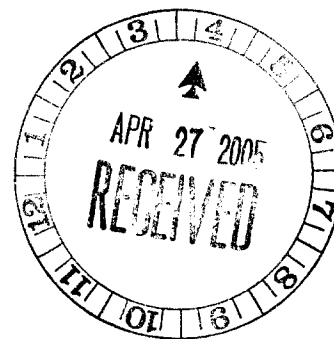


April 27, 2005

213879



Via Hand Delivery

The Honorable Vernon A. Williams
Secretary
Surface Transportation Board
1925 K St. N.W.
Washington, D.C. 20423

RE: STB Docket No. 42071, *Otter Tail Power Company v. The Burlington Northern and Santa Fe Railway Company*

Dear Secretary Williams:

Please find enclosed for filing the original and ten (10) copies of the Final Brief of Otter Tail Power Company (*Public Version*) in the above referenced proceeding. Also enclosed are three (3) compact disks containing the electronic version of the written text in Word and PDF.

An extra copy of the Brief is enclosed for stamping and returning to our offices.

Should you have any questions regarding the foregoing, please do not hesitate to contact the undersigned.

Sincerely,

Nicholas J. DiMichael
Jeffrey O. Moreno
Counsel for Complainant

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Office of Proceedings

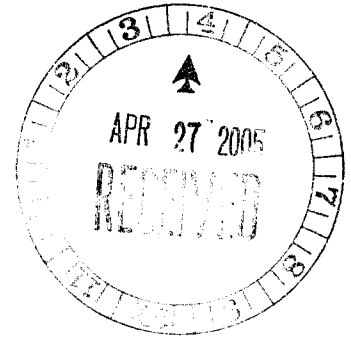
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cc: Counsel for Defendant

213879

**BEFORE THE
SURFACE TRANSPORTATION BOARD**



OTTER TAIL POWER COMPANY,

Complainant,

v.

BNSF RAILWAY COMPANY,

Defendant.

Docket No. 42071

FINAL BRIEF OF OTTER TAIL POWER COMPANY

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Public Record

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Dated: April 27, 2005

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TABLE OF ABBREVIATIONS

TERMS

BNSF	BNSF Railway Company
CMP	Constrained Market Pricing
CNW	Chicago & North Western Railroad
EIA	Energy Information Administration
FEC	Florida East Coast Railway
ICC	Interstate Commerce Commission
MMP	Modified Mileage Prorate
MOW	Maintenance of Way
MRL	Montana Rail Link
MSP	Modified Straight-Mileage Prorate
OTRR	Otter Tail Railroad
Otter Tail	Otter Tail Power Company
PRB	Powder River Basin
RCAF-A	Rail Cost Adjustment Factor (Adjusted for Productivity)
RCAF-U	Rail Cost Adjustment Factor (Unadjusted for Productivity)
SAC	Stand-Alone Cost
SARR	Stand-Alone Railroad
STB	Surface Transportation Board
UP	Union Pacific Railroad
WRPI	Western Railroad Properties, Inc.
WC	Wisconsin Central

ICC OR STB PROCEEDINGS

APS	<u>Arizona Public Service Co. v. The A.T. & S.F. Ry. Co.</u> , 2 S.T.B. 367, 438 (1997)
Duke/CSX	<u>Duke Energy Corp. v. CSX Transportation, Inc.</u> STB Docket No. 42070 (served Feb. 4, 2004)
Duke/NS	<u>Duke Energy Corp. v. Norfolk Southern Ry. Co.</u> , STB Docket No. 42069 (served Nov. 5, 2003)
FMC	<u>FMC Wyoming Corp. v. Union Pac. R.R. Co.</u> , STB Docket No. 42022 (served May 12, 2000)
Guidelines	<u>Coal Rate Guidelines, Nationwide</u> , 1 I.C.C. 2d 520 (1985)
McCarty Farms	<u>McCarty Farms, Inc. v. Burlington Northern, Inc.</u> 2 S.T.B. 460 (1997)
Nevada Power II	<u>Bituminous Coal – Hiawatha, Utah to Moapa, Nevada</u> , 10 I.C.C.2d 259 (1994)
PPL	<u>PPL Montana v. The Burlington Northern and Santa Fe Ry. Co.</u> , STB Docket No. 42054 (served Aug. 20, 2002)
PPL II	<u>PPL Montana v. The Burlington Northern and Santa Fe Ry. Co.</u> , STB Docket No. 42054 (served March 24, 2003)
TMPA	<u>Texas Municipal Power Agency v. The Burlington Northern and Santa Fe Ry. Co.</u> , STB Docket No. 42056 (served March 24, 2003)
WTU	<u>West Texas Utilities Co. v. The Burlington Northern R.R.</u> , 1 S.T.B. 638, 712 (1996)
Xcel	<u>Public Service Co. of Colorado d/b/a Xcel Energy Company v. The Burlington Northern and Santa Fe Ry. Co.</u> , STB Docket No. 42057 (served June 8, 2004)
Xcel II	<u>Public Service Co. of Colorado d/b/a Xcel Energy Company v. The Burlington Northern and Santa Fe Ry. Co.</u> , STB Docket No. 42057 (served Jan. 19, 2005)

FINAL BRIEF OF OTTER TAIL POWER COMPANY

Complainant, Otter Tail, hereby submits its Final Brief in this proceeding, which challenges the reasonableness of rates charged in BNSF 90062 for the transportation of coal in unit trains from PRB mines to the Big Stone Generating Station, near Milbank, South Dakota.

In this proceeding, Otter Tail has presented two different SAC analyses. Otter Tail's "Base" case, which is its preferred case, uses actual BNSF divisions data to allocate revenue from cross-over traffic between the OTRR, and the residual BNSF. Otter Tail's "Alternative" case uses the MSP methodology. However, in order to stay within the statistical boundaries of its regression algorithm based on BNSF's actual divisions, the Base case traffic group contains 31.7 million fewer tons of coal than the Alternative case.¹ The STB's decision whether to accept actual divisions or the MSP method will determine which traffic group, and consequently which SAC analysis, to use. In all other respects, the issues in this case are the same whether the Board applies actual divisions or the MSP method.

