equal force of reason, complain that the current rail systems of the big four railroads are "artificial" because they are the product of government-approved mergers and/or restrictions upon competition.<sup>2</sup> What shippers seek is simply a better balance. A reasonable way of thinking about this is as an adjustment necessitated by the increased market power gained by the railroads in the mega-mergers, and the merging carriers' notable failure to keep their promises that they would compete vigorously after the mergers.

Yet another theme of the railroads at the hearing was that they must charge monopoly, non-competitive prices because this is the only way they can earn adequate revenues and attract investment capital. But common sense shows this contention to be incorrect. For example, Mr. Ward of CSX touted the large investments in raising tunnel clearances to permit direct routing of double stack intermodal traffic from ports to inland hubs in the Midwest. Yet clearly intermodal traffic is competitive, and so these projects demonstrate that railroads are willing to make capital investments even when those investments will benefit solely competitive traffic.<sup>3</sup>

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<sup>2</sup> For example, the Board's current "Bottleneck" rate policy allows railroads to artificially restrict competition by extending their bottleneck segment monopolies to downstream competitive segments.

<sup>3</sup> This and a similar project by the Norfolk Southern also received assistance from state and federal grants, notwithstanding the repeated assertions by AAR President Hamberger at the hearing, and by the AAR in full page newspaper ads, that railroad investments are being made without "taxpayer money." See, e.g., *Railway Age*, March 9, 2011, <http://www.railwayage.com/breaking-news/aar-class-i-s-to-invest-12b-in-2011-capex.html>.

In fact, basic economics shows that investment is stimulated, not deterred, by increasing competition, and specifically by the type of access remedies at issue in this proceeding. Dr. Willig and his colleagues, in a paper prepared on behalf of AT&T, examined interconnection in the telecommunications industry and found specifically that increased access would stimulate, not deter, investment:

The increased competition enabled by UNEs [unbundled network elements] can be expected to result in lower retail prices both because of the efficiency improvements induced by competition and because of the pressure competition places on above-cost pricing. Lower prices will result in increased demand. The growing demand will induce additional facilities investment by [incumbent carriers and entrant carriers]. Additionally, in a competitive environment, both the incumbent and the entrant will face enhanced incentives to improve quality and innovate with respect to services, leading to further investment.

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[O]ur results unambiguously refute the *Investment Deterrence Hypothesis*, and provide strong support for the *Competitive Stimulus Hypothesis*. Overall, we estimate that a 1% *reduction* in UNEs rates corresponds with approximately 2.1% to 2.9% *increase* in [incumbent carrier] investment. Thus, restricting access to UNEs, as the [incumbents] advocate, would *both* reduce the competitive alternatives available to consumers *and* reduce the [incumbent's] capital spending in their networks.

Robert D. Willig, William H. Lehr, John P. Bigelow, and Stephen B. Levinson "Stimulating Investment and the Telecommunications Act of 1996," white paper prepared on behalf of AT&T, October 2002. See copy attached.

In sum, a rebalancing of rail competition policy is not about transferring money from one industry to another -- it is about making the economy stronger for everyone.<sup>4</sup>

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<sup>4</sup> The Interested Parties emphasize that the Board's statutory authority to implement competitive access remedies does not depend upon whether or not railroads have technically achieved revenue adequacy under the Board's standards. In fact, the Staggers Act granted the ICC its competitive access authority at a time when the consensus was that railroads were not revenue-adequate. To the extent the Board currently deems any Class I railroad to be revenue-inadequate, notwithstanding the compelling evidence to the contrary seen every day in the financial marketplace, the Interested Parties submit that the Board should reopen and reexamine its revenue adequacy standards.

**C. Railroads Do Not Have Unique Capital Needs**

It is also a myth that rail carriers have unique capital needs that make them unlike other industries such as utilities and telecommunications. If so, this would be news to Warren Buffett, who in buying the Burlington Northern stated that he viewed BNSF as similar in many ways to the electric and pipeline utility companies already owned by Berkshire Hathaway, and that BNSF would therefore be included in the "regulated utility" section of Berkshire Hathaway's reports. See Berkshire Hathaway 2009 letter to shareholders at p. 9, available at: <http://www.berkshirehathaway.com/letters/2009ltr.pdf>. In short, Mr. Buffett, the person actually supplying the capital, and presumably in the best position to say why the capital was supplied, does not view the railroads as different or special, but very much like other capital intensive regulated industries.

