

STATE OF MINNESOTA
OFFICE OF ADMINISTRATIVE HEARINGS
FOR THE MINNESOTA PUBLIC UTILITIES COMMISSION

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Front Desk

In the Matter of a Petition by
Excelsior Energy, Inc. for Approval
Of a Power Purchase Agreement, Under
Minn. Stat. § 216B.1694,
Determination of Least Cost
Technology, and Establishment of a
Clean Energy Technology Minimum
Under Minn. Stat. § 216B.1693

PUC Docket No. E-6472/M-05-1993
OAH Docket No. 12-2500-17260-2

**SURREBUTTAL TESTIMONY OF
THOMAS D. CROWLEY**

1 The above matter is before Administrative Law Judges Steve M. Mihalchick and Bruce
2 Johnson. Pursuant to Minnesota Rules Chapter 1400, the following is submitted as surrebuttal
3 testimony offered by Minnesota Power.

4 **Q: Would you state your name, background and present position.**

5 A: My name is Thomas D. Crowley. I am an economist and President of the economic
6 consulting firm of L. E. Peabody & Associates, Inc. The firm's offices are located at
7 1501 Duke Street, Suite 200, Alexandria, VA 22314 and 5901 Cicero Avenue, Suite 504,
8 Chicago, IL 60646.

9
10 **Q: Have you previously provided testimony in this proceeding?**

11 A: Yes, I provided Direct Testimony on behalf of Minnesota Power ("MP"), a party to this
12 contested case, addressing rail delivery issues related to the proposed Mesaba Project.

13

1 **Q: What is the purpose of your Surrebuttal Testimony in this proceeding?**

2 A: My surrebuttal testimony will respond to the Rebuttal Testimony and Exhibits of
3 Excelsior Energy Inc.'s ("Excelsior") witness Ralph Olson. Specifically, I will respond
4 to Mr. Olson's comments regarding fuel transportation and coal supply pricing issues.

5

6 **Q: Are you sponsoring any documents and exhibits in this filing?**

7 A: Yes

8 **Exhibit TDC-1**, relevant section of the Interstate Commerce Commission's ("ICC")
9 decision in *Union Pacific -- Control -- Missouri Pacific; Western Pacific*, 366 I.C.C. 462,
10 538-39 (1982) ("UP/MP/WP");

11 **Exhibit TDC-2**, relevant section of the Surface Transportation Board's ("STB")
12 embraced decision in Docket No. 41242, *Central Power & Light Company v. Southern*
13 *Pacific Transportation Company*, Docket No. 41295, *Pennsylvania Power & Light*
14 *Company v. Consolidated Rail Corporation*, and Docket No. 41626, *MidAmerican*
15 *Energy Company v. Union Pacific Railroad Company and Chicago and North Western*
16 *Railway Company*, Served April 28, 1997 ("Bottleneck II");

17 **Exhibit TDC-3**, relevant section of the National Industrial Transportation League's
18 ("NITL") written testimony in STB Ex Parte No. 658, *The 25th Anniversary of the*
19 *Staggers Rail Act of 1980: A Review and Look Ahead*, Filed October 12, 2005;

20 **Exhibit TDC-4**, articles from transportation industry, utility industry and general
21 business publications detailing the railroads' increasing market power and rise in coal
22 transportation rates;

1 **Exhibit TDC-5**, Smith Barney/Citigroup, U.S. Equity Research Report, Class I's Can
2 Parlay Pricing Policies, Trucking Cost Hikes Into Higher Rates, August 25, 2005;
3 **Exhibit TDC-6**, *Coal Age* article, Coal Price Volatility Is Here to Stay, May, 2004;
4 **Exhibit TDC-7**, excerpts from the United States Government Accountability Office
5 Report to Congressional Requestors, Freight Railroads: Industry Health Has Improved,
6 But Concerns About Competition And Capacity Should Be Addressed, October 6, 2006
7 available at <http://www.gao.gov/new.items/d0794.pdf>; and
8 **Exhibit TDC-8**, *Railway Age* article, Facing the Challenges Of a Growth Industry,
9 December 2005.

10
11 **Q: What general observations do you have with respect to the issues raised by Mr.**
12 **Olson in his rebuttal testimony?**

13 A: Based on an examination of Mr. Olson's Rebuttal Testimony and Exhibits, I believe that
14 Mr. Olson has overestimated the impact of potential competition on the delivered price of
15 fuel to Excelsior's proposed Mesaba Project, and has underestimated the market power of
16 the western coal hauling railroads and national coal producers that could potentially
17 provide rail service and fuel to the Mesaba Project. I also believe that Mr. Olson has
18 incorrectly assessed the transportation options available to the Mesaba Project and the
19 state of the national rail network. This has lead Mr. Olson to develop expectations about
20 the delivered price of fuel that I believe are unattainable in the current coal supply and
21 transportation markets.

1 **Q. Why do you believe Mr. Olson has missed the target so much on his assessment of**
2 **the fuel transportation and coal markets?**

3 A: I believe that Mr. Olson improperly assessed the fuel transportation and coal markets due
4 to his lack of experience in purchasing coal and transportation for free-standing
5 generating stations. Mr. Olson's resume, which he included in his Rebuttal Testimony as
6 Exhibit No. (RO-1), indicates that he spent the majority of his career working for Puget
7 Sound Energy in various management positions, including fuel supply positions at the
8 Centralia and Colstrip Generating Stations. The coal Mr. Olson was responsible for at
9 both the Centralia and Colstrip Generating stations was supplied primarily from mines
10 adjacent to the generating stations, inferring that he has had limited experience with the
11 different aspects of the past or current issues in the overall coal transportation industry.
12 For example, the Centralia Generating Station receives the vast majority of its coal from
13 the adjacent Centralia Coal Mine and receives minimal amounts of coal from the Powder
14 River Basin.¹ Likewise, the Colstrip Generating Station, where Mr. Olson's resume states
15 he was responsible for coal supply agreements, is supplied primarily from the adjacent
16 Rosebud mine and receives little coal from other Montana Mines.² There is a vast
17 difference in negotiating coal supply and transportation contracts for primary sources of
18 fuel such as Excelsior would purchase for the proposed Mesaba Project and negotiating
19 contracts for supplemental levels of coal as Mr. Olson did at Puget Sound Energy. A

¹ In 2005, 80 percent of the Centralia Plants coal tonnage came from the adjacent Centralia coal mine, and 20 percent from other sources. Source: 2005 Energy Information Administration Form 423 data available at <http://www.eia.doe.gov/cneaf/electricity/page/eia423.html>.

² According to Federal Energy Regulatory Commission ("FERC") data, the Colstrip plant received 100 percent of its coal supply in 2005 from the adjacent Rosebud mine. Source: 2005 FERC Form 423 data available at <http://www.ferc.gov/docs-filing/eforms/form-423/overview.asp#skipnavsub>.

1 chief concern when negotiating primary coal supply and transportation contracts is the
2 cost associated with assuring the timely production and delivery of the coal. This
3 assurance carries with it costs that are not present when negotiating for the purchase and
4 delivery of supplemental sources of coal. Simply stated, I know of no coal burning
5 electric utility that relies on spot purchases of coal as the primary vehicle for acquiring
6 coal to fuel a power station. Rather a combination of long term/short term agreements
7 are put in place to guarantee supply. In today's transportation and fuel supply market
8 places, both transportation and coal are selling at considerably higher prices over what
9 they were selling for just a few years ago for both the so-called competitive and captive
10 shippers.

11
12 **Q: Mr. Olson contends that intramodal competition at the mine origins is not required**
13 **to ensure competitive delivered pricing to the proposed Mesaba plant because the**
14 **proposed plant will have destination and fuel type competition and will have an**
15 **ability to use coal with unfavorable burn characteristics that the railroads will price**
16 **low to move. Do you agree with his contentions?**

17 **A:** No. As I explained in my Direct Testimony, a truly competitive situation will occur only
18 if the destination competitors also have competition at the origin and have relatively
19 similar costs. If only one carrier can access a shipment origin, such as a coal mine, that
20 carrier can dictate the price of transportation. The ICC, and its successor agency the
21 STB, the federal agencies charged with regulating rail transportation, have long
22 recognized that if a rail carrier has a monopoly over any segment of a route, the carrier

1 will exercise its monopoly power and set prices accordingly. I have included as Exhibit
2 TDC-1 a copy of the relevant section of the ICC's decision in UP/MP/WP, and as Exhibit
3 TDC-2 the STB's embraced decision in Bottleneck II. The ICC and STB found through
4 these decisions that a railroad with a segment monopoly will likely push the through rates
5 as high as possible and keep the monopoly profits for itself.³ Many of the locations from
6 which Excelsior claims they will procure coal, including Northern Powder River Basin
7 ("PRB") mines and Illinois Basin mines, are served by only a single carrier. If Excelsior
8 plans to source coal from these locations, it must expect to pay monopoly rents to the
9 carriers controlling access to the mines.

10
11 In addition, Mr. Olson's position that Excelsior will enjoy lower transportation rates
12 because the proposed Mesaba Project may be able to use less marketable coal that will
13 move at lower rates does not overcome the economic dynamics and pricing research of
14 the rail transportation industry. Railroads spend a great deal of time and effort analyzing
15 coal markets to understand the marketability of each type of coal located on its system
16 and its competitor's systems as well as the price of transportation from these markets. A
17 railroad will establish its price to a destination equal to the delivered price of the next
18 lowest substitute, and which maximizes its profits given all movements. In a capacity

³ The ICC's UP/MP/WP decision discusses the principles of railroad pricing when there is competition at the origin and captivity at the destination. See UP/MP/WP at 538-539. The STB subsequently ruled in its Bottleneck II decision that the same railroad pricing principles hold equal relevance if there is captivity at the origin, and competition at the destination.

1 constrained environment, in which the rail carriers claim they are now in, a railroad will
2 opt for higher revenue/profit traffic at the expense of lower revenue/profit traffic. Stated
3 differently, historically low rate traffic will pay a premium over historical levels or will
4 not be handled by the railroad.

5
6 Finally, in order for fuel type competition to be effective, the delivered cost of fuel from
7 different regions of the country have to be relatively similar. With a limited number of
8 producers and transporters involved in the supply chain, the likelihood of employing fuel
9 type competition as an effective form of competition is extremely remote.

10
11 **Q: Mr. Olson contends that you stated in your Direct Testimony in this proceeding that**
12 **true competition will exist only if competitor's costs of service are nearly the same.**
13 **Is Mr. Olson's contention accurate?**

14 **A:** No, Mr. Olson has misstated my Direct Testimony. I stated that true competition will
15 only lead to lower transportation prices when there is competition at the origin and
16 destination and the providers have relatively the same costs of service. Ignoring the
17 predicate of origin and destination competition leads to a nonsensical response that it is
18 only equal costs that determine true competition.

19
20 **Q: Mr. Olson also contends that in a competitive world, service providers possess many**
21 **available pricing options, including full cost of service pricing and incremental**

1 **pricing. Do these available pricing options apply to the rail movements to the**
2 **Mesaba Project?**

3 A: No, because Mr. Olson has ignored the practical economic applications of the current rail
4 market. The transportation market in which the Mesaba Project will enter can best be
5 described as a duopoly. According to economic theory, a number of possible pricing
6 options exist along a continuum in a duopoly market. These include true competitive
7 pricing, marginal cost pricing (also known as Bertrand pricing behavior), pricing based
8 on the market demand for the output that is simultaneously offered by the competitors
9 (also known as Cournot pricing behavior) and monopoly pricing (collusive profit-
10 maximizing behavior).

