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News Update
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ARC Leads Shipper Groups in STB Filing

On September 27, ARC filed comments with the STB calling for changes in railroad industry cost of capital standards. In this move, ARC partnered with Montana Governor Brian Schweitzer, and was joined by a number of rail shippers of agricultural commodities.

This proceeding is especially important because it may lead to recognition that the nation's major railroads are financially strong and do not need to be protected from competition. For decades, erroneous cost of capital standards have exaggerated the railroads' financial need, even at times when they had no trouble raising capital in the financial markets. If the STB adopts the changes put forth by ARC and its partners, the shipper concerns will start receiving even more attention in Washington.

Attached are the comments of Governor Brian Schweitzer, on behalf of himself, ARC, and listed shipper groups.

BEFORE THE

SURFACE TRANSPORTATION BOARD

EX PARTE NO. 664

METHODOLOGY TO BE EMPLOYED IN DETERMINING THE
RAILROAD INDUSTRY'S COST OF CAPITAL

OPENING COMMENTS OF
THE HONORABLE BRIAN SCHWEITZER, GOVERNOR, STATE OF MONTANA
ALLIANCE FOR RAIL COMPETITION
MONTANA WHEAT & BARLEY COMMITTEE
COLORADO WHEAT ADMINISTRATIVE COMMITTEE
COLORADO ASSOCIATION OF WHEAT GROWERS
IDAHO BARLEY COMMISSION
IDAHO WHEAT COMMISSION
IDAHO GRAIN PRODUCERS ASSOCIATION
MONTANA GRAIN GROWERS ASSOCIATION
NEBRASKA WHEAT BOARD
NEBRASKA WHEAT GROWERS ASSOCIATION
OKLAHOMA WHEAT COMMISSION
SOUTH DAKOTA WHEAT COMMISSION
SOUTH DAKOTA WHEAT INC.
TEXAS WHEAT PRODUCERS BOARD
TEXAS WHEAT PRODUCERS ASSOCIATION
WASHINGTON WHEAT COMMISSION
NATIONAL ASSOCIATION OF WHEAT GROWERS
NATIONAL BARLEY GROWERS ASSOCIATION

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Dated: September 27, 2007

I. INTRODUCTION

The Honorable Brian Schweitzer, Governor of Montana, and the other entities listed above commend the Board for responding to widespread concern that its old and outdated cost of capital methodology significantly understates the financial health of the railroad industry. These commenting parties include various Grower groups, the Alliance for Rail Competition, the National Association of Wheat Growers and the National Barley Growers Association (hereafter, "Agricultural Interests"), which collectively represent over 100,000 farm producers in the United States.

These farm producers include virtually all of the wheat and barley growers in the United States, who are concentrated in the grain growing belts of the Great Plains and many other parts of the country from the eastern U.S. to the West Coast. The Agricultural Interests are charged with representing the interests of their members in the marketing of their grains both domestically and internationally. A vast majority of the wheat and barley producers represented by the Agricultural Interests are captive to single rail carriers for significant portions of their freight shipments.

The Board's proposal to modernize its approach by adopting a Capital Asset Pricing Model ("CAPM") approach in place of the Discounted Cash Flow ("DCF") approach is welcome, and well-supported. In addition, this policy change may lead to the reduction or elimination of distortions in other areas of rail regulation resulting from erroneous fears of railroad revenue inadequacy. Regulation that better balances the interests of railroads, shippers and the public should in turn lead to improvements in rail service and pricing even when STB jurisdiction is not invoked.

It is not the purpose of the Governor and these Agricultural Interests in their opening comments to focus on technical issues of railroad accounting and the capital markets. The Governor and these Agricultural Interests generally support the opening comments being filed by the Western Coal Traffic League, as well as the comments of the U.S. Department of Agriculture.

Our focus in this round will instead be on related issues of railroad financial health and fundamental regulatory concerns raised by ICC and STB decisions in which perceptions of railroad industry financial weakness may have received excessive weight.

