

Before the U.S. Surface Transportation Board

STB Ex Parte No. 722
RAILROAD REVENUE ADEQUACY

STB Ex Parte No. EP 664 (Sub-No. 2)
PETITION OF THE WESTERN COAL TRAFFIC LEAGUE TO INSTITUTE A
RULEMAKING PROCEEDING TO ABOLISH THE USE OF THE MULTI-STAGE
DISCOUNTED CASH FLOW MODEL IN DETERMINING THE RAILROAD INDUSTRY'S
COST OF EQUITY CAPITAL

Reply Comments of the
U.S. Department of Agriculture

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Date: November 4, 2014

Authority and Interest

The Secretary of Agriculture is charged with the responsibility under the Agricultural Adjustment Act of 1938 and the Agricultural Marketing Act of 1946 to represent the interests of agricultural producers and shippers in improving transportation services and facilities by, among other things, initiating and participating in Surface Transportation Board proceedings involving rates, charges, tariffs, practices, and services.

Introduction

The U.S. Surface Transportation Board (Board) has initiated this proceeding to examine its procedures in determining railroad revenue adequacy and how this concept will bear upon the railroad industry, shippers, and the regulatory environment. USDA welcomes the opportunity to comment on this proceeding.

As USDA has stated before, the Board is called upon to strike the balance between competition and regulation and between the needs of shippers and the needs of railroads. USDA sees the goals of this proceeding as being no different. Railroads must remain revenue adequate, and shippers must be fairly served and protected from market power. It does not have to be either one or the other. It should be both.

Revenue Adequacy – Maintaining the Balance between Competition and Regulation

Shippers believe the railroad industry has reached the point of revenue adequacy and that their concerns have been treated as secondary to promoting revenue adequacy. This was appropriate when the rail industry was in dire straits prior to enactment of the Staggers Act, but is hard to accept in an environment of revenue adequacy. Shippers believe they were promised the dichotomous benefits of competition and counterbalancing regulatory oversight, but that they have not received their fair share of either. With great hope, they look to the point when the rail industry becomes fully recognized as revenue adequate by the Board, seeing it as a turning point for fostering greater competition and extending effective regulatory oversight in order to maintain balance and fairness. They see it as a time to address enduring concerns such as railroad market power, limited competition in the industry, and largely inaccessible rate challenge processes. They think it unreasonable to never alter the particular revenue earning trajectory the railroad industry has followed since the inception of the Staggers Act. It is true the current path has worked to reach revenue adequacy, but it is not true that no other paths will work or could work better.

Were railroads perfectly competitive, there would be little need for the Board. As such, railroads operate as a partially deregulated industry, serving competitive traffic over a portion of their network and captive traffic over the remainder. It is unrealistic to group the entirety of the network under one designation or the other. Competitive traffic should operate under competitive rules, and non-competitive traffic should be afforded the protections available to other consumers of regulated industries.

In a regulated setting, certain guidelines must exist to prohibit a regulated industry from achieving supra-competitive earnings at the expense of the customers it serves. Such a scenario would distort the optimal allocation of scarce resources within an economy and is therefore

undesirable from a societal perspective. The Coal Rate Guidelines, Nationwide, 1 I.C.C.2d 520 (1985), (Guidelines), provide an indication as to the protections that must be afforded shippers against supra-competitive earnings. Railroads possess market power over certain traffic and in specific regions, and captive shippers require effective regulatory protection where competition is absent.

As a matter of principle, the Board should facilitate competition, allowing market forces to discipline rates to shippers. A greater reliance on competition reduces the need for regulatory intervention, and thus the complexities, costs, inefficiencies, and ambiguities that accompany it. Specific instances of how competition can be increased have been raised to the Board, such as addressing bottleneck rates on an individual basis, supporting and encouraging increased interswitching and terminal trackage rights, reducing paper barriers, and investigating instances where railroads reportedly refuse to compete.

In instances where competition is limited, the Board should endeavor that its regulatory approach serves to approximate a competitive solution. Rate challenge procedures should be accessible and offer cost-effective protection for shippers. Although railroads strongly advocate the Stand-Alone Cost (SAC) test as the best and most reliable method for judging the reasonableness of rates, shippers have demonstrated the SAC test is increasingly expensive and complex, and several studies have called into question the validity of the theoretical underpinnings of the SAC test.¹ As it stands, the SAC test attempts to approximate a competitive outcome by assuming no barriers to entry for a competing railroad. Yet the test itself stands as a significant barrier for most shippers to challenge rates. As a result, shippers have advocated for additional methods, especially ones that can be facilitated by a finding of a revenue adequate railroad. Several promising methods for grain shippers were proposed in Ex Parte 665, *Rail Transportation of Grain, Rate Regulation Review*, and USDA understands the Board has recently contracted with a private-consulting firm to explore additional options that address the time, cost, and complexity of bringing rate challenges before the Board. USDA hopes that a workable solution will be implemented as quickly as possible.