11
12 In today's rail transportation market, there is ample anecdotal evidence that railroads are
13 not offering truly competitive pricing. I have included as Exhibit TDC-3 a copy of the
14 NITL's written testimony in STB Ex Parte No. 658, *The 25th Anniversary of the Staggers*
15 *Rail Act of 1980: A Review and Look Ahead*, Filed October 12, 2005, in which the NITL
16 discusses, beginning at page 24, the duopoly nature of the railroads and their failure to
17 offer true competitive pricing.⁴ Similarly, railroads are also not providing marginal
18 pricing because, in a Bertrand pricing scenario, each competitor attempts to supply all of
19 the quantity that the market demands to the extent economically feasible. Railroads, with
20 their isolated capacity constraints (what Mr. Olson calls "bottlenecks") and their desire to

⁴ The NITL is a member-based organization founded in 1907 to represent shippers in their dealings with various regulatory bodies, and is the largest shipper organization in the United States.

1 improve bottom-line earnings growth, cannot supply all of the quantity demanded by the
2 market, and have shied from marginal cost pricing.

3
4 If railroads are not offering truly competitive pricing or marginal cost pricing, only two
5 duopoly pricing possibilities remain. First, railroads can price using Cournot Pricing
6 behavior, where the railroads set their prices at such a level that demand equals the total
7 quantity produced by both firms, and each firm takes the quantity set by its competitor as
8 a given, evaluates the residual demand, and then behaves as a monopoly. Or second, the
9 railroads will split the market between them and act as individual monopolists. My
10 recent experiences in negotiating with railroads suggest that the firms probably exhibit a
11 pricing behavior more similar to a monopolist or Cournot rather than Bertrand,
12 particularly since the railroads are now experiencing capacity constraints. Neither the
13 Union Pacific Railroad Company ("UP") nor the BNSF Railway Company ("BNSF"), the
14 primary carriers of western coal traffic, attempt to seize all of the traffic they can,
15 because their capacity is constrained in certain locations. Because of this, both carriers
16 are aware that they could never handle all of the other's competitive traffic and have set
17 higher prices accordingly. There is no reason that Excelsior will be exempt from this
18 behavior.

19
20 **Q: Mr. Olson also claims that the relative cost of service does not impact transportation**
21 **pricing, but rather the number of options available drives prices. Do you agree with**
22 **Mr. Olson's claim?**

1 A: No. Whether in a duopoly or in a more openly competitive situation, the low cost
2 producer will price at, or just below, its estimate of the price of the other competitor or
3 the other alternative. This is because each competitor would be aware that their costs are
4 not the same. For the proposed Mesaba Project, BNSF will have the lower operating cost
5 over a joint UP/Canadian National Railway ("CN") movement from the Southern PRB.
6 This is due to the fact that BNSF can offer single line rail service and because the
7 distance from Southern PRB is 12 percent less than the distance over a combined UP/CN
8 movement (1,315 miles vs. 1,176 miles from Reno Junction to Taconite, MN). The
9 differential in costs will translate to an economic rent that BNSF will enjoy because both
10 BNSF and UP/CN will use the higher cost of service as the pricing floor.

11
12 **Q: Mr. Olson calls your statement in your Direct Testimony that Excelsior will have**
13 **difficulty negotiating favorable rail rates given current railroad practices**
14 **"unfounded and speculative." Do you have evidence to support your statement?**

15 A: Yes. I have several documents to support my statement. Exhibit TDC-4 contains a
16 number of articles from transportation industry, utility industry and general business
17 publications detailing the railroad's increasing market power and coal transportation
18 rates.

19
20 **Q: What do the articles you include in your Exhibit TDC-4 indicate about current**
21 **railroad pricing practices?**

1 A: The articles outline the western coal carriers' implementation of public pricing
2 instruments and general increases in coal transportation rates. For example, UP and
3 BNSF have been remarkably consistent in their pricing strategies. BNSF started to move
4 toward public pricing of coal in 2003, while UP began to move toward tariff-based public
5 pricing in 2004. Both carriers are moving from long-term contracts which had been a
6 minimum of 5-years to 10- and 20-year terms, to short-term contracts of one to three
7 years. In addition, rates on both railroads have increased considerably, sometimes
8 doubling, with both railroads issuing "take it or leave it ultimatums" regarding pricing.
9 The railroads have clearly begun exercising their considerable market power to the point
10 where, as indicated in the articles, the United States Department of Justice has launched
11 an inquiry into the possible anti-competitive practices involving the transportation of
12 coal. It is into this pricing environment that Excelsior contends it will be able to negotiate
13 low transportation rates from the carriers. Based on current railroad pricing practices, I
14 believe this contention is incorrect.

15
16 **Q: Mr. Olson alleges that you stated in your Direct Testimony that MP's Boswell**
17 **Generating Station will have rail rates lower than the proposed Mesaba Project.**
18 **Are Mr. Olson's allegations correct?**

19 A: No, Mr. Olson has again misstated my Direct Testimony. I never claimed that MP's
20 Boswell Generating station would have lower rail transportation rates than the proposed
21 Mesaba Project, though it is possible. I instead stated that MP has more certainty about
22 the possibility of being able to negotiate a reasonable price for future rail service than a

1 purchaser, like Excelsior, with no existing agreement and no existing relationship with
2 the railroad. I based my statement on the fact that MP has had a long term working
3 relationship with BNSF and have been able to work together as business partners.
4

5 **Q: Mr. Olson states that the proposed Mesaba Project's ability to use different types of**
6 **coal will allow for an unprecedented number of fuel options, thereby allowing a Fuel**
7 **Supply subcommittee to effectively and quickly capture the lowest delivered price of**
8 **fuel. Do you agree with Mr. Olson's statement?**

9 A: No. Mr. Olson's statement relies upon two faulty implicit assumptions. First, that the
10 coal producers and the railroads have little market power and will rush to provide the
11 lowest prices in the face of overwhelming competition. Second, that Excelsior can
12 achieve the lowest delivered price of fuel by using short-term agreements to maximize
13 flexibility. The Class I railroads and large coal producers have extensive market power,
14 and, based on current market trends, neither group will rush to offer the lowest prices
15 available. Since the late 1990's, consolidation within the railroad industry has led to
16 strong duopoly competition, leading to higher rail rates for almost all players. Exhibit
17 TDC-5 contains a copy of a 2005 equity analysts report prepared by Smith
18 Barney/Citigroup explaining the railroads' avoidance of what the Smith Barney/Citigroup
19 calls "rogue pricing policies" that have led in the past to undisciplined efforts to gain
20 marketshare at the expense of increasing returns. This avoidance of "rouge pricing" has
21 led to higher transportation prices across all commodities. Similarly, consolidation within
22 the coal industry has led to a small number of large producers, who control production in

1 the PRB and Illinois Basin, limiting the amount of sourcing options and pricing. Exhibit
2 TDC-6 contains a 2004 *Coal Age* article discussing the impact of consolidation within the
3 coal mining industry. As the number of mine operators decline through consolidation, the
4 more difficult it will be for coal buyers to leverage geographic competition, and to obtain
5 the rock bottom prices envisioned by Mr. Olson. As with the railroads, the mine
6 operators are not rushing to the bottom of the pricing curve.

7
8 Mr. Olson's second assumption rests upon the belief that short term, more flexible
9 transportation and coal agreements will lead to lower prices. This assumption is not
10 necessarily true, especially in the case of the rail transportation industry. Exhibit TDC-7
11 contains an excerpt from an October 2006 United States Government Accountability
12 Office ("GAO") report on the state of the rail industry. The GAO found that both shipper
13 and railroad groups have noted that railroads now prefer shorter term contracts for their
14 ability to raise prices more quickly in the face of revised market demand. In other words,
15 the railroads seek shorter term contracts to allow them to exercise their market power
16 sooner and to more quickly raise rates. The GAO's findings completely contradict Mr.
17 Olson's position that shorter, more flexible contracts will allow Excelsior to lower its
18 delivered cost of fuel.

19
20 **Q: Mr. Olson contends that you have provided no proof that the railroads will not**
21 **compete for the proposed Mesaba Project's traffic and that when the railroads**

1 complete their “debottlenecking” projects, they will compete for new business to
2 bolster revenues. Are Mr. Olson’s contentions correct?

3 A: No. As I showed above, the Class I railroads are not effectively competing for business,
4 and have settled into a duopolistic state which maximizes their revenues and profits. Mr.
5 Olson’s contention that the railroads will seek additional traffic to bolster revenues and
6 will therefore offer lower rates to Excelsior is contradictory to public pronouncements by
7 the railroads. Railroads are attempting to maximize top-line revenue growth not by
8 adding additional traffic, but by raising prices on existing traffic. Railroads are not as
9 interested in adding large volume shippers who expect low rates to their systems, but
10 large volume shippers that will offer more money to transport product over a system the
11 railroads’ claim has limited capacity.

12
13 In addition, Mr. Olson confuses the railroads’ projects to remove choke points along their
14 system, what he terms “debottlenecking,” with the addition of vast amounts of capacity.
15 When railroads have a great deal of excess capacity on their system, as they did in the
16 late 1970’s and early 1980’s, they will attempt to fill this capacity in the short-run by
17 offering lower rates. They will do this economically since any contribution to the fixed
18 cost of the infrastructure is desirable. However, when this excess capacity dissipates, they
19 will only carry the most profitable traffic and rates will increase. The so-called
20 “debottlenecking” projects that Mr. Olson alludes to are not adding excess capacity to the
21 rail systems, but removing isolated choke points along key routes to improve fluidity.
22 The railroads will not needlessly add capacity and then turn around and lower rates as

1 Mr. Olson infers. In fact, the opposite is expected to happen as railroads will attempt to
2 increase rates if they attempt to add capacity. I have included as Exhibit TDC-8, a
3 December 2005 *Railway Age* article in which BNSF's Chief Executive Officer Matt Rose
4 stated:

5 We can only meet future demand by reinvesting adequately both to
6 maintain the quality of our infrastructure and to expand our railroad's
7 capacity to handle more freight. And we can only do this if we can
8 reach a return on invested capital that is greater than the cost of capital,
9 and maintain that level of performance through the business cycle.

10 Because rail customers will reap much of the primary benefits of
11 expanded infrastructure, they will need to share some of the burden;
12 rates will need to continue to go up in all sectors of our business to
13 match the value derived from our service.

14 It is obvious based on Mr. Rose's statement that the railroads can be expected to increase
15 their rates after making additional capital infrastructure expenses, and not decrease them
16 as Mr. Olson contends.