I. OTTER TAIL'S USE OF ACTUAL DIVISIONS IS THE BEST EVIDENCE FOR ALLOCATING CROSS-OVER TRAFFIC REVENUE.

Since its first decision involving cross-over traffic, the Board, and the ICC before it, have allocated revenue using a methodology that was intended, in the absence of actual divisions, to estimate what would be the market-based divisions between a SARR and the incumbent.² In Duke/NS at 20, note 29, however, the Board, in an unexplained departure from its precedent, declared that actual divisions would not be "particularly instructive" evidence for the proper allocation of cross-over revenues. This statement constituted mere *dicta* in that decision, since neither party had offered evidence based on actual divisions. In this proceeding, however, Otter

¹ See OTP Supp. Opening Evidence at I-2 to 3 (Jan. 9, 2004).

² E.g., Nevada Power II; McCarty Farms; FMC.

Tail has used evidence of actual divisions to allocate cross-over revenue.

In Nevada Power II at 267-68, the ICC adopted a straight-mileage prorate allocation method, which it described as “consistent with the treatment in our staff’s preliminary analysis of historically interlined traffic for which actual (market-based) divisions are not available.” In a separate statement commenting on this newly adopted approach, Chairman McDonald declared “We find that the proper approach is to estimate what the *market-based* divisions would be, and *this will be the standard for future cases.*” Id. at 280 [emphasis added].

In FMC, the ICC issued its strongest declaration that its mileage-based methodology, which is manifested in the MMP and MSP procedures, is a mere surrogate for actual, market-based divisions. Citing to both Nevada Power II and McCarty Farms, the ICC declared that “[MMP] is the best procedure for allocating revenues to carriers *where market-based divisions are not available.*” FMC at 27, note 62 [emphasis added]. The ICC further noted that, although FMC had requested actual divisions from UP in discovery in order to develop a statistical algorithm based on actual divisions data, UP’s refusal had:

denied FMC the opportunity to produce an alternative algorithm that might be more suitable [than MMP] *for estimating market based divisions* for these movements. Thus, *in the absence of any better evidence*, we [the ICC] use FMC’s method [MMP] to estimate divisions for these movements.

Id. at 30 [emphasis added]. The ICC further affirmed the superiority of actual divisions when it rejected UP’s evidence based on standard division sheets because that evidence was “*not as instructive* as UP’s actual divisions of total movement revenue.” Id. at 31 [emphasis added].

Although the ICC and the Board have employed various *procedures* to allocate cross-over revenue, their *approach* consistently has been to apply a procedure *that would approximate market-based divisions*, in the absence of actual divisions. Until Duke/NS, the agency repeatedly described its mileage-based revenue allocation methodology as an estimate for “market-based”

divisions, but consistently held that actual divisions would be “better” evidence.

In this case, BNSF produced actual divisions data, which Otter Tail used to develop an algorithm that tests mileage as the independent variable.³ Not surprisingly, the algorithm shows a very strong correlation between mileage and BNSF’s actual divisions across the general population, just as mileage is the key variable in the MSP methodology. Otter Tail’s algorithm is superior, however, because it is based on BNSF’s actual market divisions.⁴

In rejecting actual divisions as not “particularly instructive” in its Duke/NS footnote, the Board seems to have lost sight of the fact that the MMP and MSP procedures are, first and foremost, estimates for market-based divisions, not costs. While the Board is correct that these procedures bear some relationship to costs, it misconstrues the concept to conclude that cost considerations are paramount and that market considerations are irrelevant.

In fact, the Board has expressed a preference for actual divisions because they reflect *both* cost and market considerations. The recovery of costs, among other factors, is implicit in market-based divisions. Specifically, the Board observed that “market-based divisions result from the interaction of supply considerations (the relative *costs* incurred by the carriers in providing the interline movement) and demand considerations (the relative bargaining power of the two carriers).” Nevada Power II at 280 (Chairman McDonald commenting).

A purely cost-based procedure, on the other hand, is contrary to the underlying assumption of contestability in a SAC analysis. The OTRR should have the same ability to attract and carry traffic as BNSF, including the option to carry traffic for only a portion of the

³ OTP Op. Ev. at III-A-17 to 20 (June 13, 2003); OTP Reb. Ev. at III-A-78 to 87 (April 29, 2004).

⁴ BNSF also has attempted to discredit Otter Tail’s application of the regression algorithm on various statistical grounds. Otter Tail has refuted each of those arguments at pages III-A-78 to 87 of its April 29, 2004 Rebuttal Evidence. Moreover, Otter Tail’s regression technique is comparable to the Board’s own regression analysis in Xcel at 29-31, which the Board used to calibrate road property investment to account for the addition of Jeffery Energy Center traffic to BNSF’s operating plan.

entire movement. The OTRR also should have the same bargaining options that BNSF enjoys when it engages in rate division agreements with other carriers. This means that the OTRR's rate divisions should reflect the outcome of the same bargaining process that presently occurs between BNSF and other carriers. BNSF's actual, market-based, divisions are by definition representative of the divisions that BNSF achieves through such negotiations. Thus, it would be an impermissible entry barrier to artificially impose a cost-based approach to revenue allocation in the absence of any evidence that BNSF negotiates its own revenue divisions in this way. Since Otter Tail's market-based algorithm replicates real-world considerations, it is a superior revenue allocation methodology, which has been consistently recognized since Nevada Power II.

II. OTTER TAIL HAS PRESENTED THE ONLY INTEGRATED AND FULLY-FUNCTIONAL OPERATING PLAN FOR THE COMPLETE OTRR.

At the outset of this case, Otter Tail presented an operating plan based upon the String Model and BNSF presented its operating plan based, only in part, upon the RTC Model. At the invitation of the Board, however, Otter Tail submitted supplemental evidence on March 1, 2005 that also presents an operating plan (for its Base and Alternative cases, excluding rerouted non-coal traffic) based upon the RTC Model.⁵ Otter Tail, however, modeled the *complete* OTRR on the RTC Model, while BNSF has submitted an incomplete and flawed operating plan based upon a disconnected analysis of four separate OTRR segments.

BNSF's segmented approach ignores the inter-relationships between various line segments of a large rail network. Instead, BNSF chose to divide the OTRR into four segments and to derive operating statistics for each segment separately. Moreover, BNSF modeled only two unconnected line segments, between Oriva, WY and Converse, WY, and between Glendive, MT and Fargo, ND, on the RTC Model. BNSF merely accepted Otter Tail's capacity evidence

⁵ See OTP Supp. Ev. (March 1, 2005), as modified by OTP Supp. Errata (March 17, 2005).

based on the String Model for the other two segments.

