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BEFORE THE
SURFACE TRANSPORTATION BOARD

In the Matter of: Report: Alternatives to URCS	)	Ex Parte No. 771

REPLY TO COMMENTS BY THE WESTERN COAL TRAFFIC LEAGUE

THE WESTERN COAL TRAFFIC LEAGUE
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Dated: May 24, 2023

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In its Comments, the Western Coal Traffic League ("WCTL") sponsored the joint testimony of Thomas D. Crowley and Robert D. Mulholland. Messrs. Crowley and Muhlholland are experienced economists with expertise in railroad cost-finding and, in particular, URCS. In their testimony Messrs. Crowley and Muhlholland supported many of the findings, conclusions, and URCS recommendations put forward in the Christensen Report ("Report").

By contrast, the railroad Commenters – found little (Association of American Railroads or "AAR") or nothing (BNSF Railway Company or "BNSF") to say about the Report and its URCS alternatives. Instead, both the AAR and BNSF devoted their Comments to various URCS alternatives of their own creation including use of replacement costs in the calculation of variable property costs (BNSF Comments, p. 8) and the separation of intermodal shipments for cost-finding purposes (AAR Comments, p. 12).

In their reply testimony, Messrs. Crowley and Mulholland address the principal new alternatives to URCS which the railroad parties commended and demonstrate that each is economically unsound.

CONCLUSION

As demonstrated in WCTL's Comments, there is merit to some of the alternatives proposed for URCS om the Report. For this reason, the Board should move forward with a proposal to modify its general purpose costing system.

Respectfully submitted,

By: ______________________________

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DOCKET NO. EP 771
REPORT: ALTERNATIVES TO URCS

Reply Verified Statement

of

Thomas D. Crowley
President

and

Robert D. Mulholland
Senior Vice President

L. E. PEABODY & ASSOCIATES, INC.
ECONOMIC CONSULTANTS

On Behalf Of

THE WESTERN COAL TRAFFIC LEAGUE

Dated: May 24, 2023

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I. INTRODUCTION

We are Thomas D. Crowley and Robert D. Mulholland, President and a Senior Vice President, respectively, of L. E. Peabody & Associates, Inc. L. E. Peabody & Associates, Inc. is an Economic Consulting Firm that specializes in addressing economic, transportation, marketing, financial, accounting and fuel supply matters. We have spent most of our consulting careers of over 50 and 25 years, respectively, evaluating railroad operations, capacity, costs and profitability and pricing issues for shippers, producers, railroads and government agencies. Our credentials are included as Exhibit No. 1 and Exhibit No. 2 to the February 23, 2023 Verified Statement ("VS") that we filed in this proceeding on behalf of the Western Coal Traffic League ("WCTL").

We were asked to review and respond to the railroads' February 23, 2023 filings, which included the Association of American Railroads ("AAR") and the supporting Verified Statement of Michael R. Baranowski plus comments filed by counsel for the BNSF Railway ("BNSF").

Our evaluation of the railroads' filings is summarized below under the following topical headings:

II. Regulating an Evolving Market
III. Railroads' Motivation for Changes
IV. Conclusion

II. REGULATING AN EVOLVING MARKET

When the Staggers Rail Act of 1980 ("Staggers") was enacted, railroad revenue adequacy was perceived as an aspirational, rather than attainable goal. The regulatory rate limit on captive shipments that was built into the *Coal Rate Guidelines*[1] was intended to ensure that the railroads were able to impose differential pricing to extract supra competitive rates on captive traffic. Profits from this captive traffic were viewed as crucial to ensuring the continued provision of common carrier service on less profitable exempt routes, and the overall financial health of the railroads.

Fast forward nearly half-a-century and the landscape has changed dramatically. Whereas there were dozens of Class I railroads in 1980, there are now six (6).[2] As market power became consolidated, Class I railroads sold off lower density, less profitable branch lines to Class II and Class III railroads.[3] As BNSF stated in its Comments, "traffic densities have increased across rail networks as a result of traffic growth, abandonments, and line sales."[4]

Furthermore, the Class I railroads recently implemented precision-scheduled railroading ("PSR"). Under the PSR model, resources (principally labor and equipment) are theoretically used more efficiently. The cost savings resulting from PSR have been accompanied by declines in service levels.[5] However, the reduced costs combined with increasing rates[6] resulted in increased profits across the board. As shown in Exhibit No. 3 to our February 23, 2023 VS, Class I railroads achieved revenue adequacy on an annual basis (by the Surface Transportation Board's ("STB" or

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1 *Coal Rate Guidelines, Nationwide*, 1 I.C.C. 2d 520 (1985) ("*Coal Rate Guidelines*").

