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**BEFORE THE
SURFACE TRANSPORTATION BOARD
Washington, DC 20423**

In the Matter of:

SIMPLIFIED STANDARDS FOR RAIL RATE CASES

**STB Ex Parte No. 646
(Sub-No. 1)**

**REPLY COMMENTS OF
ARKANSAS ELECTRIC COOPERATIVE CORPORATION**

Arkansas Electric Cooperative Corporation ("AECC") respectfully submits these comments, which address issues raised in the opening comments submitted by other parties regarding the proposals advanced by the Board in this proceeding.¹ The Board's July 28 Decision described proposals that would establish methodologies for "medium-size" and "small" rail rate disputes, and the criteria that would define eligibility for application of those methodologies. In these reply comments, AECC focuses primarily on issues raised by other parties regarding the eligibility criteria and the proposed "Simplified-SAC (SSAC)" methodology that would apply to "medium-size" rail rate disputes. For "small" rail rate disputes, AECC again defers to the comments of shippers more directly affected by the methodology applied to that category of traffic.

¹ AECC's interest in this proceeding is described in AECC's opening comments, which were submitted on October 24, 2006.

REPLY ISSUES

The opening comments of the railroad parties raise several issues related to the following general themes:

- the need for revenues sufficient to support needed rail infrastructure;
- the relationships among rail capacity constraints, price levels and market power;
- limitations on the use of simplified procedures;
- shipper selection of the route in the SSAC methodology; and,
- burdens on shippers and carriers created by the Board's proposals, and the resulting incentives for litigation.

Each of these is discussed below.

A. Rail Revenues and Infrastructure

The opening comments submitted by several parties, including Union Pacific Railroad (UP), BNSF Railway (BNSF) and the Association of American Railroads (AAR), attempt to link the reforms contemplated by the Board to railroad revenue adequacy and infrastructure needs. The comments essentially argue that the Board should not implement reforms that would constrain rail revenues to any significant degree, because the railroad industry is not yet revenue adequate but faces substantial investment requirements.

As was the case when the railroads raised a similar argument in STB Ex Parte No. 657 (Sub-No. 1), this line of reasoning promotes a cross-subsidy that is contrary to the entire purpose of Constrained Market Pricing (CMP), as well as to the public interest. Under CMP, the revenue from a given subset of a railroad's traffic is limited to that needed to cover the costs of efficient operations and provide a market return on the

capital assets required to serve that traffic. As long as the constrained market-based rates ensure that the subject traffic provides a market rate of return on the assets it uses, constraints on high rates cannot be the source of any overall revenue or capacity inadequacy on the part of the defendant carrier.

There are many circumstances that could cause a defendant carrier to be revenue-inadequate even if that carrier's market-based rates are constrained for one or more specific movements. For example, the carrier may maintain a residual network that is not appropriate for the carrier's other traffic. Also, the carrier may not have aggressively pursued available productivity-enhancement measures.

The carrier's infrastructure that is not needed by the issue traffic is not a relevant consideration because the prescribed rate already covers the costs of supplying the capacity used by the issue traffic. If the defendant carrier foresees incremental capacity requirements associated with non-issue traffic, it should ensure that such traffic is fully paying its own way.²

From a public interest perspective, it would not be appropriate for the Board to permit a defendant carrier to engage in "excessive" differential pricing to counteract the financial impacts of such considerations. To do so would undermine the market forces that otherwise would motivate remedial management action. If a carrier maintains an excessive residual network, or fails to keep pace with productivity improvements, or solicits new traffic at rates that don't cover the costs of needed infrastructure, the

² UP appears to recognize that a railroad should "...take on new business only when it can support the costs of adding the incremental capacity it consumes." *Opening Submission of Union Pacific Railroad Company* at p. 9 (Oct. 24, 2006). UP also raises the possibility that future investments may change the capital cost associated with the infrastructure used by the issue traffic in future years. In "rolling forward" the analysis during the 5-year period envisioned by the Board, it would appear to be reasonable to incorporate such increased capital costs, provided that the increases in revenue, operating cost and contribution associated with traffic increases during that period are also incorporated in the analysis.

financial markets will only react to the extent that the consequences of such decisions impact that carrier's financial results. Revenue and capacity needs are legitimate concerns of railroad management, but should not prevent the Board from implementing meaningful constraints on differential pricing.