In order to fully and accurately evaluate an integrated rail system, all major segments of the network must be tested in unison. Because BNSF's segmented approach does not do this, it fails to capture the impact of activity occurring on one line segment upon other line segments. BNSF's failure is particularly egregious because its version of the OTRR has undergone several significant changes over the course of this proceeding. In its October 8, 2003 Reply Evidence, BNSF excluded nearly 70 million tons of coal and 4 million tons of non-coal traffic from the OTRR. In its March 22, 2004 Supplemental Reply Evidence, BNSF added 14 million tons of coal traffic and removed an additional 13.7 million tons of non-coal traffic. Then, in its March 1, 2005 Supplemental Evidence, BNSF added 84 million tons of coal. With each iteration, however, BNSF modified only the line segments traversed by the added or excluded traffic, without any consideration of impacts upon the other line segments. As demonstrated by Otter Tail's modeling of the complete OTRR on the RTC Model, there are significant downstream impacts associated with all of the above traffic modifications, for which BNSF fails to account.⁶

BNSF's only accommodation to the inter-relationship between its four OTRR segments is an attempt to link trains moving from one segment onto the next segment. Even then, BNSF's linking methodology causes trains to disappear between segments or causes trains leaving one segment to appear at the next segment either before or after their actual time of departure.⁷

In Reply to Otter Tail's March 1, 2005 Supplemental Evidence, BNSF has accepted Otter Tail's mainline capacity and transit time assumptions based on the RTC Model.⁸ But, this limited acceptance of Otter Tail's RTC Model only perpetuates BNSF's flawed segmented

⁶ OTP Reply to BNSF Supp. Evid. at I-1 to 4 and III-C-2 to 5 (April 4, 2005).

⁷ OTP Reb. Evid. at III-B-40 to 42 (April 29, 2004).

⁸ BNSF Reply to Supp. Evid. at III.C-2 (April 4, 2005).

approach. For example, BNSF accepts the mainline capacity generated by Otter Tail's RTC Model, but rejects Otter Tail's yard dwell times and configurations, which are critical inputs to the RTC Model's determination of mainline capacity. BNSF, however, has not attempted to reconfigure Otter Tail's RTC Model with BNSF's dwell times and yard configurations to determine their impact upon mainline capacity. As a consequence, BNSF has ignored the impact of its dwell times and yard configurations upon the very same mainline capacity that BNSF claims to accept. Thus, BNSF's segmented approach, even in its acceptance of Otter Tail's RTC Model, once again ignores the integrated nature of a large rail system such as the OTRR.

BNSF's failure to model the entire OTRR is particularly perplexing in light of its own acknowledgement in this case of the integrated nature of rail networks:

The true test of a rail capacity analysis model is its ability to perform complex iterative processes to keep track of the many events occurring on a railroad at each moment in time. The model must be able to dispatch and track the movement of trains, and *to adjust for the ripple effect that individual dispatching decisions will have on other trains using the network*. Railroad traffic patterns can be influenced by many factors, *including events occurring far beyond the geographic boundaries of a line segment under study*. The RTC Model can process complex train movements and incorporate upstream and downstream events and activities.

BNSF Reply Evid. at III.B-20 (Oct. 8, 2003) [emphasis added]. BNSF has chosen not to avail itself of the full capabilities of the RTC Model, and in doing so, has failed to capture the ripple effects that occur beyond the geographic boundaries of the OTRR segments that it has chosen to model. Because Otter Tail has developed the only functional operating plan that is based on a fully integrated model of the complete OTRR, the Board should accept Otter Tail's plan.

III. BNSF HAS USED IMPROPER LOCOMOTIVE SPARE MARGINS, PEAKING FACTORS, AND DWELL TIMES.

Even though BNSF, as noted above, has accepted Otter Tail's transit times based upon the RTC Model, BNSF's calculation of the OTRR's locomotive requirements differs

significantly from that of Otter Tail. BNSF levels several criticisms at Otter Tail's methodology.⁹ Many of those are meaningless, however, since over 80% of the difference between the parties' locomotive requirements is attributable solely to their determination of the spare margin and peaking factor. Most of the remaining 20% is due to differences in dwell times. Thus, even if BNSF's other criticisms were accurate (which they are not), they would have only a *de minimis* impact upon the locomotive requirements of the OTRR.

Otter Tail has applied a {{[REDACTED]}} spare margin and a 6.7% (6.3% in its Alternative Case) peaking factor to determine the locomotive requirements of the OTRR. In contrast, BNSF has applied {{[REDACTED]}} spare margins for SD70 and C44-9 locomotives, respectively, and an extraordinary 35% peaking factor. Otter Tail's spare margin and peaking factor are fully supported by evidence and precedent, while BNSF's numbers artificially inflate the OTRR's locomotive requirements well beyond any realistic levels.

Otter Tail based its spare margin upon the terms of a locomotive maintenance contract {{[REDACTED]}} BNSF argues that this contract has been suspended. While this is true, {{[REDACTED]}}¹⁰

BNSF attempts to discredit this evidence by citing to several scenarios in which it claims that a locomotive would be available under these contracts but not available for actual service. These include deadheading, servicing, awaiting placement onto trains, accidents, and scheduled maintenance. But, servicing and awaiting placement already are accounted for in the OTRR's scheduling; accidents are sufficiently rare so as not to have a material impact on spare margins;

⁹ BNSF Reply to Supp. Evid. at III.C-4 to 10 (April 4, 2005).

¹⁰ OTP Reb. Evid. at III-C-38; OTP Reb. Workpaper, Vol. III, pp. 5750-56 (April 29, 2004).

and scheduled maintenance is in fact part of the availability guarantee in these contracts, contrary to BNSF's representations.¹¹ Finally, since BNSF's major concern over deadheading pertained to Otter Tail's non-coal locomotive fleet, the elimination of the vast majority of the OTRR's non-coal traffic renders that issue moot.¹²

BNSF's spare margins are an improper attempt to impute its own experience onto the OTRR. BNSF's own experience is based upon the average age of locomotives in the Alliance and Havre locomotive pools and BNSF's average utilization of these locomotives.¹³ These factors have no relevance to the OTRR's operations and its fleet of brand new locomotives.

BNSF's 35% peaking factor imposes inefficient operating requirements upon the OTRR that BNSF does not impose upon itself. BNSF would require the OTRR to acquire a fleet of equipment to meet its single peak day of demand, while sitting idle for the rest of the year. In Xcel II at 13, the Board rejected BNSF's attempt to impose a similar peaking factor because "No real-world railroad would buy locomotives to use only once a year and store away for the remainder of the year." Otter Tail's peaking factor is based upon the number of locomotives that the OTRR would have to lease on a short-term basis to meet its peak demand.