2 In contrast, there are tens of thousands of rail shippers in the U.S.

3 "Short line and regional railroads, most of which are new since Staggers, operate approximately 45,000 route miles in 49 states." *Freight Railroads & The Staggers Rail Act of 1980* - Association of American Railroads (aar.org).

4 February 23, 2023 *Comments of BNSF Railway,* filed in STB Docket No. Ex Parte 771 ("BNSF Comments"), p. 7.

5 *See*, STB Docket No. EP 770 *Urgent Issues in Freight Rail Service*, decided April 7, 2022.

6 Revenue per net ton-mile of freight increased by more than three (3) percent per year on average over the 10-year period from 2013-2022, according to the Class I railroads' Annual Reports Form R-1.

"Board") standards) multiple times over the last decade, and the five (5) largest Class I railroads meet the standard for long-term revenue adequacy proposed by the STB's internal Rate Reform Task Force ("RRTF") in 2019.[7]

Railroads now wield sufficient market power on exempt traffic to reduce or eliminate the "shortfall" that was meant to be recovered through differential pricing on regulated traffic. However, the railroads became accustomed to extracting supra competitive rates on regulated shipments, and they are reluctant to pass on any cost efficiencies gained via PSR or other means. As BNSF stated in its comments:

> [A] maximum rate paradigm that overly emphasizes R/VC ratios disincentivizes investments that make railroads more efficient.[8]

Within the current regulatory framework, the best way for the railroads to extract even more revenues from their regulated traffic base is to increase regulatory costs, and by extension, legally protected profits on captive shipments. As such, the railroads are dismissive of all of Christensen Associates' proposals that would reduce URCS costs for regulated traffic, but are open to different alternatives that would produce a more favorable result. Or as BNSF stated:

> [R]ather than devote Board resources to further analysis of the proposals in the Christensen Report, BNSF believes the Board should devote those resources to improving URCS as described [in BNSF's comments]."[9]

It is no surprise that the railroads offered several suggested changes to URCS in this proceeding. The railroads lobbied for some of the suggested changes before (including in the Ex Parte 431 proceeding), while other proposals are new, perhaps having been in development and/or

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7 RRTF defined long-term revenue adequacy as being achieved when a railroad's average return on investment ("ROI") equals or exceeds the average railroad industry of cost of capital ("COC') over a time period that is not shorter than five (5) years and includes both a year in which a recession began and the following year.

8 BNSF Comments, p. 5.

9 BNSF Comments, p. 2.

waiting on the shelf for just this occasion. The railroads' proposed adjustments have a common goal: to increase URCS costs and by extension rates for regulated traffic and eliminate as much traffic as possible from STB jurisdiction.

The state of the industry demonstrates that the railroads earn adequate revenues. Changes to URCS that are designed to elevate regulatory costs and the commensurate profits that the railroads generate should be viewed with skepticism by the Board. In the following sections, we address some of the specific changes proposed by the railroads.

III. RAILROADS' MOTIVATION FOR CHANGES

Christensen Associates evaluated potential changes to both Phase I and Phase III of URCS. As we stated previously, the Board elected not to release Christensen Associates' supporting materials with the Report, citing "the preliminary and exploratory nature of this request for comments."[10] Because we were unable to review the workpapers supporting the Christensen Report, we could not fully evaluate the Report findings.

However, in our February 23, 2023 VS, we noted that Christensen Associates found a low correlation between: (1) return on investment ("ROI") and depreciation ("DPR") expenses; and (2) volume changes, and advocated for an update to the default variabilities for ROI and DPR applied in URCS Phase I. Application of the Phase I alternatives considered by Christensen Associates would result in across-the-board reductions in URCS variable costs.[11]

We further noted that this result was logical under the current state of the industry in which the railroads are largely revenue adequate, because reduced URCS costs would result in increased revenue to variable cost ratios ("R/VCs"), and an increased share of traffic subject to STB jurisdiction.

