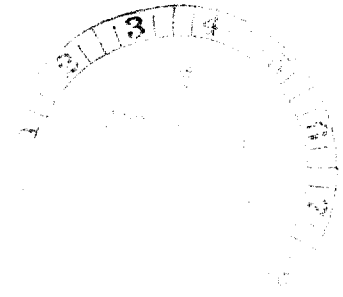


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**BEFORE THE
SURFACE TRANSPORTATION BOARD**



STB Ex Parte No. 661

RAIL FUEL SURCHARGES

**VERIFIED STATEMENT OF MARCELLA SZEL
OF CANADIAN PACIFIC RAILWAY COMPANY**

My name is Marcella Szel. I am Senior Vice President, Marketing and Sales for Canadian Pacific Railway Company ("CPR"). My business address is 401 9th Avenue, S.W., Calgary, Alberta T2P 4Z4 Canada. I have more than 25 years of service with CPR including 20 years of legal experience in litigation, administrative and transportation law. In my current position, I am responsible for all aspects of the company's marketing and sales programs, which have sales revenues in excess of \$4 billion (CDN). I am also responsible for CPR's price & yield management ("P&YM") team. The P&YM team is responsible for, among other things, CPR's corporate yield management, including the design and implementation of CPR's fuel surcharge program.

The purpose of this Verified Statement is to describe the fuel surcharge program on the CPR system, which includes U.S. subsidiaries, Soo Line Railroad Company ("Soo") and Delaware and Hudson Railway Company, Inc. ("D&H"), and particularly focusing on its U.S. operations.

Part I of my testimony explains why it is necessary for CPR to utilize a surcharge to offset the rising cost of diesel fuel consumed in its business. Part II identifies the fundamental

principles underlying CPR's fuel surcharge program. Part III describes the manner in which the fuel surcharges are currently applied by CPR on its carload, intermodal and grain traffic.

I. CPR'S FUEL SURCHARGE PROGRAM IS A NECESSARY RESPONSE TO ESCALATING AND VOLATILE DIESEL FUEL PRICES

As the Board recognized in establishing this proceeding, "[t]he cost of fuel is a significant component of the operating costs of providing rail service." (Decision served March 14, 2006 ("*March 14 Decision*") at 1.) Fuel is CPR's second largest cost component, trailing only employee compensation and benefit costs. In 2005, CPR spent in excess of half a billion dollars for fuel, including over U.S. \$100 million consumed in its U.S. operations.

The price that CPR must pay for diesel fuel is dependent on both the price of crude oil and the cost of refining crude oil into finished product. Both of these cost inputs have increased dramatically in recent years. The price of West Texas Intermediate ("WTI") crude oil has skyrocketed from approximately \$10 per barrel in 1999 to nearly \$73¹ per barrel in April 2006. The difference between the price of crude oil and the price of refined petroleum product (referred to in the petroleum market as the "crack spread") has likewise increased substantially over the past several years as demand for refined products exceeded refining capacity. Between January 2000 and January 2004, the crack spread averaged approximately \$4.00 per barrel. However, the crack spread increased to \$5.80 per barrel during 2004, and rose as high as \$18.00 per barrel in March 2005. The average crack spread for March 2006 was \$11.92 per barrel.²

The volatility of fuel prices presents a challenge for CPR and other transportation providers. Significant and unpredictable increases in a major cost component such as fuel can

¹ *The Wall Street Journal*, April 26, 2006, C12, Crude Oil, Light Sweet June futures settled at \$72.88 per bbl on the NYMEX on April 25, 2006.

² Developed from historical information on WTI & No. 2 Fuel Oil (Heating Oil) as traded on NYMEX and reported by Bloomberg.

have a serious adverse impact on CPR's earnings and cash flow and hence its ability to make necessary capital investments. CPR has taken a number of actions in recent years to respond to this challenge.

First, CPR has pursued an aggressive campaign to reduce fuel consumption in its operations. CPR consumes fuel not only in operating trains, but also in performing capital and maintenance projects, in construction and in ancillary business activities. A cross-functional team, consisting of representatives from field operations, network management, engineering, mechanical and product design is responsible for investigating and managing fuel savings initiatives. This included the adoption of new technologies and best operating practices, the promotion of awareness among all employees on how they can contribute to fuel conservation, and the compilation of data regarding CPR's performance with respect to fuel efficiency.