Although BNSF has accepted Otter Tail's mainline capacity and transit time assumptions based on the RTC Model, it continues to adhere to its Reply Evidence dwell times. Those dwell times, however, are unrealistically excessive. Furthermore, BNSF has not made any attempt to reconfigure the dwell times in Otter Tail's RTC Model to demonstrate their feasibility by running the RTC Model to completion. The Board, however, easily can verify this for itself.

Otter Tail designed an efficient operating plan, including all yard activities, based on the

¹¹ OTP Reb. Ev. at III-C-38 to 39 (April 29, 2004).

¹² See e.g., BNSF Reply Ev. at III.C-62 to 63 (Oct. 8, 2003).

¹³ OTP Reb. Ev. at III-C-37 (April 29, 2004).

real-world experience of Richard H. McDonald, a former Vice President of Operations for the CNW. Mr. McDonald's plan allots 2 hours at Glendive and Donkey Creek to exchange power, perform FRA-certified inspections, remove bad order cars, insert spare cars, and change crews.¹⁴ In contrast, BNSF has allotted 6 hours for these activities at Glendive, Donkey Creek *and* Converse,¹⁵ based on observations of BNSF's existing operations at its Alliance Yard. BNSF, however, assumes that all of these functions must be performed sequentially, whereas Mr. McDonald recognizes that some can be performed simultaneously. Furthermore, BNSF has included intentional train "holds" as "dwell" time, when in fact the reason for holding the train had nothing to do with yard activities.¹⁶ Finally, the Board has accepted the fact that a SARR's yards need not function in the same fashion as the incumbent's existing yards. TMPA at 76.

In addition, Otter Tail has allotted 15 minutes for interchanges between the OTRR and connecting carriers, compared to 1 hour allotted by BNSF. Otter Tail's evidence is based on Mr. McDonald's actual experience at CNW interchanging trains under a run-through agreement with UP at Fremont, NE.¹⁷ Therefore, Otter Tail has demonstrated the feasibility of its dwell times.

IV. OTTER TAIL HAS PRESENTED EVIDENCE THAT THE OTRR CAN ACHIEVE SUBSTANTIAL PRODUCTIVITY GAINS SIMILAR TO THE RAIL INDUSTRY AS A WHOLE.

A hotly contested issue in recent SAC cases has been how to adjust the base year operating expenses for inflation over the 20-year SAC analysis period. This case is no exception. As in prior cases, Otter Tail has adjusted operating expenses by a forecast of the RCAF-A and BNSF has used a forecast of the RCAF-U. However, unlike those cases, Otter Tail

¹⁴ OTP Op. Ev. at III-C-21 (June 13, 2003).

¹⁵ Otter Tail allots 45 minutes at Converse, since it is not necessary to exchange locomotives or perform FRA-certified inspections.

¹⁶ See OTP Reb. Ev. at III-C-31 to 32 (April 29, 2004) for a full discussion of this evidence.

¹⁷ Id. at III-C-32 to 33.

has presented substantial evidence to justify selection of the RCAF-A over the RCAF-U.

The Board's selection of the RCAF-U over the RCAF-A in recent decisions has reflected an incomplete analysis at best. While acknowledging that a SARR would realize some productivity improvements over the course of the SAC analysis period, the Board has concluded:

The potential impact of such improvements would be far less than for existing railroads, which make changes incrementally as older-technology assets wear out or become obsolete....Although RCAF-U may somewhat overstate the [SARR's] costs over the 20-year period, RCAF-A would understate them more. Faced with a choice between the two, the Board has consistently used RCAF-U. See Duke/CSXT at 30; CP&L at 27-28; Duke/NS at 37; TMPA at 161.

Xcel at 33. However, the Board has never cited to any evidence that the RCAF-A would understate the SARR's costs more than the RCAF-U would overstate them.

The Board's selection of the RCAF-U to inflate operating expenses in prior cases is fundamentally inconsistent with its use of the EIA index of projected changes in coal transportation rates to forecast future changes in the SARR's revenues.¹⁸ The EIA forecast assumes that a portion of future railroad productivity gains are passed through to shippers in the form of lower rates. But, the RCAF-U assumes that the SARR has no productivity gains. As a consequence, the SARR's operating expenses are presumed to increase at a faster pace than its revenues. This "double-whammy" becomes more aggravated in each year of the SAC period.

Moreover, the Board's selection of the RCAF-U is inconsistent with its insistence that complainants give real world examples to demonstrate the feasibility of their evidence. See e.g., Part V, infra. As a consequence, the Board has saddled the SARR with real-world inefficiencies, but denied it any real-world productivity gains. The Board cannot have it both ways.

Nevertheless, in this proceeding, Otter Tail *has identified* numerous examples of current

¹⁸ See e.g., TMPA at 29; Duke/NS at 64, n. 78.

and impending productivity events that the OTRR *would realize* very early in the 20-year SAC analysis period.¹⁹ These examples demonstrate that, in fact, the RCAF-U would overstate the OTRR's costs far more than the RCAF-A would understate them. Thus, under the Board's all-or-nothing approach, Otter Tail's evidence dictates that the Board should select the RCAF-A. At the very least, the evidence in this record would support an approach where the RCAF-U is used in the first few years of the SAC analysis period, and the RCAF-A is used in the remaining years.

A large number of productivity gains would occur through changes in technology and operating and maintenance practices that the OTRR would implement within a few years, if not immediately. The only productivity gains in the RCAF-A that would not be immediately implemented by the OTRR would be those related to capital investments. Many of those gains, however, still would be implemented within the SAC period as the OTRR replaces capital assets.

At pages III-G-5 to 9 of its April 29, 2004 Rebuttal Evidence, Otter Tail detailed 16 recent and impending productivity events, almost all of which would be implemented by the OTRR between 2002 and the end of 2007. For example, technology is evolving quickly to improve locomotive fuel efficiency, such as microprocessors that are expected to be available as early as 2005 and that can be retrofitted for existing locomotives.²⁰ In addition, top-of-rail lubrication systems that are currently being tested to improve fuel efficiency would be implemented immediately by the OTRR.²¹

Locomotive suppliers are testing management systems that will alert the user to pending maintenance problems, leading to decreases in unplanned maintenance. Since these systems can

¹⁹ See OTP Reb. Ev. at III-G-3 to 13; OTP Reb. Workpapers, Vol. III, pp. 6424-92 (April 29, 2004).