¹ From an economic standpoint, there are serious questions about whether the use of the SAC test is even appropriate in the context of 21st century U.S. railroads. In particular, it is clear from both the original scholarly sources and subsequent discussions in the literature that the primary rationale for the test – that if one group of customers pays more than SAC for their service, it necessarily follows that this allows other customers to pay less than the incremental cost for their service, and hence there is direct evidence of cross subsidies from the former customers to the latter – applies only in the context of a rate-of-return constrained public utility, a setting that clearly does not characterize the U.S. freight railroads. See, e.g., Gerald Faulhaber, *Cross-Subsidization: Pricing in Public Enterprises*, 65 AMER. ECON.R. 966 (1975); William Baumol, John Panzar, and Robert Willig, *Contestable Markets and the Theory of Industry Structure* (1982); Mark Meitzen and Alexander Larson, *The uses and abuses of stand-alone costs*, 2 UTILITIES POL. 135, 143 (1992) (“Only when economic profits are constrained to zero ... does the duality between stand-alone and incremental costs hold.”); Leigh Hancher and Jose-Luis Buendia Sierra, *Cross-Subsidization and EC Law*, 35 COMMON MARKET L.R. 901, 908 (1998) (“Critics of this approach have pointed out that it is based on the assumption that the regulated firm in question makes no long-term excess profits.”); Faulhaber, *Cross-Subsidy Analysis with More than Two Services*, 1 J. COMP. L. & ECON. 441 (2005) (“The SAC tests are not helpful under conditions of positive economic profits”); Pittman, *Against the Stand-Alone-Cost Test* (“If the lack of a zero-profit constraint on the firm breaks the link between SAC and IC [incremental cost], then failure to satisfy SAC for one set of products does not imply cross subsidization of a second set”).

Where to Draw the Line for a Revenue Adequate Railroad

There is general agreement that, in order for the railroads to efficiently recover high fixed costs, it is necessary and appropriate that shippers without competitive options pay a higher share of these fixed costs than other shippers.² However, it is neither appropriate nor the law that the degree to which these captive shippers are discriminated against be unlimited.³

The question remains of how to determine the balance between rate relief and revenue adequacy. Railroads, to the degree they operate competitively, should not be penalized from earning revenues. Conversely, shippers, to the degree they are captive, should not be required to pay more than necessary for the carrier to be revenue adequate. The Constrained Market Pricing (CMP) principles established in Guidelines are summarized as:

A captive shipper should not be required to pay more than is necessary for the carrier involved to earn adequate revenues. Nor should it pay more than is necessary for efficient service. And a captive shipper should not bear the costs of any facilities or services from which it derives no benefit.

CMP contains three main constraints on the extent to which a railroad may charge differentially higher rates on captive traffic. The revenue adequacy constraint ensures that a captive shipper will “not be required to continue to pay differentially higher rates than other shippers when some or all of that differential is no longer necessary to ensure a financially sound carrier capable of meeting its current and future service needs.”⁴

As the Board noted in its announcement of this proceeding, Guidelines declares that:

[The] revenue adequacy standard represents a reasonable level of profitability for a healthy carrier. It fairly rewards the rail company’s investors and assures shippers that the carrier will be able to meet their service needs for the long term. Carriers do not need greater revenues than this standard permits, and we believe that, in a regulated setting, they are not entitled to any higher revenues. Therefore, the logical first constraint on a carrier’s pricing is that its rates not be designed to earn greater revenues than needed to achieve and maintain this “revenue adequacy” level.⁵

One interpretation of the language from Guidelines is that if a revenue adequate railroad were fully able to cover its fixed costs from the revenues earned on competitive traffic, its ability to use differential pricing on captive shippers should be limited. By facilitating simplified rate challenge procedures for captive traffic that incorporate revenue adequacy, captive shippers should have better protection against railroad market power. Strong protection for captive

² This approach is known as Ramsey pricing or 3rd degree price discrimination. *Coal Rate Guidelines, Nationwide*, 1 I.C.C. 2d 520 (1985).

³ *Coal Rate Guidelines, Nationwide*, 1 I.C.C. 2d 520 (1985).

⁴ Surface Transportation Board, *Ex Parte No.657 (Sub-No. 1) Major Issues in Rail Rate Cases*, October 30, 2006, at 6-7, citations omitted.

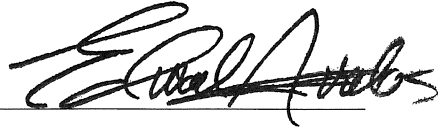
⁵ Guidelines, 1 I.C.C. 2d at 535.

shippers could incentivize railroads to increase competition in an effort to maximize revenues by increasing the traffic base that is competitively served.

Conclusion

Shippers generally believe the rail industry has reached the point of revenue adequacy. USDA believes the burden of differential pricing on captive shippers should be eased for railroads that are revenue adequate. One method for accomplishing this is by establishing simplified rate-challenge procedures developed specifically for use when a railroad is determined to be revenue-adequate. Changes in rail policy occurring as a result of revenue adequacy should continue to preserve revenue adequacy while offering greater protections to captive shippers.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Edward Avalos", written over a horizontal line.

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CERTIFICATE OF SERVICE

I, Bruce Blanton, certify that on this 4th day of November, 2014, caused a copy of the foregoing document to be served by first-class mail, postage prepaid, on all parties of record in STB Docket Numbers EP 722 and EP 664 (Sub-No. 2).

A handwritten signature in black ink, appearing to read "Bruce Blanton", written over a horizontal line.

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