**D. Increased Competition Would Not Prevent Differential Pricing**

Finally, it is not true that making competitive access remedies available to shippers would prevent railroads from engaging in differential pricing. Differential pricing and competition are not inconsistent. Many competitive industries, including the industries of several Interested Parties, engage in differential pricing. Their ability to do so, however, is capped by the competitive markets for their goods. The stand-alone cost ("SAC") standard for reasonable rail rates also caps a railroad's ability to differentially price by simulating a competitive rate. But rate reasonableness challenges are very expensive, and the policy of the statute is that competition rather than regulation be the preferred means of establishing reasonable rates. Hence the Interested Parties are merely asking the Board to rely to a greater extent on real competition rather than simulated competition to set rates.

## **II. Response to Specific Board Questions**

### **A. If Railroads Do Not Compete Now, Why Would Access Make Them Compete?**

We share the Board's concern. It may turn out that railroads will refuse to take advantage of the ability to provide new competitive service to shippers. For this reason, we have in our comments called upon the Board to make use of statutory remedies going beyond competitive access. See the following section.

We also believe, however, that increasing the number of points where competition is possible will gradually lead to a competitive dynamic in which more traffic is in play in more contracts, leading to more potential and actual shifts of traffic, and a more proactive stance on the part of railroads to compete for business. We underline that we believe most of the activity will not be at the Board, but rather in private negotiations. The dynamic of those negotiations, however, is crucially dependent upon the availability of access, and of clear standards for obtaining other credible remedies at the Board, as outlined in the following section.

### **B. Would Shippers Prefer Access, or Better Reasonableness Remedies?**

The Interested Parties believe that the lack of competition between two railroads today is greatly facilitated by the small number of locations and movements where there is even the potential for rail-to-rail competition. Increasing competitive opportunities through reciprocal switching will decrease the ability of carriers to engage in parallel behavior, and as noted, competition is the preferred means under the statutory rail transportation policy for establishing reasonable rates. But the Board also needs to consider reforms to its rate regulation process for those shippers who still would not benefit from rail competition.

Immediate reforms for small rate cases are relatively easy and simple. The goal should be to have a relatively inexpensive proceeding available to shippers who, regardless of the size of

their companies, do not ship large volumes throughout the year on the same traffic lanes, but rather have a more diffuse pattern of movement. The existing small rate case process fails to fulfill this goal because the relief caps preclude effective remedies that warrant the lower, but still significant, litigation costs. The Board's rationale for imposing relief caps was "to encourage complainants to use the method best suited to the amount in dispute," due to the less precise nature of the Three-Benchmark standard for small rate cases. See, STB Ex Parte No. 646 (Sub-No. 1), *Simplified Standards for Rail Rate Cases*, pp. 7-8 (served March 19, 2008). But the reality is that the imprecise nature of the Three-Benchmark approach tends to produce higher prescribed rates than the more precise SAC approach, because the Three-Benchmark approach is based on comparisons with other rail rates, which in a world of reduced rail competition results in comparisons with other rates that also are exceedingly high. Similarly, most of the simplifications in the Simplified-SAC approach produce higher prescribed rates by removing the shipper's ability to address efficiencies. Consequently, complainants have ample incentive to use SAC even without relief caps. But many complainants, for whom SAC still remains too costly given the value of their case, find that Three-Benchmark and Simplified-SAC also are too costly given the capped value of their case. Therefore, the Board should remove the small rate case relief caps.

The Interested Parties also endorse a very simple change to the Board's market dominance standards which would accord with the clear testimony at the Board's hearing in this matter that the presence of two railroads does not guarantee rail-to-rail competition, because railroads do not always choose to compete. Specifically, the Board should adopt a policy that makes clear that a rail customer's physical access to more than one Class I railroad creates only a rebuttable presumption that the rail customer is not subject to market dominance, but that the

presumption can be overcome by evidence that one of the two railroads is not effectively competing for the rail customer's business.