²⁰ OTP Reb. Workpaper, Vol. III, pp. 6453-57, 6478-80 (April 29, 2004).

²¹ *Id.*, pp. 6430-52, 6473-77.

be retrofitted onto existing locomotives, they could be implemented by the OTRR immediately.²²

The OTRR also would realize coal car efficiencies at the same pace as the overall rail industry, since most of the OTRR's coal shippers supply their own rail cars, which is typical of the industry. Some of these improvements are suspension trucks that produce less wheel wear; new metal alloys that minimize defects and increase wheel life; composite coal cars that have lower tares than aluminum cars, but with equal or better strength; and 315,000 GWR railcars.²³

Productivity in MOW procedures would be implemented by the OTRR immediately. These include Rail Profile Maintenance Software that identifies high contact stress areas for preventative maintenance; performance based track geometry inspection procedures to prioritize maintenance activities; and new rail flaw and broken rail inspection systems to streamline inspections and more quickly pinpoint defects.²⁴

Increases in system efficiency through Positive Train Control and GPS tracking would be implemented by the OTRR along with the rest of the rail industry.²⁵

Technology improvements in communications will rely less on expensive wire-based communication systems, and instead emphasize mobile communication and signaling.²⁶ Since the OTRR updates its IT software on an annual basis and its IT hardware every six years (and radios every five years), it will realize these productivity improvements on a continuing basis, beginning very early in the SAC analysis period.

To the extent that new locomotive technology cannot be retrofitted onto existing

²² Id., pp. 6453-57.

²³ Id., pp. 6435-36, 6450-51, 6458; OTP Reb. Electronic Workpaper "EIA Nominal Rate Index.PDF".

²⁴ OTP Reb. Workpaper, Vol. III, pp. 6439-40 (April 29, 2004).

²⁵ Id., pp. 6444 and 6451.

²⁶ Id., p. 6451.

locomotives, the OTRR still will have the opportunity to benefit from those technologies as early as 2007. Otter Tail used a BNSF SD70MAC lease, BNSF 2001-C, to determine the OTRR's locomotive lease costs. {{ [REDACTED]

[REDACTED] } }²⁷ Thus, the OTRR would have the same opportunity as BNSF to replace its locomotives with newer ones beginning in 2007. Furthermore, as the OTRR acquires new locomotives to handle its traffic growth over the SAC analysis period, it will realize all of the productivity associated with those new locomotives.

Because the OTRR is built to handle its peak year traffic in 2022, it also will experience *substantial* productivity gains as it grows into that capacity over the course of the SAC period. Over this time, the OTRR's coal traffic will increase by more than 25%.²⁸ At a time when Class I railroads are experiencing capacity constraints, the OTRR's productivity, through the greater utilization of its capital assets, actually will outpace the industry as a whole. This form of productivity was discussed by BNSF's own President in speeches on May 9, 2001 and September 10, 2003.²⁹ Indeed, some of the productivity gains of the Class I railroads over the past two decades can be directly attributed to growing into their excess capacity, just as the OTRR will grow into its excess capacity over the 20-year SAC period.

This evidence stands in stark contrast to BNSF's unsupported assertion that "because the OTRR is designed to be the most efficient, least-cost railroad, it would be inappropriate to impute to the OTRR improvements in productivity that the nation's Class I railroads are still in

²⁷ Because this lease and associated documents are 1200 pages long, Otter Tail included only the locomotive rate and term pages in the workpapers. Section 10, however, was not among those pages, since Otter Tail did not originally anticipate a need to include those pages.

²⁸ OTP Reb. Ev. at III-G-10 (April 29, 2004).

²⁹ OTP Reb. Workpaper, Vol. III, pp. 6481-89 (April 29, 2004).

the process of achieving.”³⁰ Otter Tail’s evidence has thoroughly rebuffed that assertion and, under the Board’s current all-or-nothing approach, has justified its use of the RCAF-A.³¹

Moreover, even if the Board were to retreat from its all-or-nothing approach, Otter Tail clearly has shown that the Board *cannot* adopt the RCAF-U for the *entire* SAC analysis period, but must adopt a reasonable transition to the full RCAF-A that begins very early in the SAC analysis period. As noted above, Otter Tail’s evidence shows that significant productivity gains *could* be achieved as early as 2002 and many more at various times up through 2007. Therefore, at the very latest, the RCAF-A should be used beginning on January 1, 2008.

V. OTTER TAIL HAS PRESENTED A FEASIBLE MAINTENANCE OF WAY PLAN BASED UPON “REAL-WORLD” EXPERIENCE.

Otter Tail has proposed an efficient and workable MOW plan based upon real-world experience. The crux of the OTRR’s MOW plan is its reliance upon contractors for program maintenance, which substantially reduces the number of MOW personnel that the OTRR must hire. This reflects a long-term trend in the rail industry that has reduced the number of personnel required to perform various functions. The OTRR is not constrained by the same legacy labor agreements that have required the Class I railroads to implement these changes more gradually.

Although the Board has rejected similar MOW plans in recent cases, Otter Tail has presented more extensive evidence to support its plan. In Xcel at 79, the Board summarily “reject[ed] the notion that the MOW function can be outsourced.” Otter Tail, however, has shown that RailAmerica currently outsources 95% of its capital maintenance work, resulting in

³⁰ BNSF Reply Ev. at III.G-2 (Oct. 8, 2003).

³¹ Any attempt to quantify prospective productivity gains would be speculative at best. Indeed, the Board itself uses a multi-year lagged average to measure productivity in the RCAF-A. Railroad Cost Recovery Procedures - Productivity Adjustment, Ex Parte No. 290 (Sub. No. 4), 5 I.C.C. 2d 434 (1989).

significant savings.³² Thus, there no longer is any basis for the Board to summarily reject MOW outsourcing as a least-cost, feasible alternative to the incumbent railroad's MOW practices.

The OTRR MOW plan was developed by Richard H. McDonald, based on his real-world experience as Vice President–Engineering for the CNW and as Vice President–Chief Engineer of WRPI, where he was responsible for the planning, construction and operation of the WRPI line into the PRB. During his long railroading career, Mr. McDonald also was a Roadmaster, Assistant Division Engineer, Division Engineer of Track, and Division Engineer.