CPR's locomotive fuel conservation project focuses upon achieving greater fuel efficiency for the company's locomotive fleet. CPR also has a motor vehicle fuel conservation program for its highway vehicle fleet that develops and promotes fuel efficiency initiatives. These efforts have had beneficial effects.

Second, CPR has made a substantial investment in locomotive technologies. It has acquired 560 new locomotives in the last 10 years, through an investment in excess of \$1 billion, to make its fleet the most efficient possible for the particular train operations that it conducts. CPR has also commenced a four-year program to purchase yard locomotives known as "Green Goats" developed by Railpower Technologies Corporation. This hybrid conversion program is expected to improve fuel efficiency by 40-60%, and to reduce noise, greenhouse gas emissions and maintenance costs. CPR also has an on-going program to modify older locomotives with new technology to improve fuel consumption.

Collectively these efforts have yielded a 20% reduction in fuel consumption from 1998 through 2005. In 2004, CPR's average fuel consumption rate was 1.20 U.S. gallons per 1000 GTMs, placing it second in the rail industry with respect to this measure of fuel efficiency. In 2005, CPR tied for the highest ranking in the industry by further reducing its fuel consumption rate to 1.18 U.S. gallons per 1000 GTMs.³

Third, CPR has engaged, to a limited degree, in fuel hedging strategies. However, hedging is a risk management activity that is anticipatory in nature. In a volatile fuel market, hedging is by no means certain to produce cost savings; the results produced may be either positive or negative. Given the uncertainty about future fuel price trends, CPR, like all other Class I railroads, has reduced its use of hedging as a cost containment strategy.⁴

The dramatic rise in the cost of diesel fuel has far outstripped CPR's ability to offset the impact of higher fuel prices through internal cost-saving measures alone. As a result, CPR found it necessary to mitigate the effect of rising fuel prices by imposing a fuel surcharge on traffic that moves over its system. Most railroads, motor carriers, air freight carriers and ocean shipping lines now assess surcharges to offset the rising cost of fuel consumed in providing service.

CPR's first fuel surcharge was implemented in 2000 and withdrawn in early 2002 in response to falling WTI prices. In June 2002, a new program was implemented that applied to all traffic excluding U.S. originating grain. However, application of this program was somewhat limited initially due to CPR's existing portfolio of transportation contracts. Those contracts typically relied upon the Rail Cost Adjustment Factor ("RCAF") for mitigating the cost of fuel.⁵

³ Source: Class I railroad annual financial reports.

⁴ See "Fuel Hedge Positions of Major Railroads," North American Equity Research, September 23, 2005.

⁵ CPR has largely moved away from the use of RCAF-based price adjustments in its

CPR subsequently extended its fuel surcharges to U.S. grain traffic in 2004. Today, more than 90% of CPR's U.S. tariffs and transportation contracts include a fuel recovery mechanism.

The Board's *March 14 Decision* indicates that some shippers are concerned that railroad fuel surcharges "are designed to recover amounts over and above increased fuel costs."

(*March 14 Decision* at 1.) This is certainly not true of CPR's fuel surcharge program. Even though CPR now collects a fuel surcharge on most of its U.S. business, fuel surcharge revenues do not fully offset the incremental annual increase in CPR's cost of diesel fuel. In 2005, fuel surcharge revenue in connection with U.S. shipments covered only 80% of the incremental increase from 2004 to 2005 in the cost of fuel consumed in CPR's U.S. operations. CPR experienced a shortfall of 50% between the incremental cost of fuel and the revenues generated by fuel surcharges for its U.S. operations between the years 2003 and 2004. CPR's fuel surcharge program is not designed to recover amounts in excess of the increase in its fuel expense during a given year and it has not done so. To the contrary, CPR has continued to under-recover the incremental increases in its fuel costs. Further, under CPR's current fuel surcharge tariffs, any reduction in fuel prices automatically results in a corresponding reduction in the level of its fuel surcharges.

II. THE FUNDAMENTALS: CPR'S FUEL SURCHARGE PROGRAM PROVIDES TRANSPARENCY, TIMELINESS, EASE OF ADMINISTRATION AND FAIRNESS

In developing and managing its fuel surcharge program, CPR has been guided by a number of fundamental principles:

transportation contracts with shippers. In those instances in which an RCAF-based contract remains in effect, CPR does not assess an additional fuel surcharge on the shipper's traffic.