17
18 **Q: Mr. Olson contends that you stated in your Direct Testimony that the proposed**
19 **Mesaba Project should not expect rail rates to fall from where you expect coal to be**
20 **sourced from. Is this correct?**

21 **A:** No. As a fundamental issue, I never indicated where I expected Excelsior would receive
22 its coal from, but instead just reacted to comments made by Excelsior about where it

1 expected to receive its coal from. Moreover, as I demonstrated above, rail rates to all
2 shippers are increasing as the railroads flex their market power, and Excelsior will not be
3 immune from these increases.
4

5 **Q: Mr. Olson contends that the proposed Mesaba Project's use of high sulfur or/or**
6 **high sodium coal will allow it to open under-produced coal reserves, and that these**
7 **new reserves can be transported on "non-bottleneck" corridors at competitive**
8 **prices leading to low delivered fuel costs. Do you agree with Mr. Olson's claim?**

9 A: No. Mr. Olson fails to recognize that in pricing their services, railroads attempt to
10 maximize their profit, relative to competitive forces or lack there-of, no matter the route
11 of the movement. A railroad will maximize its profit on whatever route the product is
12 shipped over, and will price its services accordingly. The fact that a railroad transports
13 coal from a new reserve makes little difference to the railroad. It will expect to make a
14 certain level of profit on the movement, and will price accordingly.
15

16 **Q: How do you respond to Mr. Olson's contention that the BNSF and CN have**
17 **mainlines within 2 miles of the proposed Mesaba Project site, and that Excelsior**
18 **contemplates the construction of rail spurs from both railroads to provide diversity**
19 **in transportation.**

20 A: As he has done throughout his Rebuttal Testimony, I believe that Mr. Olson has
21 overstated the facts. First, as I discussed above, Mr. Olson has failed to consider the
22 different operating costs each railroad will incur in transporting coal to the proposed site,

1 and the rates will depend on the highest relative cost of transportation. Second, the rail
2 lines that Mr. Olson refers to as BNSF and CN “mainlines” are in fact light-density spur
3 lines that may not possess the ability to carry the projected volumes. According to
4 Excelsior’s application, the proposed Mesaba Project is expected to transport a maximum
5 of 2.7 million net tons of coal per year.⁵ Based on a railroad industry standard rule of
6 thumb of 1.6 gross tons to 1 net ton for unit coal trains, the proposed Mesaba Project
7 would expect to transport approximately 4.32 million gross tons per year. The BNSF
8 spur line from Gunn, MN to the proposed site near Taconite, MN currently carries
9 between 5 and 10 million gross tons per year.⁶ This would indicate that the density over
10 the BNSF spur line could increase between 43 and 86 percent if the proposed Mesaba
11 plant is built. The CN spur line which runs from Kennan, MN west towards the Taconite,
12 MN site has even less density transporting between 0.1 and 4.9 million gross tons per
13 year.⁷ Transporting the proposed tonnage over this line segment could increase the
14 density on the line between 88 percent and 4,320 percent. Adding the proposed amount of
15 Mesaba Project traffic to these light density spur lines will not come without costs, which
16 both railroads will assuredly pass on through higher rates. That is even assuming the CN
17 attempts to move the traffic over such a lightly used rail line.

18
19 **Q: Does this conclude your surrebuttal testimony?**

20 **A: Yes.**

⁵ See Supplemental Testimony and Exhibits of Excelsior Energy, Thomas L. Osteraas - Exhibit ____ TLO-2, Petition - Appendix A Mesaba Energy Project Report to the MPUC at Section 1, Page 20.

⁶ See the National Railroad Density Map available at <http://www.rrpicturearchives.net/default.aspx>.

⁷ See *id.*

Exhibit TDC – 1

FINANCE DOCKET NO. 30,000¹

**UNION PACIFIC CORPORATION, PACIFIC RAIL SYSTEM,
INC., AND UNION PACIFIC RAILROAD COMPANY-CON-
TROL-MISSOURI PACIFIC CORPORATION AND MISSOURI
PACIFIC RAILROAD COMPANY**

Decided September 24, 1952

¹This decision embraces Finance Docket No. 30,000 (Sub-No. 1), Union Pacific Corporation, Pacific Rail System, Inc. and Union Pacific Railroad Company-Control-The Western Pacific Railroad Company; Finance Docket No. 30,000 (Sub-No. 2), Application of Union Pacific Corporation Under 49 U.S.C. §11301 for Authority to Issue Securities; Finance Docket No. 30,000 (Sub-No. 3), Application of Missouri Pacific Corporation Under 49 U.S.C. §11301 for Authority to Issue Securities; Finance Docket No. 30,000 (Sub-No. 4), Application of Western Pacific Railroad Company Under 49 U.S.C. §11301 for Authority to Issue Securities; Finance Docket No. 30,000 (Sub-No. 5), Union Pacific Railroad Company-Trackage Rights at Kansas City over-Missouri Pacific Railroad Company; Finance Docket No. 30,000 (Sub-No. 6), Union Pacific Railroad Company-Trackage Rights at St. Joseph over-Missouri Pacific Railroad Company; Finance Docket No. 30,000 (Sub-No. 7), Missouri Pacific Railroad Company-Trackage Rights at Omaha-Council Bluffs over-Union Pacific Railroad Company; Finance Docket No. 30,000 (Sub-No. 8), Union Pacific Railroad Company and Missouri Pacific Railroad Company-Pooling between Omaha-Council Bluffs and Kansas City; Finance Docket No. 30,000 (Sub-No. 9), Union Pacific Railroad Company and Missouri Pacific Railroad Company-Pooling Between Beloit and Saffra, Kansas; Finance Docket No. 30,000 (Sub-No. 10), Union Pacific Railroad Company and Missouri Pacific Railroad Company-Pooling between Lincoln and Kansas City; Docket No. MC-F-14448, Union Pacific Corporation, Pacific Rail System, Inc., and Union Pacific Railroad Company-Control-WPX Freight System, Inc.; Docket No. MC-F-14449, Union Pacific Corporation, Pacific Rail System, Inc., and Union Pacific Railroad Company-Control-Missouri Pacific Truck Lines, Inc.; Finance Docket No. 30,000 (Sub-No. 14), Southern Pacific Transportation Company, St. Louis Southwestern Railway Company-Trackage Rights-Union Pacific Railroad Company-Ogden to Omaha/Council Bluffs; Gibbon to Topeka; Finance Docket No. 30,000 (Sub-No. 15), Southern Pacific Transportation Company, St. Louis Southwestern Railway Company-Trackage Rights-Union Pacific Railroad Company-Ogden to Omaha/Council Bluffs; Gibbon to Topeka; Finance Docket No. 30,000 (Sub-No. 16), St. Louis Southwestern Railway Company-Trackage Rights-Missouri Pacific Railroad Company-Kansas City to St. Louis; Finance Docket No. 30,000 (Sub-No. 17), St. Louis Southwestern Railway Company-Trackage Rights-Aichison, Topeka and Santa Fe Railway Company Utilized By Missouri Pacific-Vicinity of Kansas City; Finance Docket No. 30,000 (Sub-No. 18), Denver and Rio Grande Western Railroad Company-Trackage Rights-Missouri Pacific Railroad Company Between Pueblo, CO and Kansas City, MO; Finance Docket No. 30,000 (Sub-No. 19), Denver and Rio Grande Western Railroad Company-Trackage Rights-Western Pacific Railroad Company Between Salt Lake City, UT and points in Utah, Nevada and California; Finance Docket No. 30,000 (Sub-No. 20), Missouri-Kansas-Texas Railroad Company-Trackage Rights-Missouri Pacific Railroad Company-Between Sedalia and St. Louis, MO; Finance Docket No. 30,000 (Sub-No. 21), Missouri-Kansas-Texas Railroad Company-Trackage Rights-Missouri Pacific Railroad Company-Between San Antonio and Laredo, TX; Finance Docket No. 30,000 (Sub-No. 22), Missouri-Kansas-Texas Railroad Company Use of Terminal Facilities at Laredo, TX; Finance Docket

(footnote continued on next page)

1. In Finance Docket No. 30,000, acc Union Pacific Railroad Company, an poration, and of Missouri Pacific Railroad Company authorized, subject to conditions.
2. In Finance Docket No. 30,000 (Subporation, Union Pacific Railroad Company subsidiary, Inc., of Western Pacific Railroad Company authorized, subject to conditions.
3. In Finance Docket No. 30,000 (Sub share convertible preferred stock by
4. In Finance Docket No. 30,000 (Sub Pacific Corporation is authorized.
5. In Finance Docket No. 30,000 (Subcific Railroad Company is authorize
6. In Finance Docket No. 30,000 (Sub Company for trackage rights over : City is granted, subject to condition:

(footnote 1 continued.

No. 30,000 (Sub-No. 23), Missouri-Kansas-T Railroad Company-Between San Antonio an No. 24), Missouri-Kansas-Texas Railroad Co Finance Docket No. 30,000 (Sub-No. 25), M Missouri Pacific Railroad Company-Between 30,000 (Sub-No. 26), Missouri-Kansas-Tex Railroad Company-Between Union and Lin Missouri-Kansas-Texas Railroad Company L No. 30,000 (Sub-No. 28), Missouri-Kansas Atchison, KS; Finance Docket No. 30,000 (Trackage Rights-Union Pacific Railroad Co Finance Docket No. 30,000 (Sub-No. 30), M Facilities at Council Bluffs, IA; Finance D Railroad Company-Trackage Rights-Union Topeka, KS; Finance Docket No. 30,000 (Su of Terminal Facilities at Topeka, KS; Finance Railroad Company-Trackage Rights-Termine 30,000 (Sub-No. 34), Kansas City Southern Company-Acquisition and Trackage Rights (and IL; Finance Docket No. 30,000 (Sub-N: pany-Trackage Rights-Union Pacific Railro Finance Docket No. 30,000 (Sub-No. 36), E Missouri Pacific Railroad Company Between 30,000 (Sub-No. 37), Burlington Northern Railroad Company Between Falls City, NE a 38), Burlington Northern Railroad Company tween Thebes and West Vienna, IL; Financ Railroad Company-Trackage Rights-Missour Fort Gibson, OK; Finance Docket No. 30,00 Trackage Rights-Missouri Pacific Railroad Co Docket No. 30,000 (Sub-No. 41), Burlingto Pacific Railroad Company Between Hoxie an Burlington Northern Railroad Company-Ta Hastings, NE and Ogden, UT; and Financ Western Transportation Company and Miss:

high as possible and divide the profits in accordance with their relative bargaining power with each other. If only one carrier on the route has a segment monopoly, then that carrier will have an incentive, and will often have the ability, to keep all available monopoly profits to itself.

BN and OSC contend that a utility will receive the benefit of competition between carriers serving the origin point of a coal movement, even if only one carrier serves the destination, so long as the destination carrier is unaffiliated with, and thus neutral toward, the carriers serving the origin (neutrality theory). We conclude that the neutrality theory has not been shown to support BN's arguments with respect to the coal transportation markets involved in these proceedings.

A carrier with a destination monopoly will likely push the through rate as high as possible and keep the monopoly profits to itself by playing off competing connecting carriers against one another in setting divisions. That is, the through rate will be at the level maximizing net revenue for the traffic, subject to regulatory limits, and the destination carrier will establish favorable through service with the origin carrier willing to take the lowest division of the through rate for its segment of the movement. Although a destination carrier might not always be successful in executing this strategy, it will always have the incentive of profit-maximization to attempt to execute the strategy. Therefore, this rate strategy will be pursued and should succeed unless there are obstacles to its execution with respect to a specific movement.