The OTRR MOW plan is modeled on WRPI's plan. Mr. McDonald has stressed the importance of proper design and construction of rail infrastructure to MOW by contrasting the WRPI experience with BNSF's experience on its parallel line.³³ This evidence illustrates that the WRPI line, which was more carefully constructed than the BNSF line, has experienced far fewer MOW problems. Thus, the OTRR's MOW activity should more closely resemble WRPI's.

BNSF's reference to actual experience on its PRB rail line is not instructive precisely because its line was constructed to different standards than the WRPI line. Nor is BNSF's reference to its real-world MOW experience on the other OTRR line segments particularly instructive. Those lines were constructed up to 100 years ago with much older technology. Although they have been upgraded, they are not comparable to a newly constructed OTRR.

The OTRR's 14 person field teams cover the same positions over a similar size territory as Mr. McDonald supervised while at WRPI, CNW, and the New York Central/Penn Central. Indeed, Mr. McDonald observes that BNSF's proposed engineering staff would dwarf the staffs he supervised while a Division Engineer on the New York Central/Penn Central 30 years ago.³⁴

³² OTP Reb. Ev. at III-D-98 to 99; OTP Reb. Workpaper, Vol. III, p. 6077 (April 29, 2004).

³³ OTP Reb. Ev. at III-D-95 to 98 (April 29, 2004).

³⁴ OTP Reb. Ev. at III-D-107 (April 29, 2004).

The OTRR's densest line segment, which is in the PRB, would be constructed to similar specifications as WRPI. Therefore, it is reasonable to conclude that the OTRR's MOW requirements would be similar to WRPI's. Also, because this is the densest line segment on the OTRR, a MOW plan based upon the WRPI experience is a conservative benchmark for the entire OTRR. The only difference between the OTRR's MOW plan and WRPI's is that the OTRR will outsource all MOW work that can be scheduled and accomplished in a practical, efficient and economic manner, which allows the OTRR to employ fewer MOW personnel.

BNSF's attempt to justify its MOW work force based on comparisons to MRL, FEC, and WC is an apples-to-oranges assessment. Because none of these railroads outsources program maintenance, they would be expected to have larger MOW forces than the OTRR. In addition, MRL is a spin-off railroad with outdated track composed primarily of jointed rail and poor tie and surface conditions, and FEC carries an entirely different mix of traffic from the OTRR, much of it time-sensitive, and unlike the OTRR, it operates commuter services.³⁵

It would be particularly egregious for the Board to impose a MOW plan upon the OTRR that is based upon other railroads with much older track and, at the same time, inflate operating expenses by the RCAF-U. This would saddle the OTRR with the inefficient practices of the current rail industry, while denying the OTRR the productivity gains that these same railroads would experience through improved MOW practices.³⁶

There are more appropriate benchmarks against which to measure the reasonableness of Otter Tail's MOW plan. One benchmark is the average number of track miles per field person. Otter Tail's OTRR averages one field person for every 6.4 track miles, compared to 2.6 miles for

³⁵ Id. at III-D-107 to 108.

³⁶ See Part IV, supra. Improvements to MOW procedures are a prime example of a significant productivity improvement that the OTRR would benefit from at the same time as the entire industry.

BNSF's OTRR. WRPI, with considerably higher tonnages than the OTRR, averaged one person for every 5.8 track miles. Otter Tail has presented a more reasonable MOW plan than BNSF.³⁷

Another benchmark is the operating maintenance cost per track mile. The OTRR averages \$14,500 per track mile for spot maintenance, compared with BNSF's proposal of \$40,546. In the real-world, however, BNSF's 2002 R-1 Annual Report shows that BNSF itself expended only \$14,247 per track mile.³⁸ Thus, Otter Tail's evidence is extremely reasonable based on this real-world comparison.

A third benchmark is the portion of total MOW expenditures that is operating expense (*i.e.* spot maintenance). Otter Tail's spot maintenance for the OTRR is 21.9%, while BNSF's is 46.5%. Otter Tail's figure is very close to the real-world BNSF's actual spot maintenance of 25.6%, as calculated from BNSF's 2002 R-1 Annual Report.³⁹

VI. THE PPL CROSS-SUBSIDY TEST VIOLATES CONSTRAINED MARKET PRICING PRINCIPLES.

In its December 13th order, the Board directed the parties to perform a cross-subsidy analysis in accordance with the standards adopted in PPL. Although, unlike the complainant in PPL, Otter Tail has demonstrated that there is no cross-subsidy of the OTRR based upon its own evidence, Otter Tail recognizes that the Board could select between elements of both parties' evidence in a manner that might create a cross-subsidy when applying the PPL test. Therefore, Otter Tail is compelled to register its objections to the PPL test as a violation of CMP principles.

Guidelines does not compel the Board's methodology for determining the existence of a cross-subsidy. A proper cross-subsidy test should ensure that the complainant's captive traffic

³⁷ Id. at III-D-122.

³⁸ Id. at III-D-145 to 146.

³⁹ Id. at III-D-106.

does not cross-subsidize other traffic, not root out cross-subsidies, as the Board defines them, across the defendant's (or the SARR's) entire system. Guidelines at 523-24. Indeed, the Board does not, nor could it, impose the PPL test upon real-world railroads. Nor has it ever suggested that an existing railroad should abandon any portion of its system or refuse to handle traffic that does not cover its stand-alone costs when isolated from the rest of the rail system. Yet, that is precisely what the Board would require of the SARR. This is contrary to CMP.

The ICC has correctly observed that the "objective of the SAC constraint is to simulate a competitive rate standard for non-competitive rail movements by determining the rate that would be available to shippers in a contestable market environment." Nevada Power II at 266, citing Guidelines at 529. The ICC also explained the relationship of sunk costs to CMP theory:

In simulating a contestable market in our SAC analysis, we do not eliminate sunk costs; rather, *we assume that the costs that are sunk for actual rail carriers will also be sunk for the hypothetical efficient entrant*. Therefore, we must exclude from our SAC analysis any behavior that would make sunk costs a barrier to costlessly reversible entry.

* * *

In sum, to determine the rates that would be available to shippers if rail markets were contestable, we cannot take account of any post-entry responses by incumbents. Instead, *we view the entrant as if it were a replacement for that segment of the rail system whose services the entrant would be offering*.

Nevada Power II at 267 [emphasis added] [footnotes omitted].