It appears from the August 21, 2007 Request for Extension of Time filed by the AAR that the railroads, too, intend to address in their comments the context in which the choice between CAPM and DCF is being considered, and that the railroads intend to argue for preservation of the status quo as to their cost of capital based on their interest in preserving ineffective regulation of rail rates and service. The Board must reject such arguments.

Montana has a particular interest in these issues because virtually all of its rail-dependent shippers are captive to a single railroad. Over 94% of rail freight moving between Montana and other states moves via BNSF. Montana is a leading producer of agricultural commodities. As determined by its Agricultural Statistics Service, Montana ranks third in all wheat production, fifth in winter wheat production, fourth in spring wheat production, second in barley production, and second in oat production in the U.S.

Moreover, Montana is located hundreds of miles from the main destinations for its products, including export elevators in the Pacific Northwest, making truck transportation difficult and expensive. As one of the nation's larger states in land area (it is the fourth largest State in the Union), Montana also depends on a network of in-state elevators for originations of rail shipments of wheat and other products.

Current members of the STB are aware of these facts. Both Chairman Nottingham and Vice Chairman Buttrey have visited Montana and have heard directly from Montanans about rail rate and service concerns. Notably, former Chairman Nober, who now works for BNSF, acknowledged these concerns in testimony delivered March 31, 2004 before the House Committee on Transportation and Infrastructure, saying:

> Areas of the country are disproportionately dependent on rail service in general, and on a single rail carrier in particular, for their economic health. Many who are from the upper Midwest feel that, because of the importance to their states of producing bulk commodity-based products, their region's economies are particularly dependent upon the business practices of a single railroad.

In addition, Governor Schweitzer and these multi-state Agricultural Interests collectively represent over 100,000 farm producers in the United States, and have participated actively in a number of STB proceedings. Details of their grain transportation concerns were provided to the Board in Ex Parte No. 665, Rail Transportation of Grain. See, in particular, the Supplemental Comments filed January 12, 2007 by Montana Wheat & Barley Committee, et al., and Governor Schweitzer.

As detailed in those Comments, growers of wheat and barley are unique in the rail transportation world. They generally bear but do not directly pay railroad freight rates and charges. In Montana, growers are captive in large part because virtually all grain shipments are handled by just one railroad system, BNSF or its affiliates. In addition, in Report 07-94, "Freight Railroads – Industry Health has Improved, but Concerns about Competition and Capacity Should be Addressed," and subsequent reports, GAO has identified pockets of captivity in North Dakota, Idaho, Colorado, Texas, Oklahoma, Kansas, Minnesota, Nebraska, South Dakota, Oregon and Washington.

Unlike many other rail customers, farm producers are unable to pass excessive rail freight costs on to any other party. The growers' grain receipts are adversely affected by rail rates that are some of the highest in the nation. Grain producers are frustrated with the Board's lack of focus on providing solutions and avenues for relief from exploitation by market dominant railroads. Due to the fact that this nation's railroads have achieved or are reaching revenue adequacy even under current standards, Governor Schweitzer and these Agricultural Interests petitioned the Board in Ex Parte No. 665 to open an investigation, develop relevant facts, and report on the railroad business practices that are transferring wealth from the public sector to the private sector, eliminating competition, controlling movements and markets and creating excessive economic burdens on farm producers and state governments.

These conditions have developed over many years, and the Governor and these Agricultural Interests do not expect them to be remedied overnight. The Board's recent proceedings, and its decision to conduct a comprehensive study of rail competition, are welcome. However, the regulatory status quo is not acceptable.

II. THE BOARD SHOULD REPLACE DCF WITH CAPM IN DETERMINING RAILROAD INDUSTRY CAPITAL COSTS

The Governor and these Agricultural Interests anticipate that the Railroads will oppose the Board's proposal on substantive grounds, though a credible case for continued reliance on DCF is difficult to make. As recognized in the Board's Notice served August 14, 2007 in this proceeding, the DCF approach is flawed because it assumes continuation in perpetuity of current growth rates. It is telling that the Federal Reserve System abandoned DCF in favor of CAPM some years ago.