BN and OSC assert that a neutral destination carrier usually will not be able to execute this "vertical price squeeze" and, therefore, has an incentive to merge with an origin carrier in order to drive the through rate to the optimum profit-maximizing level. We are not convinced either that a carrier with a destination monopoly for steam coal traffic will generally be unable to execute the described rate strategy or, on the other hand, that a neutral destination carrier that is unable to execute the strategy would be significantly more capable of raising the through rate to the level that maximizes its profits after affiliation with an origin carrier.

At the ex post stage, effective competition requires that competing origin lines have independent access to a power plant, either directly or through interlining. However, if the origin carriers must all interline with the same connecting carrier to reach the destination, then independent access is lacking, even if the destination carrier is not affiliated with an origin carrier. An origin carrier must have access to the destination over a route independent of the other origin carrier's route, not merely access by interlining with a carrier independent of the other origin carrier. This is the meaning of "independent access" needed for effective competition, as discussed in *CSX*, 363 I.C.C. at 571, 572. Independent access is

366 I.C.C.

not the same thing as access over. Contrary to BN's assertions, our petition requires independent access. If independent access by competing carriers does not support the rate, then the rate, rather, is at odds with the rationale.

In *CSX* and in various coal rate cases, the power of carriers with destination monopolies, with a destination monopoly usually over the rate regardless of whether the carrier is on the lines of an affiliate. Therefore, if a utility is not created, or increased competition at the destination carrier with an origin carrier, we conclude that in the usual case a utility will not create origin competition if it must rely on the usual circumstances, the benefits of competition usually inure to the benefit of the carrier served has a sufficiently strong bargaining leverage over the destination carrier.

We do not reject the possibility that a utility might flow through to a utility and not, however, presume that the utility will obtain the through rate. Rather, we require a showing that the utility obtain the benefits of origin competition exclusively by one carrier at the destination. The most persuasive evidence is testimony that it has effectively obtained, or that it has effectively obtained, competition at the plant with monopoly.

At best, the neutrality theory is not convincing. If a carrier merge, the merged carrier will attempt to maximize its profits. It will not convincingly demonstrate that it will exercise increased market power. We are persuaded by BN's arguments that the merged carrier will not be able to execute a vertical price squeeze without an affiliate. It is shown that a destination carrier will not be able to execute a vertical price squeeze without an affiliate that ability after an affiliation.

BN argues that lack of information inhibits the destination carrier from setting the level maximizing profits for the traffic. The carriers are substantially ignorant of

366 I.C.C.

ts in accordance with their relative only one carrier on the route has a r will have an incentive, and will ailable monopoly profits to itself. will receive the benefit of competi- n point of a coal movement, even if 1, so long as the destination carrier ard, the carriers serving the origin at: the neutrality theory has not ts with respect to the coal transpor- eedings.

ly will likely push the through rate poly profits to itself by playing off one another in setting divisions. level maximizing net revenue for and the destination carrier will es- the origin carrier willing to take for its segment of the movement. ot always be successful in execut- : incentive of profit-maximization efore, this rate strategy will be ere are obstacles to its execution

destination carrier usually will not be "squeeze" and, therefore, has an er in order to drive the through ig level. We are not convinced onopoly for steam coal traffic will iberated rate strategy or, on the other r that is unable to execute the able of raising the through rate to affiliation with an origin carrier. petition requires that competing a power plant, either directly or in carriers must all interline with e destination, then independent e carrier is not affiliated with an e access to the destination over a rrier's route, not merely access of the other origin carrier. This needed for effective competi- 571, 572. Independent access is 366 I.C.C.

not the same thing as access over a single neutral destination carrier. Contrary to BN's assertions, our conclusion in *CSX* that effective competition requires independent access to a power plant by competing origin carriers does not support the neutrality theory. The neutrality theory, rather, is at odds with the rationale of *CSX*.

In *CSX* and in various coal rate cases, we have acknowledged the power of carriers with destination monopolies over coal rates. A carrier with a destination monopoly usually will have substantial market power over the rate regardless of whether it has suitable coal on its own lines or on the lines of an affiliate. Therefore, the market power faced by an existing utility is not created, or increased by, consolidation of a monopoly destination carrier with an origin carrier, see *CSX*, 363 I.C.C. at 573. We conclude that in the usual case a utility will not benefit from ex post origin competition if it must rely on only one destination carrier. In such circumstances, the benefits of competition at the destination would usually inure to the benefit of the destination carrier, unless the utility served has a sufficiently strong bargaining position to enable it to exert leverage over the destination carrier.

We do not reject the possibility that the benefits of origin competition might flow through to a utility despite a destination monopoly. We do not, however, presume that these benefits will, in fact, always flow through. Rather, we require a showing that a specific utility is able to obtain the benefits of origin competition even though it is served exclusively by one carrier at the destination. In making this showing, the most persuasive evidence is testimony on behalf of the utility explaining how it has effectively obtained, or could obtain, the benefits of origin competition at the plant with monopoly service.

At best, the neutrality theory shows that if an origin and a destination carrier merge, the merged carrier might have an incentive to squeeze out unaffiliated origin carriers from the service route and that the merged carrier will attempt to maximize its profits. The theory, however, does not convincingly demonstrate that such a merged carrier would be able to exercise increased market power to the detriment of utilities. We are not persuaded by BN's arguments that a neutral destination carrier generally will not be able to execute a vertical price squeeze. Further, BN has not shown that a destination carrier which is not able to execute a vertical price squeeze without an affiliated origin carrier will necessarily acquire that ability after an affiliation.

BN argues that lack of information regarding origin carriers' costs inhibits the destination carrier from being able to set the through rate at the level maximizing profits for the traffic. Even if we assume that carriers are substantially ignorant of each others costs, we are not convinced 366 I.C.C.

Exhibit TDC - 2

21530
EB

SERVICE DATE - LATE RELEASE APRIL 30, 1997

This decision will be published in the bound version of printed reports at a later date.

SURFACE TRANSPORTATION BOARD¹

No. 41242

CENTRAL POWER & LIGHT COMPANY

v.

SOUTHERN PACIFIC TRANSPORTATION COMPANY

No. 41295

PENNSYLVANIA POWER & LIGHT COMPANY

v.

CONSOLIDATED RAIL CORPORATION

No. 41626

MIDAMERICAN ENERGY COMPANY

v.

UNION PACIFIC RAILROAD COMPANY

and

CHICAGO AND NORTH WESTERN RAILWAY COMPANY

Decided: April 28, 1997

The Board grants, in part, a petition for clarification of its previous decision, and denies a petition for reconsideration.

¹ The ICC Termination Act of 1995, Pub. L. No. 104-88, 109 Stat. 803 (1995) (the ICCTA), abolished the Interstate Commerce Commission (ICC) and transferred certain functions to the Surface Transportation Board (Board), effective January 1, 1996. Section 204(b)(1) of the ICCTA provides, in general, that proceedings pending before the ICC on the effective date of that legislation shall be decided under the law in effect prior to January 1, 1996, insofar as they involve functions retained by the ICCTA. The captioned proceedings were pending with the ICC prior to January 1, 1996, and concern functions which are now under this Board's jurisdiction. Accordingly, references in this decision are to the old law (West Ed. 1995) unless otherwise indicated.

-- competition, the shippers' approach would go further and artificially force competition by impermissibly depriving the bottleneck carriers of their initial rate and route discretion. Id. at 8.

On January 21, 1997, MidAmerican filed a petition for clarification of our December 31st decision, and Western Resources, Inc. (WRI) filed a petition for reconsideration. We address these petitions in turn.

PETITION FOR CLARIFICATION

MidAmerican, supported by the Western Coal Traffic League (WCTL), asks us to clarify the December 31st decision by explaining more fully the availability of bottleneck-segment rate relief where, unlike the circumstances in the dismissed complaints, a shipper has first secured a separate rate for service over a non-bottleneck segment through a shipper-carrier rail transportation contract. Bottleneck at 13-14. The Association of American Railroads (AAR) opposes this request, arguing that such a determination should be made in actual cases, not through the hypothetical examples presented in MidAmerican's petition. AAR also argues that the clarifications sought by the utility, if granted, would effectively and improperly compel what we found that railroads were not required to provide -- segment rates for through service.

We share AAR's concern that, because any particular bottleneck rate case is likely to be distinct, the Board should not prejudge a railroad's rate and routing obligations or predetermine remedies in every conceivable set of circumstances, and we will not do so here.⁵ AAR Opposition at 6, 8. However, recognizing the impact our decision would likely have on future bottleneck-rate complaints, we have sought public comment and conducted oral argument to air thoroughly the common legal and policy issues involved in these matters so that we could set forth, as completely as possible, our approach to these cases. To that end, MidAmerican's petition raises questions that we conclude should not await future cases, but instead should be addressed now.

Accordingly, we grant the petition and clarify our December 31st decision to the extent set forth below. We address MidAmerican's questions in two different settings: (1) those situations where the bottleneck carrier serves both the origin and destination at issue and provides single-line

⁵(...continued)

involved bottleneck carrier, was prepared to provide for that coal traffic. Bottleneck at 15. Further, because MidAmerican's present rail transportation contract with Union Pacific (UP) will not expire until December 31, 1997, we determined that its complaint had to be dismissed on ripeness grounds as well. Id. at 17, citing Burlington N. R.R. v. Surface Transp. Bd., 75 F.3d 685, 692-96 (D.C. Cir. 1996) (Board may not prematurely require a common carrier rate be established for post-contract shipments).

⁶ We do, however, draw on the specific facts of the three complaints before us to help illustrate and explain our decision here. See notes 13 and 14, infra.

service; and (2) those situations where the bottleneck carrier does not serve the origin at issue, but can deliver traffic to destination only after interchanging it with another carrier.⁷

Alternative Service From Origin Now Served By Bottleneck Carrier

In the first situation, the shipper seeks to forgo the bottleneck carrier's single-line service by separately contracting with a second rail carrier that also serves the origin for transportation to an interchange point on the bottleneck segment. If the shipper already has a contract with the second carrier in hand, *MidAmerican* asks whether the bottleneck carrier would then be required to establish, upon the shipper's request, a rate from that interchange point to destination that would operate in combination with the contract to complete the transportation, and whether we would separately adjudicate the reasonableness of that rate if separately challenged on rate reasonableness grounds. *Clf. Pet.* at 4-6.

In this situation, our prior decision is clear. As we stated there, where a bottleneck carrier already serves the origin, either directly or in interline service, it need not provide, on request, an additional rate for transportation over the bottleneck segment of an alternative interline route from that origin. Instead, the shipper must first proceed under our competitive access regulations to obtain an order requiring the opening of that route. *Bottleneck* at 6-11; 49 CFR 1144.5. We stated that, where it is shown, pursuant to the rules, that a carrier's refusal to establish an alternative through route would foreclose more efficient service, we will prescribe that route. We also explained that a contract obtained for service over a non-bottleneck segment of the shipper's preferred route may be useful in making a successful access case. *Id.* at 9-11.

