

BEFORE THE
SURFACE TRANSPORTATION BOARD

STB Ex Parte No. 761

HEARING ON REVENUE ADEQUACY

STB Ex Parte No. 722

RAILROAD REVENUE ADEQUACY

WRITTEN TESTIMONY OF
CSX TRANSPORTATION, INC. ("CSX")

By decision dated September 12, 2019, the Board requested written testimony from participants in the December 12, 2019 hearing on revenue adequacy. The Board invited comment on a range of revenue adequacy issues discussed in the Board's Rate Reform Task Force (RRTF) report, including:

1. Definition of Long-Term Revenue Adequacy
2. Rate Increase Constraint (RIC)
3. Suspension of Bottleneck Protections
4. Simplified Stand-Alone Cost Changes

CSX joins in the comments of the Association of American Railroads (AAR) with respect to the above recommendations and the various legal, operational and economic issues raised by the RRTF's revenue adequacy proposals. CSX's hearing testimony will be delivered by Mr. Sean Pelkey, Vice President, Finance and the company's Treasurer. Mr. Pelkey's focus will be on CSX's process for making investments and the impact that a system-wide, earnings-based

constraint such as the proposed RIC would have on those investment decisions. The following comments provide a brief overview of Mr. Pelkey's intended remarks at the hearing.

I. CSX's Recent Performance Achievements Create Strong Incentives to Invest in its Business

Through the first three quarters of 2019, CSX has:

- 1) Maintained the lowest personal injury rate of the major U.S. railroads.
- 2) Attained the fewest reportable train accidents in company history.
- 3) Delivered the most reliable and fastest network in company history for our customers, as evidenced by our industry leading position in key service metrics.
- 4) Launched our trip plan tool for intermodal and merchandise customers, which provides our customers an unprecedented level of transparency into our performance at the individual shipment level.

Mr. Pelkey will explain how CSX's recent performance would not be sustainable without consistent capital investment, and how CSX could not access necessary capital for further enhancements to its ever-improving service product without the ability to generate competitive returns.

II. CSX Makes Investment Decisions that Anticipate Returns Above the Cost of Capital

Mr. Pelkey will explain certain core tenets of corporate finance and the need for companies to generate value by investing with the goal of earning more than their cost of capital. Railroads are not unique in this respect, and there is ample evidence that companies – including many of CSX's customers – routinely earn more than their cost of capital. This explanation will include how CSX approaches the allocation of capital and how our first priority is to invest in the business. In addition, Mr. Pelkey will explain the other ways capital is deployed, including the need to provide shareholders with a return in the form of buybacks and dividends.

III. Replacement Costs are a Critical Component of CSX's Investment Decisions and are Not Reflected in the STB's Annual ROIC Calculation

Mr. Pelkey will explain CSX's investment decision process, which evaluates the projected return of the asset to be invested in – a return that is not based on the depreciated book value of that asset, but on the economic value of that investment today.

For example, when CSX purchases a freight car it evaluates that investment based on what it will cost to purchase the freight car today. The expected return is based on the value and timing of future expected financial benefits, discounted at the company's cost of capital. This forward-looking analysis differs from the backward-looking return on investment capital (ROIC) in the STB's current methodology, which is an accounting measure using depreciated original costs.

The rail industry is unique in that it has one of the highest rates of capital investment while also having extremely long-lived assets. It follows that the depreciated asset base that forms the denominator of the Board's ROIC calculation substantially under-represents railroads' true investment need. The artificially low asset base in turn generates an inflated return on investment that is being used in the RRTF report to create regulatory ceilings on rates. The end result is a proposed regulation that disincentivizes rail investment and transfers earnings from railroads to a subset of shippers.

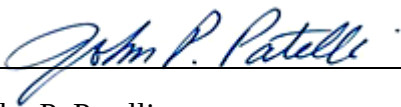
IV. Removing the Prospect of Returns Above the Cost of Capital Diminishes Incentives to Invest in the Business

Mr. Pelkey will address the challenges associated with a regulatory scheme that would preclude CSX from earning a return above the cost of capital. Such a regime would force a railroad to substantially lessen investment in its business, particularly in growth projects that typically possess a higher risk profile. Similarly, if investors believe that a railroad has no

prospect of earning more than its cost of capital, many would choose to direct their capital to businesses without such restrictions. Railroad shareholders who remain would likely demand a reduction in capital spending and require earnings to be returned to them instead of being reinvested in the business.

CSX respectfully recommends that long-term revenue adequacy, properly calculated, should be a measurement of railroad financial health, not a vehicle for system-wide earnings regulation that will diminish incentives that inspire innovation, efficiency and ever-improving customer service.

Respectfully submitted,

A handwritten signature in blue ink, reading "John P. Patelli", is positioned above a horizontal line.

John P. Patelli
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Dated November 26, 2019