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**BEFORE THE
SURFACE TRANSPORTATION BOARD**

Ex Parte No. 661

REVIEW OF RAIL FUEL SURCHARGES

COMMENTS OF ESCALATION CONSULTANTS, INC.

The Surface Transportation Board's (STB or Board) decision served March 14, 2006 provided notice of a public hearing to be held on May 11, 2006 and requested testimony to address fuel surcharges charged by railroads. Escalation Consultants submits comments in response to the invitation by the Board. Jay Roman, President of Escalation Consultants will submit oral testimony on May 11th.

Escalation Consultants is a company that deals with many bulk rail shippers on pricing and price escalation issues. We have performed a good deal of analysis on the fuel surcharge methods used by railroads to recoup their increased cost of fuel. In this regard, we conducted an analysis of railroad fuel surcharge practices for several associations, including the National Industrial Transportation League and the National Grain and Feed Association. We have also published our fuel surcharge study over the last few years on a quarterly basis and have been a frequent presenter on this topic at meetings and seminars. Escalation Consultants has performed analysis on fuel surcharges used by

railroads to recoup their increased cost of fuel and the testimony submitted relies on the results of those findings.

Escalation Consultants views the railroad fuel surcharge issue as being a price escalation issue. Fuel Surcharges are escalating fuel costs for movements to protect railroads from large increases in their cost of fuel. This is the same objective for escalation methods.

Jay Roman of Escalation Consultants has been involved with price escalation issues since the start of the Arab oil embargo in 1973. For more than thirty years he has negotiated hundreds of escalation provisions, re-negotiated provisions that were not working, been involved in resolving escalation disputes and testified on these types of provisions in proceedings in both the US and Canada. This experience over the last thirty years demonstrates that the following pattern occurs with escalation provisions.

- The farther an escalation method gets away from the cost that is being escalated the greater the likelihood for escalation problems; and;
- In a volatile market, if an escalation method that is not closely related to the cost being escalated is in effect for longer than three years it will frequently deviate significantly from real world cost changes.

Railroad fuel surcharge programs are not closely related to the change in the cost of fuel for rail movements. On this point there can be little disagreement. Some of the things that distance the fuel surcharge revenue railroads collect from the fuel expense they incur are as follows:

- Railroad fuel surcharges measure the change in fuel cost from either the price per barrel for West Texas Intermediate Crude Oil or the US average price per gallon for On-Highway Diesel Fuel. These are not the types of fuel railroads use in their movements. The changes in these types of fuel expenses are being used as surrogates for the actual change in the cost of fuel railroads purchase in their fuel surcharge programs.
- Fuel surcharges are applied to rates and not fuel cost. This means that the surcharges are being applied against railroad costs other than fuel, as well as profit.
- Fuel surcharges are calculated from base fuel costs in effect in late 2001 or early 2002. This means that four years of escalation are being calculated, for very volatile fuel costs, according to a surrogate that is not closely related to the fuel costs railroads actually incur.
- Many rates have increased substantially over the last four years. This means that the fuel surcharge is being applied against a much larger amount of revenue now than when these programs were instituted. What may have been perceived as being accurate in 2002 can be very inaccurate in 2006.

In order for an escalation method, that is not closely related to costs, to work properly it needs to be re-opened at periodic time intervals to ensure it is accomplishing its objective. This re-opener process ensures that price movement is determined from a living and breathing program (a program continually being updated to reflect real world cost changes). When an escalation

method is used that is not closely related to a cost this true up process is vital to the accuracy of the escalation method. The distance of fuel surcharge programs from the actual fuel costs they are escalating increases the need for a true up of the fuel surcharge programs.

Other issues with fuel surcharges that lead to questions about the accuracy of the railroads' surcharge programs and a greater need for a true-up are as follows:

The results of the surcharge programs are not logical. The CSX and Norfolk Southern Railroads have shorter movements and use substantially less fuel than Union Pacific and Burlington Northern Santa Fe, yet in March 2006 the primary fuel surcharge mechanism (surcharge program for carload traffic) used by the eastern carriers had a 17.2% fuel surcharge rate while the western carrier's fuel surcharges were lower at 12.5%. If fuel surcharge programs were structured to accurately recover increases in fuel costs the eastern carriers with shorter hauls and substantially lower fuel expenses would have lower fuel surcharges than their western counterparts.