We determined, however, that a shipper-carrier contract entered into under 49 U.S.C. 10709 for rail service over the non-bottleneck segment, though itself insulated from further regulatory oversight, would not relieve the shipper from having to make an access case, because the contract:

does not override the routing and long-haul protections afforded under section 10705 to the non-contracting, connecting rail carrier for service over its route segment; section 10709 was not intended to impose new regulatory obligations on non-contracting parties.

Bottleneck at 9-10 n.17. The routing protections provided to rail carriers by section 10705 are longstanding and, as we explained, confer on each railroad the initial discretion to choose the routes it will use to respond to requests for service. *Id.* at 6. In particular, the right of a rail carrier not to be short-hauled, 49 U.S.C. 10705(a)(2), originated in the Mann-Elkins Act of 1910, Pub. L. No. 218, 36 Stat. 539, 552 (1910), and protects a railroad, at the outset, from the precise result posed by *MidAmerican's* hypothetical: "hav[ing] to carry over its lines traffic originating on, or destined to,

⁷ Our analysis has equal relevance if the bottleneck exists on the origin, rather than the destination, segment. *Clarification Petition (Clf. Pet.)* at 4 n.2.

Exhibit TDC - 3

BEFORE THE
SURFACE TRANSPORTATION BOARD

Ex Parte No. 658

*THE 25TH ANNIVERSARY OF THE STAGGERS RAIL ACT OF 1980:
A REVIEW AND LOOK AHEAD*

Written Testimony

submitted by

THE NATIONAL INDUSTRIAL TRANSPORTATION LEAGUE

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Dated: October 12, 2005



G. Shift From Contracts Back to Public Pricing, and Changes in Contracts

In the past several years, a final significant change has taken place – the shift from contract back to public pricing. This development has been widely reported in the press, and the League is well aware of this change. League members report that the pace of this change seems to be gaining a considerable amount of momentum among the railroads. The change permits railroads to increase prices on little notice, but leaves shippers with little certainty in their transportation arrangements; few remedies for poor service; and subject to extremely restrictive (and perhaps unlawful) rules on loss and damage.

Contracts have been affected as well. While it is impossible to make certain judgments given the confidential nature of contracting, general information from shippers suggests that contracts have become of much shorter duration; contain few if any service guarantees; are subject to a variety of accessorial and surcharges; and often are little more than a promise by the shipper to ship a certain amount or percentage of goods and a price for transporting the goods. In short, it appears that the railroads are implementing a strategy of having few private contracts with shippers that have any real teeth or meaning to them.

III. MANY OF THE KEY CHANGES IN THE RAILROAD INDUSTRY SINCE THE STAGGERS ACT HAVE RESULTED IN AN INCREASE IN RAILROAD MARKET POWER AND HAVE DECREASED COMPETITIVE OPTIONS FOR SHIPPERS

It is very clear that a number of the changes that have taken place in the transportation industry since the passage of the Staggers Act have resulted in an increase in railroad market power and decreased options for shippers.

Railroad mergers have reduced the number of railroad competitors to just two in the East and two in the West. These mergers have reduced the number of competitive routing options as

merged carriers have closed formerly competitive gateways. Combined with the agency's ruling in its 199_ "bottleneck" decision, which eliminated the right of shippers to choose a competitive joint-line route when one railroad could provide single-line service, mergers have extended railroad bottlenecks and have turned potentially competitive routings over at least part of a movement into single-line captive movements. Rail mergers have also decreased even the indirect leverage represented by product and geographic competition, as widely-separated plants are today much more likely to be served by the same railroad. The extreme concentration of the industry, coupled with the increased use of public pricing — itself a practice whose growth has been facilitated by the small number of rail competitors in the industry -- has made the possibility of price leadership and conscious parallelism much more likely. With the growth in public prices, it becomes much easier for the two remaining competitors in the East and West to monitor each other's prices, and by their reactions to each other more easily manage their desired level of prices.

Beyond the competition-dampening effects of rail mergers since the Staggers Act, there have been other developments that have tended to increase rail market power. Increasing shipper investment in instrumentalities of transportation that used to be supplied by rail carriers themselves, such as cars and rapid loading facilities, have tied rail-dependent shippers even more tightly to the use of rail. A shift to truck competition becomes even more difficult if a company has to "write off" millions of dollars in rail-related investments, even as the price of rail transportation increases and the consistency of rail service declines.

As noted above, changes to the trucking industry have also increased the ability of rail carriers to exercise market power, as changes in fuel prices, driver shortages, increases in insurance and other costs, and other factors have caused trucks to be less and less competitive to

rail carriers over a larger segment of the railroads' traffic base. The Valentine Railroad Report noted that non-fuel truckload trucking costs increased twelve percent in the two-year period from 2003 through 2004. They are expected to jump another seven percent this year, for a total non-fuel cost increase of nearly twenty percent in just three years. Valentine Railroad Report, p. 9. When these non-fuel cost increases are combined with the large fuel cost increases recently experienced, this places motor carriers at an even greater competitive disadvantage. As noted above, the Valentine Freight Pulse 9 Report concluded that "approximately 80% of the industry's revenue is generated by customers where modal shift to truck is not a very realistic option" Valentine Freight Pulse 9 Report, p. 7. Even the transportation of motor vehicles, usually considered to be truck-competitive, was rated by the Morgan Stanley team as having only "moderate" truck competition. *Id.*

The move away from contracts and toward public pricing gives rail carriers much more opportunity to change prices quickly, and much less responsibility for the quality of service. Conversely, shippers have less and less certainty over their transportation costs, and at present, few remedies for poor service.

Overarching all of these trends is the growing realization that the rail industry is experiencing serious capacity constraints. As the Valentine Railroad Report notes, "after 90 years, the railroads have run out of excess capacity." Valentine Railroad Report, p. 8. It concludes: "[t]his lack of excess capacity has shifted the railroad's marketing philosophy from one of *incremental pricing* to one of *full cost recovery* pricing, including their cost of capital, a philosophy not used for such a broad range of railroad commodities in at least 50 years." *Id.* [emphasis in original]. The Board is well aware that shippers have been experiencing railroad "de-marketing" of less desirable movements through price hikes, and very substantial rate

Exhibit TDC - 4

The Denver Business Journal - February 28, 2005
<http://denver.bizjournals.com/denver/stories/2005/02/28/story5.html>

DENVER BUSINESS JOURNAL

BUSINESS PULSE SURVEY: Is it hard to work for someone younger than you?

Justice launches railroad investigation

The Denver Business Journal - February 25, 2005 by Cathy Proctor Denver Business Journal

The **Department of Justice** wants to know if the two largest railroads in the West are colluding on the price to transport coal from Wyoming's Powder River Basin -- the largest coal-producing area in the United States.

The coal feeds power plants throughout the nation and is prized for its low-sulfur properties. Wyoming, the top coal-producing state in the nation, produces about 400 million tons of coal a year.

But over the last several months the two railroads that carry the coal from the region, **Union Pacific Corp.** and **Burlington Northern Santa Fe Corp.**, have been under fire from power plant operators complaining that transportation prices are soaring.

Traditionally, contracts to move coal from mines to power plants have been long-term agreements, ranging from a minimum of five years to 10- and 20-year terms.

But last year, the railroads limited new contract offers to about three years, the price of those contracts has gone up -- doubling in some cases -- and the railroads are issuing "take it or leave it" ultimatums.

The justice department has requested information from both railroads about the new contracts.

"The antitrust division is looking into the possibility of anti-competitive practices involving the transport of coal," said Gina Talamona, a spokeswoman for the justice department.

Burlington Northern (NYSE: BNI) said in a recent filing with the **Securities and Exchange Commission** that it "has received a civil investigative demand from the Antitrust Division of the Department of Justice requesting information concerning the company's pricing activities relating to the shipment of coal from the southern Powder River Basin."

"We're responding to the request," said Patrick Hiatte, spokesman for Burlington Northern (BNSF).

BNSF, based in Fort Worth, Texas, is one of the largest transporters of low-sulfur coal in the United States. About 90 percent of its coal shipments come from the Powder River Basin, which sprawls across northeastern Wyoming and into Montana.

The railroad reported revenues of nearly \$2.3 billion from shipping coal in 2004, a 12 percent increase over the previous year.

The justice department formally contacted Union Pacific (NYSE: UNP) of Omaha, Neb., on Feb. 14, but the railroad started sharing information about its new transportation contracts in December, Union Pacific officials said.

"We contacted the DOJ in early December to explain our process and how we distribute the pricing information," spokesman John Bromley said. "Their subsequent action is their way of obtaining more information and we will be cooperating fully."

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Last year, Union Pacific created a tariff list for power plant customers, telling each customer what the new transportation charges would be for contracts expiring in 2005 and beyond.

The utility industry worries the list may have fallen into the hands of Union Pacific's only competitor in the West, BNSF.

"If you get a bid from one railroad that's X and the other is X plus \$5 a ton, you don't have competition. If they're using that knowledge to set rates, that seems to be anti-competitive," said Duane Richards, CEO of the **Western Fuels Association Inc.**, based in Westminster.

The association buys 20 million tons of coal a year for power plants owned by municipalities and cooperatives that are members of the association.

Xcel Energy Inc., based in Minneapolis and serving 1.2 million customers in Colorado, ships 32 million tons of coal a year to its power plants -- nearly 70 percent of it from the coal beds of the Powder River Basin.

"We certainly are aware of [the DOJ's investigation] and have interest in it because we work with both railroads, and we'll cooperate if we're contacted," said Xcel spokesman Mark Stutz.

Last year, Xcel's power plants in Colorado received 5.4 million tons of coal via BNSF and 3.1 million tons via Union Pacific. Overall, Xcel shipped 26 million tons of coal via BNSF and 5 million tons via Union Pacific in 2004, Stutz said.

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Coal's Costly Switch

BY JOHN GALLAGHER

Shippers fear UP's new coal pricing strategy will prove costly; railroad cites higher fuel, operating costs

Higher fuel costs are pushing railroads carrying western coal toward pricing strategies that coal shippers and electric utilities fear could sharply raise costs.

Union Pacific Railroad introduces a new Powder River Basin coal pricing strategy March 31 that goes against the flow of transportation pricing since deregulation by replacing individually negotiated contract rates with tariff-style one-price-for-all pricing. That has shippers in sticker shock.

"Indeed we're concerned," said Tom Cannon, executive director of the National Coal Transportation Association, an educational association that represents coal companies and electric utilities. "We're not sure exactly what it means yet. Is this the end to bilateral negotiating? We hope not."

Instead of negotiating transportation rates privately with individual customers, UP says it will post a list of rates on its Web site based on what the railroad believes will generate the revenue needed to support the business.

UP says the new strategy will simplify the way customers do business with the railroad, but shippers say the initiative takes away leverage crucial to negotiating a fair rate.

UP would not comment on the policy beyond what it posted on its Web site. According to its "Circular 111," the pricing authority for the new policy falls, the program initially will cover rates for coal moving from mines in the southern PRB in Wyoming to 35 utility destinations — about 25 percent of its coal business, according to one estimate — and where contracts are set to expire during the next three years. The program, which will apply

to short-term business and longer term moves of up to three years, eventually will be expanded to include all of the railroad's PRB coal business.

UP said it will share actual rates only with customers who are eligible to ship under Circular 111.