The Board's cross-subsidy analysis in PPL violates CMP by failing to assume that the same costs that are sunk for the incumbent also are sunk for the SARR. In the PPL analysis, the Board includes sunk costs to determine whether one segment of the SARR is cross-subsidizing the other. In order to avoid a cross-subsidy, therefore, the SARR must charge rates that cover all the attributable costs of the traffic on each line segment, including sunk costs. But, the

incumbent is under no similar constraint since it is economically rational for it to price at any level that recovers its directly variable costs, which do not include any sunk costs. See Ex Parte No. 355, Cost Standards for Railroad Rates, 364 I.C.C. 898, 899, 904 (1981). By holding the SARR to a different cross-subsidy standard than the incumbent, the Board has created an impermissible barrier to entry that would not exist in a contestable market.

In addition, if the SARR is not evaluated as an indivisible entity, the Board's cross-subsidy analysis creates another impermissible barrier to entry. Because the SARR is a *replacement* for the replicated lines of the incumbent, and since the incumbent *already* has incurred sunk costs for these line segments, the Board also must assume that these costs are sunk for the SARR. In other words, the SARR no longer has a choice whether or not to incur these costs; its costs for infrastructure such as roadbed, rail and ties are presumed to already be in the ground. Therefore, sunk costs must be excluded from any cross-subsidy analysis. Otherwise, the SARR would be at a disadvantage relative to the incumbent, because the Board's methodology would permit differential pricing by the incumbent that is not available to the SARR, which is inconsistent with the notion that the SARR is a "replacement" for the incumbent.

Moreover, the PPL test is inconsistent with the Board's fundamental statutory charge to insure that rates to captive shippers are "reasonable." 49 U.S.C. § 10701. Under the PPL test, the complaints of shippers on light-density lines are dismissed, not because their rate is "reasonable," but because there is insufficient *other* traffic on the line to provide enough revenue to pass the PPL test. In other words, the PPL test ensures that shippers in rural, light-density, areas with few transportation options – the very shippers that most need the Board's protection – are the shippers for whom the Board's protection against unreasonable rates is unavailable.

Finally, even if the Board continues to adhere to its PPL cross-subsidy test, it should

reject BNSF's proposal to apply the test a second time, after any reduction in rates that might be mandated by the SAC analysis, to determine whether the rate reduction itself creates an impermissible cross-subsidy. First, BNSF's proposal is inconsistent with CMP principles. It would create a windfall for BNSF, since aggregate system revenues would continue to exceed aggregate costs; it would fail to maintain existing demand elasticities for the entire OTRR traffic group; and it would result in a truly segmented SAC analysis where each line segment must stand on its own, which would require Otter Tail to bear the burden of revenue deficiencies on some segments while BNSF retains the residual benefit of excess revenues on other segments. Second, there is no merit to BNSF's proposal because only Otter Tail's rate actually will be reduced: at the end of this case, all other rates will remain at exactly their present level, which means there will be no cross-subsidies.

VII. OTTER TAIL HAS PROPERLY INCLUDED TRAFFIC THAT ORIGINATES AT SOUTHERN PRB MINES AND MOVES SOUTH ON THE OTRR.

BNSF wrongly excludes from the OTRR over 54 million tons of coal traffic (84 million tons in the Alternative Case) that originate at southern PRB mines, beginning at Cordero, and move south to Converse, for interchange with the residual BNSF. BNSF incorrectly claims that this traffic must share facilities directly with the issue traffic and that it does not do so.⁴⁰

First, much of this traffic does share facilities with the issue traffic. All coal from mines referenced in BNSF 90062 constitute the issue traffic, regardless whether coal has originated from those mines under the challenged rates. TMPA at 10; Xcel at 39-40. BNSF incorrectly has defined the issue traffic as only coal that originates from the Belle Ayr and Eagle Butte mines, since those were the principle sources of coal at the time Otter Tail filed its complaint.⁴¹

⁴⁰ See OTP Reb. Ev. at I-19 to I-26 and III-A-23 to III-A-27 (April 29, 2004) for a full discussion.

⁴¹ Beginning in January 2005, the Black Thunder Mine became the primary source of Big Stone's coal.

BNSF also has misrepresented the PPL II decision to fabricate a non-existent requirement that a SARR must limit itself to traffic that directly shares facilities with the issue traffic. In PPL II, the Board held simply that a complainant should not shift the *attributable* costs of facilities needed by the issue traffic upon traffic that does not use those facilities. The Board then adopted a test to determine whether any such cross-subsidy exists. Although Otter Tail objects to the Board's measure of attributable costs in its cross-subsidy test, Otter Tail has demonstrated that its evidence passes that test. That fact, alone, proves that Otter Tail has properly included the challenged coal volumes within the OTRR's traffic group. If that fact were not sufficient, the Board also rejected nearly identical arguments in Duke/CSX at 23.

VIII. THE BOARD SHOULD ACCEPT OTTER TAIL'S UPDATED COST OF DEBT EVIDENCE BASED UPON REFINANCED INVESTMENT COSTS.

At pages III-G-1 to III-G-3 of its April 29, 2004 Rebuttal Evidence, Otter Tail updated its cost of debt to reflect a lower interest rate that would be available through refinancing in 1Q03. BNSF has moved to strike this evidence as impermissible rebuttal. The Board, however, routinely has updated cost of equity evidence in prior decisions even after the record has closed. Otter Tail merely updated its cost of debt consistent with this Board precedent.

In WTU at 712, the ICC acknowledged that a SARR could refinance and lower its debt costs in the future if the opportunity presented itself. Similarly, in McCarty Farms at 523, note 126, the agency held that a SARR "would be free to choose a method of financing its debt to minimize that cost." In addition, there is ample precedent for updating other cost of capital factors in SAC proceedings even after the close of the administrative record.⁴²

In the three and a half years that this case has been pending, interest rates have dropped precipitously. On Rebuttal, Otter Tail was able to submit evidence of lower interest rates, since

⁴² FMC at 178, note 248; APS at 438.

the filing of its Opening Evidence, that would have been available to the OTRR in 1Q03. Thus, Otter Tail assumed that the OTRR would refinance its debt in 1Q03, which is just what the Board assumed a least-cost, efficient railroad would do in WTU and McCarty Farms.

IX. GAAP PRINCIPLES REQUIRE START-UP RECRUITMENT AND TRAINING EXPENSES TO BE CAPITALIZED.

Otter Tail has capitalized start-up recruitment and training expenses, while BNSF has expensed them.⁴³ In recent decisions, the Board has concluded that “generally accepted accounting principles (GAAP) treat training and recruiting of employees as an operating expense that is not capitalized.” Xcel at 75; see also Duke/CSXT at 64-65. This conclusion, however, is *incorrect* when training and recruitment costs are incurred in a start-up situation.