Reductions in regulatory costs have a negative impact on the railroads' bottom line, so it is not surprising that the railroads devoted significant verbiage to critiquing the alternatives to URCS Phase I default variabilities that were considered by Christensen Associates, as discussed in Section A below.

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[10] October 21, 2022 Decision in STB Docket No. EP 771, "*Report: Alternatives to URCS,*" p. 2.
[11] Crowley/Mulholland February 23, 2023 VS, p. 3.

Christensen Associates also considered alternatives for the development of movement-specific costs in Phase III, which would result in the reallocation of costs among shipment groups.[12] The railroads were critical of the considered alternatives:

> BNSF joins the comments of the American Association of Railroads ("AAR") in opposing the replacement of URCS with an alternative model based not on actual cost information, but on an econometric analysis of prices.[13]

AAR and BNSF offer several suggestions regarding changes to URCS cost development and allocation. Not surprisingly, the proposed changes would either systemically reallocate URCS costs from exempt traffic to regulated traffic, or raise URCS costs across the board, as discussed in Sections B and C below.

A. DEFAULT VARIABILITIES AND REGRESSION UPDATES

AAR witness Baranowski opines that Christensen Associates' assessment is invalid because reported DPR includes dated expenses that "have nothing at all to do with more recent changes in volume." He further claims that "Christensen's return on investment multiplies net investment by the railroad industry after-tax cost of capital, which has no direct linkage to annual changes in traffic volumes," and that Christensen inappropriately "uses GDP Price Index as a deflator when more railroad specific measures of changes in costs are readily available."[14]

Mr. Baranowski concludes that if Christensen Associates "looked at the more recent trends in roadway capital expenditures relative to changes in volume and used a better metric for changes

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[12] *Id.*, p. 5.
[13] BNSF Comments, p. 1.
[14] Verified Statement of Michael R. Baranowski ("Baranowski VS"), filed as Appendix A to the February 23, 2023 Comments of AAR titled "Alternatives to URCS," filed in STB Docket No. Ex Parte 771 ("AAR Comments"), pp. 13-14.

in railroad costs, it would have found that about 80 percent of road property related capital expenditures vary with changes in traffic levels."[15]

It is unclear how Mr. Baranowski arrived at his alternate variability estimate because his work papers were not produced. However, there is a threshold question of whether and how Mr. Baranowski controlled for the recent and significant capital expenses that were made to implement positive train control ("PTC"), and are therefore unrelated to changes in traffic volumes. That capital expenses related to statutorily required PTC implementation happened to occur during periods of significant volume changes does not constitute a demonstration that capital expenses vary with changes in volume. Upgrading to PTC signal systems should, however, yield productivity gains and cost reductions in the future. It is also unclear which alternate cost index Mr. Baranowski used in his analysis.[16]

Mr. Baranowski's use of a "more recent" time period in his alternate regression analysis appears to contradict his position that short-run marginal costs are inappropriate:

> Indeed, both the Board and Christensen recognize that the relevant time horizon for URCS is longer run variable cost.[17]

B. CHANGES TO COST ALLOCATION AND OPERATIONAL ASSUMPTIONS

Mr. Baranowski also made several claims regarding the validity of operating assumptions implicit in URCS, and proposed changes that he claims would better reflect the modern railroad industry. Mr. Baranowski's proposed adjustments would generally reduce URCS costs for exempt

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[15] Baranowski VS, p. 14.

[16] Mr. Baranowski also took issue with Christensen Associates' rearrangement of current URCS regression cost groupings based on the premise that related direct and overhead costs should be grouped together (Baranowski VS, pp. 14-15), and opined that modifications to account groupings should be based on "a thorough evaluation of key drivers of operational and financial reporting changes since the original URCS regressions were completed," Baranowski VS, p. 21.

[17] Baranowski VS, p. 10.

(principally intermodal) traffic, and reallocate those costs to regulated carload and unit train traffic, consistent with the railroads' incentive to increase URCS costs and maximum lawful rates for regulated traffic.