"The rate items communicate to current and potential customers in a more straightforward way the revenue needs that Union Pacific has concluded it must achieve from the coal business to those destinations in order to support ongoing capital investments to handle existing and

growing coal volumes," the company stated. "The rate items provide Union Pacific's customers with sufficient information so they can evaluate their position relative to other rail users covered by the program. This mechanism also allows Union Pacific to better respond to large price swings in the price of fuel used to transport coal."

Such a switch away from privately negotiated coal contracts and towards public tariffs has been a long time coming, according to some.

"The railroads figure that they've gotten burned, especially on increased fuel costs, when they're locked-in to contracts for long periods with escalator clauses that

didn't account fully for the cost increases," said Washington, D.C., rail attorney Fritz Kahn. "UP and BNSF have very foolishly cut their contract rates in order to pick up additional tonnage over the last few years and by going to common carrier rates they'll be able to administer pricing."

That is, with rates now



Average Rate Per Ton for Contract Coal Shipments by Rail, by Sulfur Category, 1988-1997

(1996 dollars per short ton)

Year	All coal	Low sulfur	Medium sulfur A	Medium sulfur B	High sulfur
1988	14.56	18.82	13.77	10.64	6.57
1989	13.95	17.97	13.94	8.03	6.13
1990	13.74	17.51	13.89	9.38	6.14
1991	12.26	15.53	11.58	8.99	5.77
1992	11.88	15.49	10.75	7.59	5.36
1993	11.92	14.36	10.67	7.87	5.16
1994	10.97	13.40	9.49	6.15	5.52
1995	11.13	12.92	9.74	5.27	6.31
1996	10.96	12.32	9.76	7.50	6.47
1997	10.81	12.05	9.41	8.43	5.83

Notes: Low sulfur = less than or equal to 0.6 pounds of sulfur per million Btu; Medium sulfur A = 0.61 to 1.25 pounds per million Btu; Medium sulfur B = 1.26 to 1.67 pounds per million Btu; High Sulfur = greater than 1.67 pounds per million Btu.

Source: Department of Energy

Photo courtesy Union Pacific



made public, UP rival Burlington Northern Santa Fe Railway will know what rate it needs to match or just undercut UP, thereby allowing both railroads to raise the floor on transportation rates.

Growth in the coal industry, particularly the market for western coal, represents one of the best opportunities for the railroads to capture rate increases, particularly given the slim margins in intermodal, the railroads' fastest growing business.

Although U.S. coal production has hovered around just over a billion short tons since 1996, low-sulfur coal from the West — particularly Wyoming — has increased steadily. In 2002, Wyoming continued to be the biggest coal-producing state in the country, a position it has held for 15 years, according to the Energy Information Association.

EIA statistics show that in 2002 Wyoming produced a record 373 million short tons of coal, an increase of 1.2 percent from 2001 and 31 million tons more than the combined total of the next three largest coal-producing states of West Virginia, Kentucky, and Pennsylvania.

Wall Street suggests UP's new strategy

represents a major opportunity for both carriers. "We view (UP's) new coal pricing initiative as a bold step because it is a sharp move from the historical long-term contract method and because UP appears to be fully moving over to this pricing model for its PRB coal," said Bear Stearns analyst Edward M. Wolfe. Wolfe said the potential for both railroads is "very significant" given that coal represents roughly 21-22 percent of revenue for both and because there has been downward pressure on coal transport rates for many years.

He said that so far in 2004, roughly \$225 million in coal business has moved between UP and BNSF at lower rates.

But coal shippers were unhappy with the prospect of a reversal in the downward trend in coal transportation rates since the rail industry was deregulated in 1980. Many in the industry view UP's new policy as a continuation of the railroad's ability to increase its market power.

Three coal rate case decisions by the Surface Transportation Board over the last five months, while not all in favor of the railroads, effectively raised the bar on coal transportation rates in the Eastern United

States so that Norfolk Southern and CSX feel they can charge their customers without fear of those rates being significantly turned back by the STB.

Several fuel purchasing managers contacted at UP- and BNSF-served power plants did not want to be identified but all were concerned about the effect of the new policy on rates. "The size of those (Eastern) rate increases has emboldened the railroads to be indifferent to the possibility of being sued," said one fuel buyer. He said the new rates published for coal moving to his utility already are up to three times higher than the contract rates in place. He fears that once his contract is up for renegotiation, the new, higher rates are going to stick.

The UP's new pricing trend also could take away shippers' incentives to invest in access to other competing railroads.

"It's been understood that the way to create competition at a plant is to construct a rail buildout and the STB has encouraged this," said Tom Wilcox, an attorney with Thompson Hine in Washington, D.C. "So there's concern what this will mean, as to whether there will be benefits to doing that in the future." ●

Bombardier Cuts Rail Workforce

Massive layoffs aren't seen as issue in North American rail freight market; impact greater in Europe

Montreal-based Bombardier, the world's largest manufacturer of locomotives and railcars, is finally catching up with its south-of-the-border rail equipment manufacturer neighbors — in downsizing. The U.S. industry went through that phase over ten years ago.

The \$20 billion Bombardier recently announced plans to cut its rail operations workforce by 6,600 positions, or 18.5 percent of its total workforce, and will close seven manufacturing plants in five European countries over the next two years. The restructuring will reduce the rail division's costs by \$600 million annually, the company said.

However, Bombardier's massive downsizing is not expected to have any effect on the North American freight rail industry.

The overcapacity in the European passenger rail equipment market that led to Bombardier's decision doesn't impact GE Transportation Systems and General

Motors Electro-Motive division — the players that have a lock on the North American locomotive market.

"We rationalized our manufacturing facilities over 10 years ago, so we've been through that phase," said Curt Swenson, spokesman for GM's Motive Power division. "Locomotive demand was higher especially before deregulation 20 years ago, and it took the industry awhile to adjust. As the situation changed where we were able to set our own prices and better compete, and the more efficient railroads become, the number of locomotives needed decreased."

But those conditions, Swenson said, have changed. "Is there overcapacity worldwide for rail equipment? Yes, and that's what we see Bombardier trying to address. Do we have overcapacity in the North American freight market? No — we're building as many as we can."

"The markets are completely different," said Jacques Kavafian, an analyst with

Octagon Capital. "Bombardier can't make freight cars in the U.S., and GM and GE aren't set up to manufacture passenger cars" in Europe, he said. In addition, certain management decisions that led to Bombardier's changes "are unique to that company," Kavafian said.

GE and GM do compete indirectly with Bombardier — along with Bombardier's major competitors Siemens and Alstom — in some world markets, according to GM. "But GM, for one, doesn't have the exposure to the overcapacity issues because we either build complete locomotives in North America and ship overseas complete, or ship components, such as diesel engines, for later assembly," said GM's Swenson.

GM's Electro-Motive Division manufactures diesel-electric engines at its headquarters in LaGrange, Ill., and assembled into locomotives in London, Ontario. It currently has 58,000 locomotives operating around the world. GE Transportation, headquartered in Erie, Pa., has 10,000 diesel-electric locomotives in service.

— by John Gallagher

Justice Department probes rail coal rates

The U.S. Justice Department is investigating "the possibility of anticompetitive practices involving the transport of coal." What's at issue is the growing practice of publicly publishing rates for the movement of Powder River Basin coal vs. negotiating confidential, long-term rates. BNSF Railway and Union Pacific said independently that they are cooperating with the investigation. BNSF Chairman and CEO Matt Rose commented, "It's a question of whether or not we have the right to display these prices or to change out a long-term contract. We have not been instructed to do anything differently. We don't believe that we will."

Lott appointed subcommittee chair

Sen. Trent Lott (R-Miss.) is the new chairman of the Senate Committee on Commerce, Science and Transportation-Surface Transportation and Merchant Marine Subcommittee. The subcommittee has responsibility for automobiles, trucks, railroads, Amtrak, maritime and ports, driver safety, transportation of hazardous materials, pipelines, and transportation research. Lott said that one of his first priorities will be reauthorization of the trucking and automobile safety titles in the overdue highway bill. He added that the subcommittee will be looking at freight rail and railroad safety issues "early in this Congress."

Railroad accident rates decline

In every safety category but one—switching yards—the railroad accident rate in 2004's first 11 months was lower than in the same 2003 period. The yard accident rate increased 2.58% to 20.4. But the Federal Railroad Administration reported declines in its seven other broad categories: total accidents/incidents, 7.47%; train accidents, 0.95%; other [than yard] track, 2.49%; highway-rail incidents, 1.88%; employee on duty, 0.15%; trespassers, 8.90%; passengers on train, 26.1%. Accident rates take into consideration total train-miles and hours worked plus the actual accident numbers to reflect risk exposure. The two main causes of rail fatalities continue to be grade crossing and trespasser deaths. There were 339 crossing fatalities in 2004's January-November period, a 12.5% increase over the 301 fatalities reported in the prior-year period. There were 444 trespasser fatalities, down 5.5% from the previous year. (FRA does not break out "rates" of these fatalities.)

New railcars for CTA

The Chicago Transit Authority plans to acquire more than 700 new rapid transit cars over the next few years, and has issued an RFP specifying such new-to-CTA features as a.c. propulsion with regenerative braking, security cameras, and aisle-facing seating. The RFP calls for a base order of 206 cars with options that could bring the total purchase to 706. The bids generated are expected to be opened in mid-2005, with deliveries commencing in 2008. The cars, which will replace 30- to 35-year-old rolling stock, will be acquired using capital funding from the Federal Transit Administration Formula Funds-5309 and Illinois DOT. Said CTA President Frank Kruesi: "With the loss of Illinois FIRST, the state's capital funding program, CTA's funding is shrinking both on the capital side as well as the operational side and we must carefully evaluate how to apply the limited funds that remain. Though planning a new railcar purchase may at first appear contradictory as we are faced with possible service cuts and layoffs, we cannot be short-sighted. . . . Improving our infrastructure is not a process to which we can commit and then abandon."

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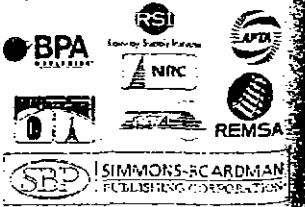
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Coal rates challenged on antitrust basis

Declaring that new coal rates published by Union Pacific and BNSF constitute unfair market practices, more than a score of coal shippers asked a U. S. District Court in Dallas, Tex., last month to find the rates to be subject to antitrust laws. The Western CoalTraffic League (WCTL) filed the complaint on behalf of its 21 members, who are paying the railroads around \$1.5 billion a year for moving coal out of the Powder River Basin in Wyoming and Montana. The action responds to increased rates arising from a railroad pricing strategy that seeks to replace confidential, long-term negotiated contracts with shorter-term contracts based on published tariffs.

A Washington-based specialist in regulatory law, the firm of Kelier & Heckman LLP, said the complaint "is evidence of the growing frustration of the shipper community with the raw exercise of market power by the railroads and the lack of a viable consumer protection program at the STB." Another Washington law firm, Slover & Loftus, is representing the coal shippers.