In prior decisions, the Board clearly has overlooked Statement of Position (“SOP”) 98-5, which provides guidance on the financial reporting of start-up costs, including employee training expenses incurred prior to the start of operations. SOP 98-5 states that “Costs of start-up activities, including organizational costs, should be expensed as incurred.” This means that the OTRR should expense start-up costs *before* it begins operations and starts to generate revenue.

For any training completed prior to the start of operations, the costs should be expensed in the calendar year in which they are incurred. Therefore, the OTRR’s start-up costs, including training expenses, should be recognized and expensed in the calendar year ending December 31, 2001, rather than in the first year of operations, beginning January 1, 2002, since that would be contrary to SOP 98-5. Thus, along with other start-up costs incurred prior to the commencement of operations, GAAP requires that recruitment and training expenses be amortized, since costs expensed prior to the commencement of operations cannot be matched with any revenues.

⁴³ OTP Reb. Ev. at III-D-91 (April 29, 2004).

X. THE AMOUNT OF REPARATIONS MUST INCLUDE FUEL SURCHARGES PAID BY OTTER TAIL SINCE 2004.

Subsequent to the filing of Opening and Reply Evidence in this case, BNSF imposed a fuel surcharge upon the Big Stone traffic, beginning in July 2004. This has raised issues as to how to treat those revenues in this case and whether any rate reduction should be from just the tariff rate or from the combined tariff and fuel surcharge rate level. In its March 1, 2005 Supplemental Evidence, BNSF erroneously concludes that fuel surcharge revenue should be excluded, but if it is included, that any rate reduction should be from the combined tariff and fuel surcharge rate levels. BNSF's conclusions would double-recover fuel costs.

The base year 2002 tariff rate that Otter Tail has challenged includes all costs, including fuel. The SAC analysis inflates those base year costs annually by the RCAF, which includes changes in total fuel costs. Since the 2002 base year rate already recovers total fuel costs, a future rate prescription based upon RCAF indexed 2002 base year costs will recover total fuel costs. Thus, any rate reduction should use only the tariff rate as the starting point, since adding a fuel surcharge to the tariff rate would double-recover fuel costs. Finally, the amount of reparations should be the difference between the prescribed rate (based on the tariff rate) and the monies paid by Otter Tail, which includes the fuel surcharges.

XI. BNSF HAS INFLATED THE OTRR'S OPERATING AND INVESTMENT COSTS BEYOND EVEN REASONABLE REAL-WORLD LEVELS.

In addition to specific costs already discussed above, BNSF has engaged in a systematic effort to add to and inflate operating and investment costs at every turn.

Where Otter Tail incorporates and applies state of the art railroading practices to determine the OTRR's locomotive, rail car, and personnel requirements, in order to capture and leverage available efficiencies, BNSF merely projects its existing operations upon the OTRR and ignores Board precedent. For example, BNSF has ignored established precedent in its

calculation of locomotive lease costs and it has assumed a lower locomotive utilization rate due to its excessive spare margin and peaking factors.⁴⁴ It has mis-characterized full service rail car leases to exclude maintenance and it has calculated maintenance costs to be almost as high as the lease rate itself. BNSF adds redundant and unnecessary operating personnel, such as adding crew haulers on top of taxi service expenses. Indeed, BNSF adds Marketing and Finance personnel, sometimes without any explanation at all. BNSF also posits compensation levels that often exceed its own purported real-world figures.⁴⁵

On the investment side, BNSF's evidence bears no resemblance to investment levels in prior western rate cases. With total investment costs over \$2.6 million per track mile, BNSF's road property investment figure approximates the cost of building a SARR in the Eastern U.S., where the Board has concluded that construction is much more expensive due to higher land values and rugged terrain.⁴⁶ In contrast, Otter Tail's road property investment is slightly over \$1.5 million per track mile.

The major difference between the Otter Tail and BNSF investment costs is in road preparation. Otter Tail based its unit costs for earthwork on established Board precedent in other Western cases, while BNSF has inflated unit costs by using unnecessarily expensive equipment, including extra steps in the grading process, and increasing costs due to various unsupported soil issues.⁴⁷ For example, BNSF included extra dozers in the construction process and it chose not to use the bulk drilling and blasting cost proposed by Otter Tail, based on precedent, for solid

⁴⁴ Id. at III-D-5 to 7, 9; TMPA at 79 (rejecting BNSF evidence based on "normalized" lease payments).

⁴⁵ OTP Reb. Ev. at III-D-19 to 22 (rail car leases), 30-31 (redundant personnel), 74-80 (compensation) (April 29, 2004).

⁴⁶ BNSF Reply Ev. at III.B-4 and III.F-2 (Oct. 8, 2003). In Duke/NS at 47 and 86, the Board adopted road property costs of \$2.61 million per track mile.

⁴⁷ OTP Reb. Ev. at III-F-57 to 75 (April 29, 2004).

rock excavation. BNSF also has attempted to interject new costs such as a winter construction premium into the SAC analysis, even though winter construction costs are a contingency cost that only would accrue if construction could not be completed in the non-winter months.⁴⁸

Although BNSF has engaged in at least four construction projects along the OTRR route in recent years, it has not presented a single document from those projects either to support its roadbed preparation costs and procedures or to refute those presented by Otter Tail. Instead, BNSF has attempted to create evidence based on highway construction projects and interviews with an equipment supplier and an unidentified general contractor. The glaring omission of evidence from any of BNSF's real-world construction projects raises a spectre that the most relevant evidence available does not support BNSF's vastly inflated investment costs.⁴⁹

Indeed, based upon evidence presented by Otter Tail from various Wyoming, North Dakota, and Montana, Department of Transportation project bids, Otter Tail most likely has conservatively overstated the OTRR's total investment costs.⁵⁰

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⁴⁸ Id. at III-F 72 to 74.

⁴⁹ Id. at III-F-56 to 57, 70 to 71.

⁵⁰ Id. at III-F-71 to 72.

CERTIFICATE OF SERVICE

I hereby certify that on this 27th day of April, 2005, I served a copy of the "Final Brief of Otter Tail Power Company" by hand delivery to counsel for Defendant at the following address:

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A handwritten signature in black ink, appearing to read "Jeffrey O. Moreno", is written over a horizontal line.

Jeffrey O. Moreno