Finally, making rate reasonableness remedies available for bottleneck segments is a key. As the Interested Parties requested in their April 12, 2011, comments (at 44-46), the Board should repeal the outdated bottleneck doctrine and enable shippers to request rates to any reasonable interchange point, so that, if railroads fail to offer competitive joint rates, the shipper can if necessary challenge the bottleneck segment components of a combination rate. Again, the Interested Parties anticipate that, as soon as the ability to request and challenge such rates were established at the Board, parties would be likely to resolve most such disputes by negotiation.

**C. What Specifically Should the Board Do Now?**

The Board should reexamine and change its policies relating to rail competition, including the policies for implementing terminal access, reciprocal switching, and bottleneck rate relief. The Interested Parties note that these remedies are interrelated, and that the effectiveness of one remedy may depend upon the availability of another. Ultimately, however, the Board may choose to consider these remedies in a single proceeding, or in several separate proceedings.

**1. Terminal Access**

The Board should adopt a policy of requiring terminal access under 49 U.S.C. 11102(a) whenever such access is practicable (i.e., would not substantially impair the ability of the incumbent carrier to handle its own traffic). The Board should make a general finding, based on the record in Ex Parte No. 705 and the new proceeding, that requiring such access is in the public interest in order to remedy a general lack of rail-to-rail competition following the mergers which led to the current structure of Class I railroads in this country, including a failure of merging carriers to engage in vigorous competition as they promised in those merger proceedings. That

general finding could be revisited at a later date if the Board finds that competitive balance has been restored. The pricing of terminal access should be a cost-based standard under which costs shall not include "opportunity costs" or elements consisting of monopoly rents or premiums.

In the new proceeding, the Board should seek comment on (1) details of a cost-based access pricing formula, (2) definition of terminal facilities, and (3) standards for railroad evidence showing impairment of incumbents' ability to handle their own traffic.

## **2. Reciprocal Switching**

The Board should adopt a policy of requiring reciprocal switching under 49 U.S.C. 11102(c) based upon a general finding, from the record in Ex Parte No. 705 and the new proceeding, that requiring such access is in the public interest and is necessary to provide competitive rail service. This is necessary in order to remedy a general lack of rail to rail competition following the mergers which led to the current structure of Class I railroads in this country, including a failure of merging carriers to engage in vigorous competition as they promised in those merger proceedings. That general finding could be revisited at a later date if the Board finds that competitive balance has been restored. The pricing of reciprocal switching should not include "opportunity costs" or elements consisting of monopoly rents or premiums, such as efficient component pricing. In the new proceeding, the Board should seek comment on standards for determining a reasonable switch rate

## **3. Bottleneck Rates**

Shippers should have the ability to request carriers to quote rates over bottleneck segments, and to challenge those rates, as stated previously.<sup>5</sup> The Board in its proceeding on rail

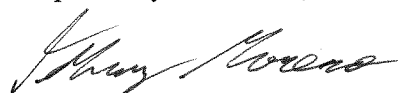
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<sup>5</sup> The Board should also be clear in its new policy that railroads participating together in a through route may not discuss between themselves the pricing of their separate components of the combination rate.

competition policy should make a general finding that, in order to remedy a general lack of rail-to-rail competition following the mergers which led to the current structure of Class I railroads in this country, including a failure of merging carriers to engage in vigorous competition as they promised in those merger proceedings, such rates and the routes for which they are requested are, in accordance with 49 U.S.C. 10705(a)(2)(C), "needed to provide adequate, and more efficient or economic, transportation." That general finding could be revisited at a later date if the Board finds that competitive balance has been restored.

In any event, so long as it is generally the case that the non-bottleneck carrier will not offer a shipper a transportation contract so that the shipper is entitled to a "bottleneck rate," as was stated without refutation by several shipper witnesses at the hearing, the Board's assumption in its "bottleneck rate" decisions that such contracts would be provided has proven not to be correct. Therefore, the Board's "bottleneck rate" policy also should be re-examined for that reason.

Respectfully submitted,



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