"With the STB making rate case litigation less rewarding over the last several years," Kellerman & Heckman said in a prepared commentary, "antitrust opens a new front, provided that the 'Keogh Doctrine,' which immunizes carrier conduct subject to regulatory agencies' remedial procedures from antitrust scrutiny, can be overcome. If WCTL is successful, however, any ruling would be limited to the form of tariff used for PRB coal pricing. This could drive BNSF and UP to completely open tariffs, frustrating their intent to avoid price signaling, and to shorter-term rate commitments. Ironically, WCTL could find itself back at the STB if the court were to refer to the board for its view of the core issue of whether a tariff with a multi-year commitment, minimum volume commitments, and fixed rate is unlawful under the ICC Termination Act."

Earlier this year, the U.S. Department of Justice confirmed that it was investigating the possibility of anticompetitive practices involving the movement of Powder River Basin coal (RA, March, p. 6).

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Rail Car Orders Rising

Capacity shortage leads to surge in demand for rail cars, intermodal units, boom time for equipment makers

Surging overall demand is fueling a business boom for rail equipment manufacturers.

GE Transportation, the \$3.5 billion subsidiary of GE, is sold out for 2005, having tallied orders for 850 locomotive deliveries. It was the company's second biggest year, compared to the 900 locomotives delivered in 1999.

"Capacity is one of the biggest challenges that the railroads face right now," said GE Transportation President and CEO Charlene Begley. "The railroads have to plan carefully their needs, and there are times when they have to play catch-up."

Such was the case last year, when the Union Pacific, the country's largest railroad, underestimated crew and power requirements needed to meet an unexpected economic surge.

For equipment manufacturers, "it's a good problem to have," Begley said.

Heavy orders for coal cars and intermodal equipment drove first quarter sales to more than 17,000 cars, according to Rail Theory Forecasts, a market analysis and railroad industry forecasting company. It projects at least 60,500 new railcars will be delivered in 2005, an increase of 15 percent over its October 2004 forecast of 52,500 cars.

"For the last 15 months, the order rate would support a 70,000 car delivery rate, if the builders could increase production," said Rail Theory Forecasts President Toby Kolstad.

Kolstad said in spite of complaints about cast parts shortages, railcar manufacturers were able to increase their production rate from 12,000 to 15,000 cars during the fourth quarter of last year "and have maintained that rate of delivery during the first quarter of 2005."

GE is positioning itself to take advantage of the market for intelligent transportation systems that will allow trains to run closer together by making better use of available track.

Once the federal government and the railroads can agree on how to deploy intelligent transportation technology, Begley said GE has a product that will be half the cost of current train signaling systems and provide double the capacity.

"There's a \$100 billion in freight that's moving over the highways that could be going on the rails," Begley said. "As the railroads get better at on-time delivery and predictability, there's going to be opportunity to capitalize on that."

BY JOHN GALLAGHER

Short Line Volume Increases

Short line traffic volume increased 11.5 percent in the first quarter over last year, an indication that small railroads are benefiting from a freight transportation market moving record volumes.

The big jump in short line traffic is comparable with results for U.S. Class 1 railroads, where carload volume was up 2.5 percent and intermodal traffic was up 7.6 percent in the first quarter. Atlanta-based RMI, which compiles short line traffic statistics in 13 commodity groups from 200 short line, regional and terminal switching railroads in North America, found that 63 percent of all short line growth in the first quarter was accounted for by carload traffic, with intermodal accounting for 31 percent.

Stone, clay and aggregates grew faster than all other commodities on short lines in the first quarter compared to last year, at 32.5 percent, followed by intermodal traffic at 31.1 percent. Four other commodities reported double-digit growth in the first quarter including petroleum and coke, waste and scrap materials, metals and metal products and intermodal. Grain and "all other" freight were the only commodities to decline.

Antitrust Signals on Capitol Hill

A Justice Department investigation launched last summer into railroad coal transportation pricing policies could soon morph into legislation proposing to eliminate the railroad's antitrust protection.

Legislation was expected to be introduced as early as last week that would take away some or all of the Surface Transportation Board's authority to provide the railroads immunity from antitrust laws, Capitol Hill sources told *Traffic World*.

Reps. Mark Green, R-Wis., and Rick Boucher, D-Va., were said to be among those involved in drafting the legislation. Neither returned calls for comment.

Railroads are exempt from antitrust laws with regard to mergers, line sales and certain rate agreements. Although Congress has considered the railroads' antitrust status in the past, legislative efforts have made little headway.

However, the current proposal would be directed to the House Judiciary Committee — not the Transportation and Infrastructure Committee — where the railroad lobby is considered to have less influence.

"The railroads don't want this to get to a debate, and the way they kept it from debate in the past was (not) kill it before makes it to the floor," said a source who requested anonymity. "No congressman wants to get up and try to argue why railroads should have immunity."

But the railroads seem to be gearing up for battle. The Association of American Railroads is finishing a position paper defending rails' antitrust exemption, says AAR spokesman Tom White.

"It's our view that we have very limited antitrust exemption now, and there are a lot of things that I've heard complaints about that have nothing to do with railroads' exemptions," White said.

An inquiry last summer by Rep. Jim Sensenbrenner, R-Wis., into possible price signaling between BNSF Railway and Union Pacific Railroad for coal transportation is said to be the impetus for the legislation. The inquiry led to an investigation by the Justice Department that is ongoing.

BY JOHN GALLAGHER

Exhibit TDC – 5

8/25/2005

Class Is can parlay pricing policies, trucking cost hikes into higher rates

By: Scott Flower

BNSF Railway Co.'s and Canadian National Railway Co.'s pricing policies help their stocks remain attractive to investors. Rate increases will provide the two roads incremental earnings leverage heading into 2006. Each incremental pricing point for BNSF and CN drives up annual earnings by \$0.20 and \$0.13, respectively, according to our estimates.

We're impressed with BNSF's and CN's service execution, which helps the railroads sustain and increase prices, and boost shareholder value. Service consistency also reduces costs and provides a solid productivity base to support incremental rate increases.

If all railroads can sustain base prices, their earnings expectations might rise and investors' confidence might go up. Sustained baseline pricing will help roads drive top-line growth, raise returns on invested capital and generate free cash flow.

Following are key factors that will enable the Class Is to raise rates beyond cyclical adjustments.

Showing their smarts. Since the consolidation period in the mid- to late-1990s led to tight duopolies, Class Is have improved their use of network capacity and become more disciplined with increasing returns on invested capital.

Large roads are avoiding rogue pricing policies and undisciplined efforts to gain marketshare at the expense of increasing returns. The change in pricing behavior is most apparent in less-competitive traffic — such as coal and chemicals — but visible in all commodities.

The cost of doing business. Meanwhile, truckload (TL) carriers' costs are rising for various reasons. Truckers are dealing with a driver shortage, higher wages to retain and recruit drivers, new U.S. Environmental Protection Agency-mandated engine emission regulations, increased insurance costs and deductibles, and more restrictive hours-of-service rules. In addition, a federal requirement that the trucking industry use ultra-low sulfur fuel by mid-2006 will increase operating costs and pressure TL carriers to increase rates.

Excluding fuel costs, truckers' expenses have risen between 6 percent and 7.5 percent during the past 18 months. Meanwhile, railroad's expenses have increased between 1 percent and 3 percent during that time period. So, roads can increase rates under the TL pricing umbrella knowing their annual costs are going up about 30 percent as quickly as truckers' expenses. The differential will enable railroads in general — and BNSF and CN in particular — to raise margins.

In the past, the fragmented nature of the TL sector, and its historically less-disciplined pricing policy, made it difficult for railroads to raise prices on certain traffic, especially intermodal. Now, the TL sector is under pressure to raise yields or allow margins vs. rail to compress.

Diesel less of a downer. Finally, oil prices have doubled during the past two years. Railroads are only 20 percent as fuel intensive as TL carriers, so a sharp rise in diesel prices has a greater impact on truckers. Fuel prices have increased TL carriers' and railroads' annual costs about 4.5 percent and 2.2 percent, respectively.

As fuel continues to impact expenses, railroads will see an increasing spread in their cost structure vs. TL carriers. The cost differential is accentuated in BNSF's and CN's long-haul, truck-competitive lanes.

Scott Flower is managing director at Smith Barney/Citigroup, U.S. Equity Research, 388 Greenwich Street, 28th Floor, New York, N.Y. 10013. He can be reached via phone (212-816-5667), fax (212-816-2405) or email (scott.flower@citigroup.com). ProgressiveRailroading.com does not endorse any company's stock.

Exhibit TDC - 6

Coal price volatility is here to stay

By Jerry M. Eyster and Trygve Gaalaas

Coal Age, May 2004

Spot coal prices in the East are at record levels for the second time in four years. The high spot prices of 2000/2001 did not translate into significantly higher delivered coal prices because the volumes being traded were small. Delivered coal prices of Central Appalachian coal did not increase significantly as a result of the rise in spot prices for Central Appalachian coal. As a result, most coal companies did not see their revenues or profits increase. This led to mine closures to bring production in line with demand. Those closures have in turn created a supply shortage and spiking spot prices. What change in marketplace fundamentals led to such increased volatility in spot coal prices?

Prior to the mid 1990s, the U.S. coal industry was a classic example of a fragmented industry. It was in chronic over capacity with many producers. There were few barriers to entry and significant barriers to exit. It lacked economies of scale and there was little advantage to size in dealing with buyers and/or suppliers. Coal served regional markets with steam coal contracts often written for supply from a specific mine. As a result, pricing was highly competitive after the surge that followed the Energy Crisis of the 1970s. Flat to slightly declining spot coal prices led one trader to describe coal as "interesting as dirt."

Over the last decade the coal industry has changed, and it is no longer fragmented. The coal industry is much more concentrated today than it was during the 1980s and early 1990s. The 10 largest producers accounted for about 64% of production in 2003 compared with 60% in 1999, 41% in 1994, and only 33% in 1989. During the 1970s, oil producers invested heavily in the coal industry, leading to a dilution of physical coal supply as new mines were developed in the Powder River Basin (PRB). As the oil giants sold their operations during the late 1980s and 1990s, the coal industry became increasingly concentrated. The recent challenge of the Arch Coal acquisition of Triton Coal by the Federal Trade Commission (FTC) on anti-trust grounds is a testament to how some industry observers view the current level of concentration in some markets.

Government mine reclamation regulations, including the requirement of extensive mine planning and the posting of reclamation bonds, limit how quickly mines can be permitted and opened and who is able to develop new mining operations. Other factors such as government restrictions on developing some coal reserves (e.g., the Kaipaworwitz reserves in Utah), the mining methods used (e.g., mountaintop removal), and the high bonus bids now being paid for Federal reserves in the PRB further limit entry into the coal business.

Through technology and consolidation, the coal industry has created significant economies of scale. The large mining companies, particularly in Northern Appalachia and the PRB, hold the best reserves. There are fewer, highly productive mines that are heavily capitalized relative to what was required only 10 to 20 years ago. Mines using longwalls, super sections, and large

shovels, trucks, and draglines dominate production and require significant capital expenditures to develop. As more production is tied to larger, more highly capitalized operations, it becomes increasingly important to operate facilities around the clock. This is particularly true of modern coal preparation plants and loadouts that have become coal factories with tight quality control and continuous scheduling.