There is a big potential for double counting fuel cost increases. Surcharge programs are asking shippers to accept that none of the large rate increases they have received since 2001 covers any portion of the increase in fuel expenses that have occurred in the last four years. Concerns about double counting of fuel cost increases are not being ameliorated by railroads, as they have not provided any support which demonstrates that fuel cost increases since 2001 have been broken out from other expenses and removed from rates

From an analysts' standpoint it appears that railroad rate increases would at least recover increases in fuel to the same degree they are recovering increased cost of their other expenses. The railroads' fuel surcharge programs escalate fuel costs from late 2001 and early 2002 so in effect railroads are asking shippers to accept that fuel costs are different than other costs. This is counter to the belief that rates are not related to cost because if that is the case, rates would contain at least as much of an increase for fuel as for other costs. Because fuel surcharges provide four years of fuel escalation, railroads need to demonstrate how they are preventing a double counting of fuel cost increases between their rates and fuel surcharge practices

It is illogical to continue to have fuel surcharges increase from 2001 fuel costs. The Department of Energy (DOE) does not project fuel costs to decrease appreciably in the future. Over the next twenty years DOE does not project the constant dollar price per barrel of crude oil to decrease below \$47.29, or, for the on-highway diesel fuel price per gallon to decrease below \$1.959. DOE's projections are well above the \$1.25 and \$1.35 per gallon prices, which initiate the western railroads' fuel surcharge methodologies and the \$23 per barrel prices, which initiate the eastern railroads' fuel surcharges. The fact of the matter is fuel costs are increasing and not decreasing. They are already substantially above DOE's 2006 projections. If the base 2001 and 2002 fuel expenses being used to calculate fuel surcharges are not made more current, then future railroad surcharges will contain fuel escalation for an ever increasing number of years. In the year of 2012 will railroads be applying ten years of fuel escalation on top of 2012 rail rates? If this issue is not addressed that is what will happen.

The position that fuel surcharges are high to compensate for contracts without fuel surcharges is confusing. Some rail customers are not yet subject to fuel surcharges due to long term contracts. Railroads have said that they utilize their existing fuel surcharge mechanisms to recover the increase in total fuel expense from those shippers they are able to obtain the surcharge from. As time goes by, this position gets weaker because each year more movements become subject to fuel surcharges. This position would have more credibility if railroads had already revised their programs in prior time periods to account for the increase in revenue that has become subject to the surcharge.

Analysis of fuel cost recovery is distorted if only fuel surcharge revenue is

considered. Railroads need to provide all sources of fuel revenue they receive.

Railroads recover increases in fuel expense in several ways other than fuel surcharges.

Three sources of fuel revenue other than fuel surcharges that need to be considered are as follows:

- Base tariff and contract rates contain an element for fuel. Railroads recovered all fuel expenses from their rates prior to the arrival of fuel surcharges. This implicitly means that some portion of revenue from current tariffs and contract rates is associated with fuel expenses. This is an amount that cannot be ignored;
- The Rail Cost Adjustment Factor (RCAF) or other contract escalation indexes have a portion of their content tied to fuel. Over the last four years a significant portion of

the increase in the RCAF index has been directly related to the increased cost of fuel.

These amounts are a part of the railroads fuel recovery and cannot be overlooked;

- The large rate increases railroads have imposed on shippers since 2001 appear to recover at least some portion of the increase in the cost of fuel railroads have incurred over the last four years. Railroads' fuel recovery numbers need to account for this.

When railroads present numbers for total fuel expenses versus total revenue collected, all of these sources of revenue need to be considered. From an analysts' standpoint fuel recovery numbers would not be complete, or accurate, without considering all sources of fuel revenue. Excluding these sources of fuel revenue recovery understates the railroads' recovery of fuel expenses.

Escalation Consultants' Fuel Surcharge Study shows that railroads over-recover their fuel cost. Escalation Consultants' fuel surcharge study demonstrates that the major US and Canadian railroads' primary fuel surcharge programs are increasing at a greater rate than railroads' fuel cost as a percentage of revenue. Understanding the change in fuel cost, as a percent of revenue, is important because this is what rate based fuel surcharges ultimately accomplish. Fuel surcharges are applied against rates/revenue in order to prevent fuel expenses from becoming a larger portion of revenue than they were before fuel costs had large increases. Therefore, if fuel surcharges are working properly, they should be closely related to the change in a railroad's fuel cost as a percent of revenue. This ratio measures the surcharge needed to protect a railroad from increases in fuel expenses.