First, CPR's surcharge program is based upon fuel price benchmarks that are market-based and transparent. CPR's fuel surcharges on U.S. traffic, excluding grain, are keyed to changes in the average price of WTI crude oil. Because WTI is traded daily on the New York Mercantile Exchange (NYMEX), its price is readily ascertainable through public sources including *The Wall Street Journal* and various websites, and can easily be tracked by customers. CPR's current fuel surcharge on carload traffic, introduced in January 2006, also incorporates an adjustment based upon changes in the Monthly Average Crack Spread ("MACS") – *i.e.*, the difference between the average monthly price of No. 2 Fuel Oil (Heating Oil) and the average WTI price. No. 2 Fuel Oil was selected as a benchmark because it is similar in composition to diesel fuel and the prices for those two refined products tend to be correlated. No. 2 Fuel Oil is also traded on the NYMEX, so information regarding changes in its price is widely available. CPR's fuel surcharge for U.S. originated grain shipments is keyed to changes in the average price of Retail On-Highway Diesel Fuel ("USHDF"), as published in the U.S. Department of Energy's EIA "Retail On-Highway Diesel Prices Report." Thus, the fuel surcharges are all tied to market-based fuel price indices that are readily accessible by the public. This enables our customers to track the level of the price benchmark applicable to their shipments at any time and, in conjunction with the formulas set out in CPR's tariffs, to ascertain the adjustment to the applicable CPR fuel surcharge resulting from changes in the market price of fuel.

Second, CPR's fuel surcharge program provides for adjustments to the level of surcharges in response to the market price of fuel and affords customers timely advice of those adjustments. Each of CPR's fuel surcharge tariffs provides for the applicable surcharge to be adjusted monthly in response to changes in the relevant benchmark. CPR previously adjusted its fuel surcharges on a quarterly basis, but has since adopted monthly adjustments in response to

the market's preference for more frequent (and in times of rapidly escalating fuel prices, more incremental) adjustments to fuel surcharges. The level of CPR's surcharges therefore tracks closely the movement of fuel prices in the marketplace. However, adjustments in the level of CPR's fuel surcharges dictated by changes in the benchmark price during a given month are not applied until the first day of the second month following the month in which the change in the benchmark price occurred. For example, an increase in the average WTI price during April 2006 will be reflected in an adjustment to CPR's WTI-based fuel surcharges that will take effect on June 1, 2006. This lag in implementing adjustments in the level of fuel surcharges is intended to give customers reasonable notice of any increase (or decrease) in the surcharge applied to their traffic, so that they know in advance the total cost of shipping their freight on CPR. CPR is in the process of rolling out a program that will provide customers automated email notification of adjustments to the future level of fuel surcharges applicable to their traffic. Changes in CPR's fuel surcharges are also posted monthly on CPR's website (www.cpr.ca).

Third, CPR's fuel surcharge tariffs incorporate formulas that are simple to administer and easy for customers to understand. Surcharges are expressed in terms of a percentage of the base freight rate. This percentage-based approach, which has been widely adopted not only by the railroad industry but by many carriers in other transportation modes, is administratively simple and easy to calculate. Percentage-based surcharges are also particularly useful in connection with interline shipments, as they simplify the process of invoicing multiple segments by the billing carrier. CPR evaluated other possible models for its fuel surcharges, but concluded that they would be cumbersome, costly to manage, and particularly complex to apply in connection with interline traffic. CPR handles rail shipments involving literally hundreds of thousands of combinations of commodities, car types, weights, distances, terrain and competitive factors. It

would be extremely difficult to devise, much less effectively manage, a fuel surcharge program that attempted to incorporate the specific characteristics of every individual shipment. The enormous complexity of such an approach also holds the potential for errors in calculating surcharges in connection with tens of thousands of freight invoices each month. CPR's customers tell us that billing accuracy is an important factor in their selection of a carrier. Adoption of more complex surcharge formulas would run counter to customers' desire for simplicity and accuracy, without reducing the overall amount that CPR must collect to offset the rising price of fuel.

Fourth, and finally, CPR has endeavored to implement a fuel surcharge program that is fair and equitable, and reflects to some degree the traffic characteristics of different commodity groups. As stated above, some form of fuel recovery mechanism is applied to more than 90% of CPR's U.S. business. While a relatively small volume of traffic moving under older transportation contracts is not currently subject to a fuel recovery mechanism, all CPR account managers and marketing representatives are required to incorporate the appropriate fuel surcharge into every new tariff and contract document.