Large coal companies are better positioned to manage the risks involved in developing new mines. Coal supply contracts are generally for less than 10 years and usually have price re-openers that keep contract prices close to current market levels. Therefore, coal companies must put their own capital at risk in developing new operations. Large coal companies have a greater ability to diversify their operating and market risks across a portfolio of mines, regions, and contract terms. They can also offer buyers coal sourcing flexibility and a full range of risk management instruments (including contracts with put and call provisions). The large coal producers are better positioned to arrange additional services such as coal transportation and ash disposal.

The downside of such large, high productivity operations is that when something goes wrong, significant tonnage can disappear from the supply chain. When continuous mining sections run into problems, the equipment can be redirected within a mine or, even if management decides to mine through a problem, only a portion of a complex's production is affected. When a longwall runs into a problem, it generally must mine through it and total mine production can take a significant hit as a result. Similarly, longwall operations can be down for weeks during panel moves, resulting in minimal production. Continuous mining operations can move mining equipment from one part of a mine to another with little impact on mine production.

Today, six of the largest 10 U.S. coal producers are publicly traded. The CEOs of these companies generally have backgrounds in business rather than mining engineering. These executives of companies that have become publicly traded in just the last four years must now pay attention to their stock price performance from quarter to quarter. Since costs for labor, supplies, and regulatory filings have been increasing faster than average revenue, coal companies have not seen their profits increase with higher spot prices. However, Wall Street stock analysts have been kind to companies that failed to meet financial targets but reined in production through closed or mothballed operations. Therefore, coal company executives are holding out for higher prices rather than add capacity to relieve short-term imbalances.

Coal suppliers and users also have eliminated most, if not all, of the physical shock absorbers that kept coal supply plentiful and prices flat. Coal suppliers spent the 1980s and 1990s squeezing costs out of their operations. In some cases, wage and benefit packages were cut in order to compete with lower cost operations. In the past small mines provided surge capacity when markets became tight and spot prices climbed. Small operations generally do not have the economies of scale that allow them to compete in today's marketplace. Many mining operations used to operate only one or two shifts a day over a five-day week. Production at these operations could be increased by adding another production shift or by working Saturdays. However, as small mines have closed and operating mines worked more shifts, the ability of the coal industry to adjust supply to changes in demand has become increasingly limited. Longer permitting lead

times (particularly in Central Appalachia) have further limited the coal industry's ability to add capacity quickly.

Electric power generators are the primary users of coal. They also have wrung costs out of their coal supply chains. One major trend has been the reduction of coal stockpiles held at generating plants. Figure 2 shows both the level of coal stockpiles at the end of each year and the days supply based upon the average consumption for the coming year. Large stockpiles were usually built up prior to nationwide United Mine Worker (UMW) strikes. However, such strikes have become a thing of the past. Today, plant managers are attempting to reduce working capital by drawing down their fuel stockpiles.

Nationally, the power sector ended 2003 with 122 million tons stockpiled for a 43-day supply. Nationally, coal stockpiles reached this level or less two previous times. There was no spike in prices when stockpiles reached 38-day supply at the end of 1997 because supply was in line with use. Prices did spike when stockpiles fell to a 39-day supply at the end of 2000 because use appeared to be growing faster than supply. The power sector pulled down stockpiles by 39 million tons in 2000 before supply responded. Unfortunately, demand growth evaporated in 2001 and the power sector rebuilt stockpiles by 36 million tons during the year. The strategy of minimizing stockpiles is correct because even if low stockpiles force coal plants to purchase in a high priced market, it is generally more cost effective for them to pay the higher prices for a short period than to maintain a large inventory indefinitely. The volume of coal traded at the highest prices has been small relative to the amount of coal locked into lower contract prices.

Today, the coal use in the power sector is expected to continue growing slowly, but coal production in the East has not increased in response to higher prices, according to estimates made by the Energy Information Administration (EIA). Steam coal also is being diverted to metallurgical markets. However, during the price spike of 2000/2001, it took Central Appalachian production nearly five months to increase production after spot prices started to increase in August of 2000. Figure 3 shows how production increased during 2001. This delayed response to a spot price increase is simply another of the structural constraints leading to price volatility.

Price is the one factor that remains to bring use in line with supply. As a result, the coal industry has witnessed two significant spot price shocks during the last four years. These shocks are not so much a result of unique confluence of events as they are of a basic change in industry structure. Coal producers and buyers are like commuters on the highway cruising along at 70 mph with only a couple of car lengths between them. Every lane is full and as long as everything goes smoothly, drivers and passengers arrive home on time for dinner. However, if there is a small accident, traffic can back up for miles and it can take considerable time to re-establish traffic flow. While it takes time to remove the highway congestion, markets relieve congestion with pricing. High prices determine who really needs (and is willing and able to pay for) coal now. Recent changes in coal industry structure almost guarantee periodic price spikes since the physical shock absorbers are gone. Coal price volatility is here to stay.

Jerry M. Eyster and Trygve Gaalaas are with PA Consulting's Global Energy Practice in Washington, D.C. They specialize in market and strategic analyses of coal, coal transportation, and environmental regulations.

Exhibit TDC - 7

October 2006

FREIGHT RAILROADS

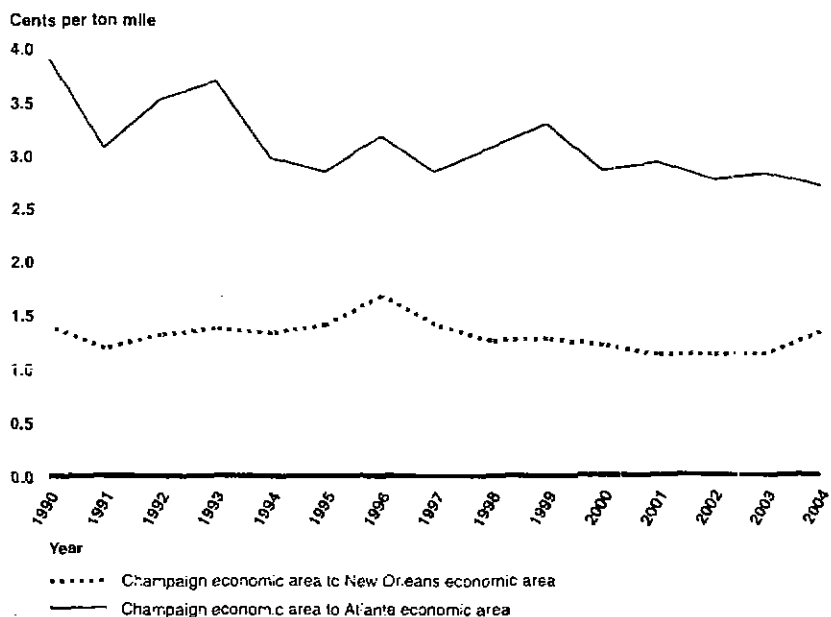
Industry Health Has
Improved, but
Concerns about
Competition and
Capacity Should Be
Addressed



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Figure 11: Comparison of Rate Changes from Champaign, Illinois, Economic Area to New Orleans, Louisiana, Economic Area and Champaign, Illinois, Economic Area to Atlanta, Georgia, Economic Area, 1990-2004



Source: GAO analysis of STB data.

Besides the number of rail carriers serving a location, the use of contracts for rail service can affect the competitive landscape. The Staggers Rail Act allowed railroad and shipping companies to enter into confidential contracts for rail service and also placed all traffic running under contract outside the remaining rate regulations. According to railroad and shipper groups, the duration of contracts has declined, in part because of the railroads' desire to quickly react to shifting market demand, which can result in charging higher rates. Other shippers were concerned that moving away from confidential contracts to public pricing could represent price signaling and further reduce competition between railroads. In 2004, 70 percent of tonnage and 71 percent of industry revenue moved under contract.

Exhibit TDC - 8



Facing the challenges of a growth industry

Perhaps at no time in their long history have the railroads been in such a good—and at the same time, difficult—position. Can they handle it?

By William C. Vantuono, Editor

Twenty-five years after it was passed by a U.S. Congress that recognized the urgency of deregulating an industry facing a crisis with potential “grave consequences for our economy,” in the words of President Jimmy Carter, the Staggers Rail Act of 1980 “has proven to be the best framework for making rail transportation a viable and healthy transportation option for shippers.”

That 25th anniversary analysis of Staggers, by Kansas City Southern President and CEO-U.S. Operations Art Shoener in comments

to *Railway Age*, pretty much reflect the state of the industry as 2005 draws to a close. Like last year at this time, the railroads are still dealing with the challenges of fluidity, velocity, capacity, and consistency (*RA*, December 2004, p. 15). The good news is that, in the words of Norfolk Southern’s newly installed President and CEO Wick Moorman, “North American railroads are in the fortunate position of facing the challenges of a growth industry.”

However, turning a well-known former Union Pacific marketing slogan into a question, can we handle it?

2006 FREIGHT RAIL OUTLOOK

2006 will be somewhat higher than in 2005. Our market-based fuel surcharge program should enable us to mitigate higher fuel expenses as our fuel hedges wind down during 2006.

Key economic projections for 2006 include strong utility demand due to increased electricity generation, robust low-tech industrial production as the Gulf area rebuilds, and a steady increase in Chinese imports to the U.S. These factors all contribute to a positive volume outlook for NS in 2006.

BNSF Railway Chairman, President, and CEO Matt Rose

The two issues that will be most important to BNSF and the railroad industry in 2006 and beyond are service and capacity, and the two are closely linked. Demand for rail capacity is growing faster than the Gross Domestic Product. At BNSF, for example, our volume has grown nearly 17% in the past two years. Improving service through better equipment velocity is one key to our ability to continue to handle volume growth.

The other key is, of course, physical capacity. North America's appetite for imports from Asia and low-sulfur Powder River Basin coal will translate into continued strength in those markets, and continued needs for adding track and terminal capacity to serve them as well as other markets.

During its hearing on the 25th anniversary of the Staggers Act, the Surface Transportation Board heard witness after wit-

ness speak to the necessity of expanding capacity and the need for adequate returns on that capacity. Our customers want to know not only that we can meet their needs today, but also that we are expanding our capacity to meet their future needs as well. We can only meet future demand by reinvesting adequately both to maintain the quality of our infrastructure and to expand our railroad's capacity to handle more freight. And we can only do this if we can reach a return on invested capital that is greater than the cost of capital, and maintain that level of performance through the business cycle. Because rail customers will reap much of the primary benefits of expanded infrastructure, they will need to share some of the burden; rates will need to continue to go up in all sectors of our business to match the value derived from our service.

Union Pacific Chairman Dick Davison

Union Pacific will continue to increase operating productivity and yield focus. Our operating initiatives such as the Unified Plan and Lean management are improving operations in terminals and on corridors. We also will continue to proactively manage our inventory of railcars on line.

Our 2006 capital plans are still being finalized. We have indicated to Wall Street that future spending will be in the \$2.5-billion range, all-in with both cash spending and leases. Spending may be higher if demand stays strong. Capacity-wise, we will continue to focus on the Sunset Route, the Illinois/Iowa corri-

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- ▶ Meet Upcoming AAR Extended Travel Requirements Without Changing Cages
- ▶ Improves Curving and Wheel Loading to Prevent Derailments
- ▶ Controls Truck Hunting

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