In addition, the Railroads are likely to argue that DCF should be retained because a change to CAPM will allegedly jeopardize the industry's record revenues and profits through increased exposure to regulation or "re-regulation," which is the railroads' disparaging characterization of even the mildest rail consumer protection measures. The railroads are also likely to warn of reduced rail infrastructure investment absent supra-competitive profits supported by erroneous and exaggerated findings of rail industry financial weakness.

The Governor and these Agricultural Interests acknowledge that the status quo is highly favorable to the major railroads, and are not surprised by the railroads' resistance and the resistance of their financiers and investors to any modification of any of their unfair advantages. However, it is time for the Board to begin the process of leveling the playing field and restoring the balance between railroads and captive shippers that Congress called for in the Staggers Rail Act of 1980 and in subsequent legislation. An accurate determination of the railroad industry's capital costs is a critical component of that process.

Given BNSF's dominance over rail transportation in the State, Montana shippers obviously have little or no ability to call on competitive forces in seeking reasonable rail rates and service, and railroad market dominance over shipments of farm products is by no means limited to Montana. Accordingly, shippers of agricultural commodities have had to rely even more than most other captive shippers on the ICC and STB for protection against abuses of railroad market power. However, efforts to obtain relief have consistently been thwarted by the “layered defense” erected over many years to limit the recourse called for by Congress.

In many ways the railroads’ first line of defense has been the perception, which they have promoted assiduously, that their revenues are too low. Contributing to this perception are the cost of capital procedures that have been used by the ICC and STB, as well as the procedures used for determining revenue adequacy. Even assuming these procedures were not biased when adopted, it has for many years been recognized on Wall Street that, as their own SEC filings and annual reports show, the railroads have enjoyed strong financial health.

Nevertheless, this agency, continuing to fear railroad financial problems long after they have become illusory, has established too many barriers to relief for captive shippers. Some of these are required by statute, like market dominance determinations. However, the Board has tended to see competition where it does not exist. Its tests have been expensive to meet and too often ignored the critical issue of whether actual or hypothetical competition was <u>effective</u>.[1]

As the D.C. Circuit recognized in a decision issued soon after the Staggers Act became law, Congress required consideration of the effectiveness of competition as part of market dominance determinations for good reason. See <u>Arizona Public Service Co. v. United States</u>, 742 F.2d 644, 650-51 (D.C. Cir. 1984) (emphasis in original):

> At the core of the “effective competition” standard is the idea that there are competitive, market pressures on the railroads deterring them from charging monopoly prices for transporting goods. <u>Of course, any such effective competition will always be relative to a particular price that the railroads charge</u>. At some point, the availability of an al-

[1] The Board’s recent decision in STB Docket No. WCC-101, <u>Government of Guam v. Sea-Land Service, Inc., et al.</u>, illustrates this concern.

> ternative such as the horse and buggy or even people carrying oil in buckets theoretically prevents railroads from raising their rates beyond an outer bound. But the mere existence of some alternative does not in itself constrain the railroads from charging rates far in excess of the just and reasonable rates that Congress thought the existence of competitive pressures would ensure.

Concern about railroad revenues led the ICC and Board to err on the side of depriving shippers paying high rates of their day in court. The Board should give the benefit of any doubt to shippers, not railroads, because rate cases cannot be won and will not be brought where there is true effective competition that keeps rail rates reasonable.

While the decision to eliminate consideration of product and geographic competition in market dominance determinations was helpful, meeting threshold tests is of little benefit if rate reasonableness standards cannot be met. For many decades, if market dominance could be established, the only methodology captive rail shippers could invoke was stand-alone cost, because skewed cost of capital and revenue adequacy standards rendered the revenue adequacy and management efficiency constraints irrelevant. However, the cost and complexity of the SAC test have made that test equally irrelevant to all but a handful of large-volume point-to-point shippers. And the Bottleneck Decision allowed railroads to leverage a partial monopoly over entire through routes.