Specifically, Mr. Baranowski refers to arguments previously put forward by the AAR in the Ex Parte 431 proceeding, claiming changes are required in the development of URCS Phase II Switch Engine Minutes ("SEM") because "URCS does not reflect the modern-day efficiencies of the switching of intermodal flat cars and should be updated." He also claims that URCS should not treat intermodal trains as through trains, because "railroads routinely run dedicated intermodal trains." Mr. Baranowski advocates for the Board to:

> investigate the relationship between costs borne by carload business and costs borne by intermodal business to determine if URCS is attributing costs in a manner consistent with the way costs are incurred.[18]

R/VC ratios for exempt intermodal shipments significantly exceed the 180% jurisdictional threshold ("JT") that applies to captive shippers, including coal shippers. Because that traffic segment is not regulated by the Board, it does not matter if the R/VC ratio is 200% or 900%. As such, the railroads have incentive to reallocate URCS costs from intermodal to the traffic groups that include regulated shipments (like coal), where the jurisdictional threshold comes into play.

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[18] Baranowski VS, pp. 19-20. Mr. Baranowski also reiterates claims (from Ex Parte 431) that the number of Interterminal and Intraterminal ("I&I") switches is overstated, which he claims causes URCS to allocate costs to switches that do not occur "thereby understating the cost assigned other switches that do occur." He similarly claims that URCS unit costs are developed based on overstated origin and terminal switches, and understated interchange switches, due to the reliance on AAR CS-54 data included in URCS, which reports Rule 11 interline movements as local to each participating railroad (*Id.,* p. 21). Mr. Baranowski further states that rather than using the number of carloads in a shipment to determine the type of service provided for URCS costing, URCS should use the Annual Report Form R-1 standard, which classifies unit trains as "specialized scheduled shuttle type service in equipment … dedicated to such service" (*Id.,* p. 20). This change would impact the efficiency adjustments and make-whole factors applied in URCS Phase III.

C. OTHER ARGUMENTS PROFFERED BY THE RAILROADS

BNSF filed its own comments in addition to the AAR comments that BNSF endorsed. The purpose of BNSF's separate filing appears to be twofold: (1) advocate for detaching economic regulation of the railroads from the railroads' cost of providing service; and (2) offer additional methods to reallocate URCS costs from exempt to regulated traffic in the event its primary argument fails.

1. Abandonment of R/VC Based Regulation

BNSF acknowledges that it "has consistently implored the Board to recognize the limits on inferences that can be drawn about rail market power from R/VC ratios," and states that "R/VC ratios are driven by many factors that have little or nothing to do with the exercise of market power by railroads."[19]

BNSF argues that "[a] R/VC-based test rewards the highest cost, least efficient railroad and penalizes railroads that increase productivity and efficiency."[20] However, efficiency and productivity gains do not necessarily equate to improved operations. Although the railroads' migration to PSR has in fact lowered costs through tighter scheduling that enabled reductions in labor and equipment pools (greater productivity and efficiency), PSR has also led to service disruptions resulting from the leaner operations. BNSF simply wants freedom to cut costs and increase profits, without any limit to the rates it can charge captive shippers, even if those cost cuts result in reduced service offerings and/or service levels. Under this framework, captive shippers would be forced to pay the same (or more) for worse service.

[19] BNSF Comments, p. 4.
[20] *Id.*, p. 5.

To support its position, BNSF offers a red-herring justification:

> Board policy should … incentivize railroads to make investments to innovate and lower costs because railroads that increase productivity and efficiency can compete more vigorously with trucks, capture traffic from the highways, and grow volumes.[21]

This is a non sequitur, because truck-competitive traffic is not subject to STB regulation. Ensuring reasonable rates on regulated traffic has no bearing on the railroads' incentive to lower costs in order to capture the truck-competitive traffic that is exempt from STB oversight.

2. Replacement Costs for Road Property

In addition to supporting AAR's positions with respect to some of the mechanical aspects of the URCS calculations, BNSF calls for other "potential improvements to URCS." One of which is to "[c]onsider the feasibility of using current replacement costs to calculate a railroad's variable road property costs as the most economically valid measure."[22]

The Board and its predecessor agency, the Interstate Commerce Commission ("ICC"),[23] have considered and rejected this proposal several times previously, most recently in Ex Parte 679, where the Board concluded: "continued use of depreciated original cost, not replacement cost, leads to the most accurate assessment of the financial health of the railroad industry."[24] Among the reasons for the Board's rejection of the proposal was that:

> [it] would create the perverse incentive for railroads to maintain inefficient and obsolete facilities… As a carrier approached or reached revenue adequacy, it would have every incentive to hold onto track, bridges, or other facilities that are no longer used or useful because the regulatory framework would allow it to earn a full return on the full replacement costs of those assets. So, for example, if a railroad had a number of

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[21] BNSF Comments, p. 5.
[22] *Id.*, p. 8.
[23] Along with the Railroad Accounting Principles Board ("RAPB") and the United States General Accounting (now Accountability) Office ("GAO").
[24] *See*, STB Docket No. EP 679 *Association of American Railroads – Petition Regarding Methodology For Determining Railroad Revenue Adequacy,* decided October 23, 2008, at p. 7.