III. DESCRIPTION OF CPR'S CURRENT FUEL SURCHARGE TARIFFS

CPR currently publishes three fuel surcharge tariffs that apply to rail shipments of different commodity groups in the U.S. Following is a description of the relevant features of each of CPR's fuel surcharge tariffs:

A. Carload Traffic (Tariff CPRC 9600)

The fuel surcharge currently applicable to all CPR carload traffic in both the U.S. and Canada is published in Tariff CPRC 9600. Under this tariff, which became effective on January 1, 2006, the fuel surcharge on carload shipments is based upon two components: (1) the monthly average price of WTI crude oil; and (2) the MACS. When the WTI monthly average

price equals or exceeds \$25.00 per barrel, a surcharge in the amount of 3.5% of the base freight charge is applied. For each additional \$1.00 per barrel that the WTI rises above \$25.00, the fuel surcharge increases by an incremental 0.25% of the base freight rate. When the MACS equals or exceeds \$10.00 per barrel, the surcharge will increase by an additional 0.25% for every \$1.00 increase in the MACS over \$10.00. Adjustments to the fuel surcharge based upon this formula are calculated monthly, and are applied to carload shipments having a shipment date on or after the first day of the second month following the month upon which the adjustment is based.

The new WTI-based element incorporates smaller incremental increases in the fuel surcharge (0.25%) than CPR's prior carload surcharge (0.40%). Implementation of this new carload surcharge in January 2006 has resulted in a 5.1% reduction (from 17.60% to 12.50% in April 2006) in the total fuel surcharge assessed by CPR on its carload business.

B. Intermodal Traffic (Tariff CPRC 9000)

The fuel surcharge currently applicable to CPR intermodal traffic in both the U.S. and Canada is published in Tariff CPRC 9000. Under this tariff, which first became effective on June 1, 2004, the fuel surcharge on intermodal shipments is based upon the monthly average price of WTI crude oil. When the WTI monthly average price equals or exceeds \$24.00 per barrel, the applied surcharge is 2.0% of the base freight charge. When the WTI monthly average price equals or exceeds \$27.00 per barrel, the applied surcharge is 4.0% of the base freight charge. For each additional \$1.00 per barrel that the WTI rises above \$27.00, the fuel surcharge increases by an incremental 0.40% of the base freight rate. Adjustments to the fuel surcharge based upon this formula are calculated monthly, and are applied to intermodal shipments having a shipment date on or after the first day of the second month following the month upon which the adjustment is based.

C. U.S. Origin Grain (Tariff CPRC 4444)

The fuel surcharge currently applicable to CPR's U.S. origin grain traffic is published in Tariff CPRC 4444. Under this tariff, which became effective on March 1, 2006, the fuel surcharge is based upon the monthly average price of Retail On-Highway Diesel Fuel ("USHDF"). When the USHDF monthly average price equals or exceeds \$1.41 per gallon, the applied surcharge is 0.50% of the base freight charge. The surcharge increases incrementally with each increase of \$0.04 in the USHDF average monthly price. Adjustments to the fuel surcharge based upon this formula are calculated monthly, and are applied to grain shipments having a shipment date on or after the first day of the second month following the month upon which the adjustment is based.

* * * * *

By any measure, the cost of fuel has skyrocketed and has displayed extreme volatility in recent years. In the first 4 months of 2006 alone the price of crude oil has increased by more than 20%. As the foregoing discussion shows, CPR's U.S. fuel surcharge program addresses, in a fair and equitable manner, with transparency and in a timely manner, the escalating cost of diesel fuel used in providing rail service. CPR has stated publicly that "[w]e're not out to make money on our fuel surcharges," and CPR has not used its surcharge program as a profit-enhancing device.⁶ The formulas and benchmark prices used by CPR to calculate its fuel surcharges are market-based and publicly available. CPR does not believe that additional STB reporting requirements would significantly enhance public awareness of CPR's fuel surcharges.

⁶ "Tensions Mount Over Fuel Surcharges Set by Railroads," *The Wall Street Journal*, April 18, 2006, A2 (quoting CPR spokeswoman Leslie Pidcock).

CPR continuously monitors its fuel surcharge program, and it will consider changes that may be appropriate to ensure that the program continues to accomplish its intended objectives.

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VERIFICATION OF MARCELLA SZEL

I declare under the penalty of perjury that the foregoing is true and correct. Further, I certify that I am qualified and authorized to file this testimony on behalf of Canadian Pacific Railway Company.

Executed on this 26th day of April, 2006.



Marcella Szel

Sworn before me this 26th day of April, 2006.