As an example, if a railroad's fuel costs as a percent of revenue increased 10% since the fourth quarter of 2001 (When few fuel surcharges were impacting rates) a fuel surcharge greater than 10% would be excessive because it would cause the ratio of fuel expense divided by revenue to be less than it was in the fourth quarter of 2001. In making this calculation freight revenue should be reduced by the fuel surcharge revenue railroads are already collecting in order to determine the fuel surcharge needed to keep the railroad whole.

Example Calculation

Fuel Cost as a percent of revenue

Fourth Quarter 2001	7%
Fourth quarter 2005	17%
Increase in fuel as a Percent of Revenue	10%
Average Fuel Surcharge In Fourth Quarter 2005	16%

Fuel Surcharge Amount in Excess of Fuel
Revenue Needed to Keep Railroad Whole 6%

In making this calculation between the fourth quarter of 2001 and the fourth quarter of 2005 all the large US and Canadian railroads primary fuel surcharge programs exceeded the increase in their fuel expense as a percent of revenue. Escalation Consultants' Fuel Surcharge Study shows that the amount that railroad primary fuel surcharge programs exceeded this ratio ranged from a low of 1.8% on Union Pacific to a high of 12.1% on

Canadian Pacific. However these over-recovery amounts are conservative. For example, coal shippers pay more because on western railroads the surcharges applied on coal shipments are much higher than the railroads' primary fuel surcharge. As an example, in December 2005 the Union Pacific's fuel surcharge for coal was 26% while its primary fuel surcharge (surcharge for merchandise traffic) was 18.5%, a 7.5 difference. Coal movements using Union Pacific's fuel surcharge program would therefore exceed their increase in fuel expenses as a percent of revenue by 9.3% (7.5%+1.8%). Coal represents approximately 41% of all Union Pacific tons and 20% of all its revenue, so this is an important consideration when reviewing fuel recovery numbers of railroads.

Escalation Consultants' Fuel Surcharge Study shows that as fuel prices increased the magnitude of fuel surcharge problems also increased. The study shows that the difference between the fuel surcharge generated from the primary fuel surcharge program of railroads and the change in railroads fuel cost as a percent of revenue have gotten larger as the price of on highway diesel fuel and West Texas Intermediate Crude Oil increased in value. Our analysis indicates that problems with fuel surcharge mechanisms are increasing which means there is a real need for railroads to demonstrate the recovery they are receiving from their fuel surcharge programs.

No justification has been provided for applying the surcharge against rates. As previously stated, the railroads' surcharge mechanisms are applied to the entire freight rate rather than just the portion of the rate associated with fuel expense. The application of these charges to the entire rate increases the portion of the price paid to railroads

associated with costs other than fuel such as labor, benefits, maintenance, administrative and other expenses as well as profit. It is unclear why labor, administrative and profit, are escalated for changes in the cost of fuel because railroads have not addressed this issue. However, from an analyst's standpoint if fuel surcharges are applied to the whole rate it is logical that the amount of the fuel surcharge be developed from a ratio that considers all of a railroad's freight revenue.

All of the issues referenced herein point to the inaccuracies built into the surcharge programs and the importance of having railroads provide detailed documentation which demonstrates the accuracy of the fuel surcharge programs.

The Surface Transportation Board has asked for comments on how railroads' reporting requirements should be adjusted to provide rail customers with better information on carriers' fuel costs and the revenue collected through fuel surcharges. The following is provided in response to this request.

If a primary measure of evaluating the accuracy of railroads' fuel surcharge programs is to determine how fuel surcharges compare to the change in fuel costs as a percent of revenue we believe this is also a very valid measure for calculating surcharges. For this reason we recommend that railroads submit the following data to the STB on a quarterly basis

- Total fuel expense
- Total freight revenue

- The revenue collected from all fuel surcharge programs
- A calculation where total fuel expense is divided by total freight revenue less fuel surcharge revenue.
- Railroads should submit this calculation quarterly for the previous four years.

Some of the advantages of having each railroad submit its fuel cost as a percent of revenue to the STB each quarter are as follows:

- This is a very relevant calculation for fuel surcharges that are applied against the total rate for a movement;
- It would help ensure that railroads are being adequately reimbursed for their changes in fuel cost;
- It would provide a method for eliminating the four years of fuel escalation railroads are currently receiving under their current fuel surcharge programs;
- It would enable future fuel surcharges to be more closely related to fuel cost changes in affect during the time period that rates are in affect;
- It would allow the STB to have an easy to use measure that would enable the Board to evaluate whether a railroad's fuel surcharge program is reasonable.

Respectfully submitted,

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