> decrepit bridges at the end of light-density rail lines, AAR's approach would provide the carrier a full return on the replacement costs of the bridges, in effect expecting shippers to provide the railroad and its stockholders with a return on a rail asset that is of little or no continued use and will not be replaced. In contrast, our historical-cost approach permits a carrier a full return on such a bridge only when the bridge is actually replaced.[25]

As with most of the railroads' other proposals, this adjustment is clearly intended to increase captive shippers' rates by inflating the cost inputs in URCS.

[25] *Id.*, p. 6.

IV. CONCLUSION

The freight railroad industry has evolved from an inefficient patchwork of regional rail systems in the 1970s and 1980s to the lean and highly concentrated market that exists today. The once-aspirational goal of revenue adequacy is now a reality for the six (6) remaining Class I railroads. This evolution was made possible in large part due to laws and regulations that enable the railroads to employ differential pricing and extract supra competitive rates on captive shipments.

The Christensen Report concludes that the decades-old inputs that URCS uses to determine the extent to which costs vary with output in URCS Phase I do not reflect the economics of the modern freight rail industry.[26] The Christensen Report authors further conclude that updating URCS Phase I variabilities applicable to capital costs under their preferred alternative would reduce URCS variable costs across the board (in the absence of any other adjustments). This would reduce the rate level at the statutory rate floor for shipments subject to the Board's jurisdiction, increasing the share of traffic with rates above the jurisdictional threshold,[27] a result that aligns with the current environment in which the freight railroads have demonstrated an ability to consistently achieve revenue adequacy.

Despite the good financial health of the industry, the Board has not yet developed a framework for implementing a revenue-adequacy constraint on rates, so captive shippers' maximum lawful rates remain inextricably linked to the regulatory cost of providing service, as measured by URCS.

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[26] We agree that updates based on empirical studies could improve the accuracy of URCS.
[27] It would also impact all of the models the Board uses to carry out its functions related to economic regulation.

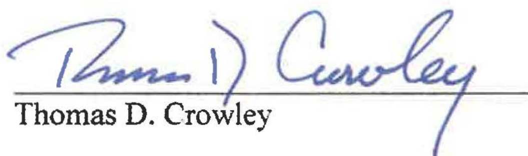
Not surprisingly, the railroads offered several proposed changes to URCS, which would either: (1) increase URCS costs across the board, e.g., increase default variabilities and use replacement cost to calculate a railroad's variable road property costs; or (2) reallocate regulatory costs from exempt traffic groups (intermodal) to regulated traffic groups (carload and unit train).

BNSF proposes to do away with cost-based economic regulation altogether, based on a misplaced argument that the railroads need freedom to innovate and cut costs in order to compete with other modes for exempt traffic, without fear of limiting the profit that they can extract from captive shippers.

Class I railroads now earn adequate revenues by the Board's standards, and this was made possible over the long term through outsized contributions the railroads are permitted to earn on captive shipments under the regulatory framework. Changes to URCS that are designed to elevate regulatory costs and the commensurate profits railroads can generate on captive shipments would perversely increase the level of permissible contribution on regulated traffic just as the need for differential pricing is waning.

<u>**VERIFICATIONS**</u>

I, Thomas D. Crowley, verify under penalty of perjury that I have read this Reply Verified Statement on behalf of WCTL, that I know the contents thereof, and that the same are true and correct. Further, I certify that I am qualified and authorized to file this statement.



Thomas D. Crowley

Executed on 5/24/23

* * *

I, Robert D. Mulholland, verify under penalty of perjury that I have read this Reply Verified Statement on behalf of WCTL, that I know the contents thereof, and that the same are true and correct. Further, I certify that I am qualified and authorized to file this statement.

Robert D. Mulholland

Executed on 5/24/2023