B. Rail Capacity Constraints, Price Levels and Market Power

At least some of the railroads parties, including UP and BNSF, attempt to argue that it is consistent with elementary economics for railroad prices to rise relative to variable costs as demand for rail services increases. According to this reasoning, such increases do not reflect an undesirable increase in railroad market power, and should not be of concern to the Board.

While superficially appealing, this argument reflects a nearly complete perversion of the economic principles upon which it purportedly rests. In economic terms, market power is defined as the degree to which a supplier is able to command a price in excess of (marginal) cost. When a railroad is able to increase the R/VC ratio on a given traffic flow through an increase in price, there is no way to conceal or sugarcoat the fact that it is exercising increased market power.

The railroad position also overlooks the portion of the underlying theory that says increased prices will draw a competitive response. The fact that a railroad can achieve increased R/VC ratios by rationing scarce current capacity ultimately rests on the diminution of competitive conduct by other current suppliers and/or on barriers to entry faced by potential new entrants.

Furthermore, the railroad argument suggests that railroads no longer possess economies of scale. If scale economies exist, railroads should be fully capable of

increasing contribution by increasing volumes at current rates. If such economies no longer exist, the entire rationale for many past merger decisions would be completely null and void, and even the Board's competitive access policies would appear to be called into question.

Ultimately, if the Board permits railroads to rely on price escalation rather than capacity investment to accommodate increasing demand, the health of the interstate rail network will be placed in jeopardy. Economic theory suggests that market power will tend to cause suppliers to make less investment and produce a lower output at a higher price than would be the case in a competitive market. If the Board turns a blind eye to the exercise of increased rail market power, it basically would be rubber-stamping the apparent wish of this highly concentrated industry to charge more and invest less. The Board should view any exercise of increased rail market power as being indicative of a loss of competitive pressure, and inconsistent with the economic principles upon which much of the current regulatory framework is based.

C. Limitations on Use of Simplified Procedures

Several of the railroad parties - including Norfolk Southern (NS)/CSX Transportation (CSX), AAR, UP and BNSF - urge the Board to restrict access to the simplified procedures. They typically portray the "full-SAC" method as the only way to ensure accurate implementation of CMP, and argue that SSAC sacrifices CMP.

There are several reasons why this argument should be given no weight by the Board. First, as outlined in AECC's opening comments, the requirement that a shipper utilize the full-SAC methodology creates opportunities for railroads to charge rates that greatly exceed those needed by the railroad to earn a market rate of return solely as a

result of the shipper's prospective litigation cost. In this light, the railroads' fondness for full-SAC reasonably can be viewed as resulting from the negotiating leverage it conveys rather than from the purity of its implementation of CMP.

It is particularly important for the Board to note its own prior observation that SSAC omits prospective design changes that would improve the efficiency of the SARR and enable the shipper to achieve a tighter constraint on the contested rate. If there is any systematic bias in the results of SSAC, it operates in favor of the railroads by eliminating the shippers' ability to benefit from efficiency improvements. All else being equal, there is no basis for any belief that the rates resulting from an SSAC analysis would be lower than the rates resulting from a full-SAC analysis.

To some extent, SSAC incorporates methodological changes that reasonably could be considered for the full-SAC methodology as well. For example, if a series of full-SAC analyses have reliably established a consistent value for a needed input parameter, it would be inefficient for the Board to require a shipper to perform a new study of that parameter in order to litigate a rate case. Indeed, as observed by Benjamin Franklin, the definition of insanity is doing the same thing over and over and expecting different results. Promoting the proliferation of reasonable methodological simplifications that build on past experience is valid and appropriate. In light of these considerations, the Board should view SSAC as a valid method for implementing CMP that, if anything, produces a looser constraint on rail rates than would a full-SAC analysis.

AECC's opening comments addressed the ways in which application of the Board's proposed eligibility criteria would create opportunities for railroads to (a)

undermine the effective relief available to the shipper simply by charging a higher initial rate ("gaming"); and/or (b) achieve a negotiating position that commands rates above the level that provides a market return on the required capital. The Board should disregard the railroads' enthusiasm for such outcomes, and adopt procedures that implement the stated Congressional intent for simplified procedures to provide shippers with meaningful relief from the cost burdens of the full-SAC process.