In recent years, the Board has modified its SAC procedures in ways it says will make them more effective (though shippers fear they will cost more and provide less relief). In addition, the Board has adopted long-awaited small rate case rules, though these rely heavily on a Simplified SAC approach that is untested and may be unworkable.[2] In any event, the Board's segment cross-subsidy test is likely to disenfranchise all captive

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[2] The Board's recent decision in Ex Parte No. 646 (Sub-No. 1), Simplified Standards for Rail Rate Cases, is currently being reviewed, and a joint shipper petition for reconsideration appears likely.

shippers not located on high-density main lines, regardless of how well or badly SAC and Simplified SAC work. As a result, rate relief is likely to remain an illusion for shippers in Montana and the other represented states who cannot invoke the Three Benchmark test.

Even shippers who qualify for such relief as is available under the Three Benchmark approach (a maximum of $250,000 per year for five years) are often forced to give up any regulatory recourse through the Hobson's choice between large rate increases under take-it-or-leave-it "contracts" and far larger rate increases for "common carrier" service.

The ICC and STB have also permitted mergers and acquisitions among major railroads that have resulted in eastern and western duopolies, with 95% of rail freight controlled by the four largest Class I railroads. Rail competition has been further limited by the agency's approval of paper barriers and other terms that have allowed Class Is to minimize or eliminate such competition as short line railroads might otherwise provide.

Such concentrated market power has been facilitated by decisions made, in part, in order to produce a financially healthy rail system. That goal has been achieved, and the Board now needs to consider whether the pendulum has swung too far toward the major railroads.

Today, the railroads are increasing rates and charges across the board, on captive and "competitive" traffic. They are also forcing shippers of all kinds to absorb operating and equipment costs, including rail car supply costs, that were formerly borne by the railroads. They are forcing State and local governments to absorb increasing costs associated with increased trucking to ever more distant elevator locations. It should therefore come as little surprise that railroads have reported increasing revenues even during calendar quarters when traffic volumes declined. Instead of wondering whether railroads will meet the Board's revenue adequacy tests, observers wonder how much the railroads' revenues will exceed levels needed for revenue adequacy.

In some of their comments, the railroads would have the Board believe that the attainment of revenue adequacy will mean the end of investment. This claim is false. Nothing in the applicable precedents suggests that revenue adequate railroads will be unable to raise rates and charges and improve their bottom lines. The only change will be that railroads will be less able to increase their revenues through differential pricing of captive traffic. Revenue burdens will instead have to be spread more evenly among captive shippers, competitive shippers, and the financial markets, where the railroads' well-established ability to attract capital will be enhanced.

In summary, as to issue after issue, ICC and STB concerns about the ability of the railroads to recover their cost of capital have tipped the scales in favor of insulating market dominant railroads from effective regulatory oversight. But the appearance of regulation without the reality of recourse creates the worst of both worlds. Major railroads like BNSF face neither the discipline of the marketplace nor the need to answer to government regulators when they abuse customers, markets, and smaller railroads.

Unchecked economic power is healthy neither for those who wield it nor for those subject to abuses. The U.S. economy should produce winners and losers based on price, service, innovation and good customer relations. The success of producers, buyers and markets should not depend on the self-interest of monopoly railroads, who may favor sub-optimal products, producers and trade patterns which maximize their own revenues.

The Board should not fear a deluge of rate cases and other regulatory filings if it adopts accurate cost of capital standards. Rate litigation is always a last resort for captive shippers, all of whom would prefer to negotiate mutually acceptable rates and charges. When captive shippers are not deprived of all leverage, the likelihood of successful negotiations increases and the need for regulatory recourse declines.

III. CONCLUSION

Governor Schweitzer and these Agricultural Interests urge the Board to replace DCF with CAPM as proposed in its August 14 Notice, and express the hope that Board action in this proceeding will be followed by action on other fronts that restores much needed balance to relations between major railroads and their customers.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that I have, this 27th day of September, 2007 served a copy of the foregoing on all parties of record, by first class mail, postage prepaid.

John M. Cutler, Jr.

s:\Montana\Opening Comment