D. Shipper Selection of Route in SSAC

Several railroad parties criticize the Board's proposal to permit a complaining shipper to select the route to be used in the SSAC methodology. They generally assert that the route should correspond to the primary route normally used by the subject traffic.

While superficially plausible, this argument overlooks the critical fact that the SSAC methodology is only applied in circumstances where the defendant railroad possesses significant market power. Especially in light of the Board's determination to apply the "maximum mark-up methodology" in the computation of prescribed rates, neither a shipper nor the Board can be confident that the carrier-selected routing for high-rated traffic will be the most efficient. Indeed, if the defendant carrier possesses enough market power for the Board's rate procedures (or the threat thereof) to provide a binding constraint, the carrier would appear to have a financial incentive to employ inefficient routings. All else being equal, a carrier facing a constrained percentage mark-up over variable costs would earn a higher contribution by maintaining variable costs at a higher level than would otherwise be achieved.³ This could produce financial incentives for the

³ An example illustrating this issue was presented in STB Ex Parte No. 657, Written Testimony of Michael A. Nelson at pp. 7-8 (April 20, 2005).

carrier to, for example, use unnecessarily circuitous routings for traffic over which it exercises high market power.

Even if it is not deliberately using inefficient procedures to handle issue traffic, a carrier may operate in circumstances that produce the same result. For example, assume a carrier has two routes that could serve traffic moving in a given corridor. Depending upon the existing infrastructure and traffic mix, the carrier might perceive that it should use the more efficient route to maximize the value of and contribution from its expedited and competitive services, and use the less efficient route for its (less service-sensitive) captive traffic. While the railroads argue that the efficiency of the utilized route can be assumed, there may well be cases where inefficient routes are used for captive traffic on the basis of traffic considerations on alternative, more efficient routes (which the railroads' proposal would disregard). If the prescribed rate is to reflect efficient handling of the shipper's traffic, the rate methodology must permit these types of circumstances to be addressed.

While bothersome to the railroads, the Board's proposal enables shippers to address these types of situations. It effectively takes the profit enhancement potential out of any deliberate strategy to "game" the process through operating inefficiencies, and provides a format for addressing inefficiencies imposed by the needs of other, off-line traffic. The Board should ensure that its final procedures preserve the ability of shippers to counteract any temptation a defendant railroad may experience to engage in inefficient routings of issue traffic.

E. Burdens on Shippers/Carriers and Incentives for Litigation

Several railroad parties note the information requirements imposed on the railroads by the Board's proposals, and anticipate that those requirements will motivate shippers to litigate rate complaints simply to obtain leverage over the railroads (i.e., due to the costs associated with production of the required information). This is essentially a mirror image of the railroads' own attempts to impose additional litigation costs on shippers through limitations on the availability of the SSAC methodology (as discussed further in Section C, above).

In its opening comments, AECC suggested that the Board should implement methods that would equalize (or equitably distribute) the reasonable and actual cost of the analysis and litigation required to establish the prescribed rates. This would address both of the concerns stated above, and appears to be consistent with DOT's suggestion that shippers and carriers should bear "symmetrical burdens".⁴ It would provide an economic incentive for parties to communicate and cooperate in the resolution of issues, and tend to limit litigation to areas that require Board direction or precedent.

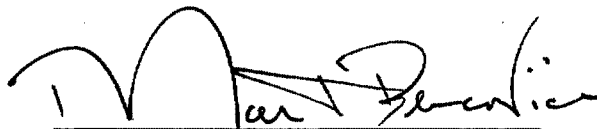
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⁴ *Initial Comments of the United States Department of Transportation* at p. 2 (Oct. 24, 2006).

AECC appreciates this opportunity to reply to the opening comments of other parties regarding the Board's proposals.

Respectfully submitted,

Arkansas Electric Cooperative Corporation

A handwritten signature in black ink, appearing to read "Martin W. Bercovici", is written over a horizontal line.

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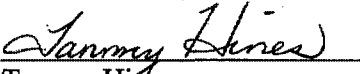
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Certificate of Service

I, Tammy Hines, a secretary in the law firm of Keller and Heckman LLP, hereby certify that a copy of the foregoing Reply Comments of Arkansas Electric Cooperative Corporation have been sent, first class mail, postage prepaid, to all Parties of Record on this 30th day of November, 2006.



Tammy Hines