

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

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JOINT PETITION FOR RULEMAKING	)	
TO MODERNIZE ANNUAL REVENUE	)	Ex Parte No. 766
ADEQUACY DETERMINATIONS	)	
	)	

**REPLY OF THE
WESTERN COAL TRAFFIC LEAGUE
IN OPPOSITION TO PETITION**

William L. Slover
Kelvin J. Dowd
Robert D. Rosenberg
Slover & Loftus LLP
1224 Seventeenth Street, N.W.
Washington, D.C. 20036
202.347.7170

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Attorneys for the
Western Coal Traffic League

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Pursuant to 49 C.F.R. § 1104.13(a), the Western Coal Traffic League (“WCTL”) hereby replies in opposition to the Joint Petition For Rulemaking To Modernize Annual Revenue Adequacy Determinations (“Petition”) filed on September 1, 2020 in the captioned proceeding by Union Pacific Railroad (“UP”), Norfolk Southern Railway Company (“NS”), and the U.S. rail operating subsidiaries of Canadian National Railway Company (“CN”) (collectively, “Railroads”). Through their Petition, Railroads seek the initiation of a rulemaking proceeding designed to ensure that neither they nor any other Class I railroads will be found to be “revenue adequate” under 49 U.S.C. § 10704 and the Board’s *Coal Rate Guidelines*,¹ effectively cancelling the positive revenue adequacy findings made by the Board with respect to all three over the past decade, and precluding such findings from being repeated in the future. It is no coincidence that the

¹ *Coal Rate Guidelines, Nationwide*, 1 I.C.C.2d 520 (1985), *aff’d sub nom. Consolidated Rail Corp. v. United States*, 812 F.2d 1444 (3d Cir. 1987).

Petition comes as the Board for the first time is considering how to implement the *Guidelines*' Revenue Adequacy Constraint.

Time limits imposed by the rules applicable to replies prevent a more fulsome response to all of the points argued by Railroads and their retained witnesses. Nevertheless, for the reasons set out below, WCTL submits that the Board should see the Petition for the results-oriented gambit that it is, and reject the Railroads' request.

INTRODUCTION

WCTL is a voluntary association formed in 1976, whose regular members consist of electric utilities that ship coal by rail from mines west of the Mississippi River. WCTL members currently ship and receive nearly 90 million tons of coal by rail each year.² Many WCTL members are dependent on a single railroad for the transportation of their essential coal fuels, and thus must depend on the regulatory regime enforced by the Board to constrain the market power of railroads in certain circumstances.

WCTL has been a leading participant in every proceeding before the Board and its predecessor, the Interstate Commerce Commission ("ICC"), concerning railroad revenue adequacy and its role in the regulatory process, since before the *Staggers Rail Act of 1980*. WCTL's participation extends from Ex Parte No. 338, *Standards and Procedures for the Establishment of Adequate Railroad Revenue Levels* in 1978, through the adoption of the *Coal Rate Guidelines* in 1985, and on through Ex Parte No. 664 (Sub-

² WCTL's members are listed on Attachment 1 hereto.

No. 4), *Revisions to the Board's Methodology for Determining the Railroad Industry's Cost of Capital* in 2019 and 2020. WCTL was a principal participant in Ex Parte No. 722, *Railroad Revenue Adequacy*, and presented written and oral testimony for the Board's December 12-13, 2019 hearings in Ex Parte No. 761, *Hearing on Revenue Adequacy*.

The Board's current standard for determining railroad revenue adequacy – measuring a carrier's rate of return on its book investment in assets committed to the provision of railroad service to the railroad industry's average cost of capital – was advocated strongly by the rail industry, and finally adopted by the Board's predecessor in 1981. *Standards for Railroad Revenue Adequacy*, 364 I.C.C. 803 (1981). The carriers' position that the standard was mandated by statutory provisions that are identical in all relevant respects to those now are codified in 49 U.S.C. § 10704(a) was clear and on the public record. *See, e.g., Standards and Procedures for the Establishment of Adequate Railroad Levels*, 359 I.C.C. 270, 273 (1978). The railroad industry consistently defended this test for more than thirty (30) years, even as Class I carriers repeatedly pressed for changes in the method of measuring the investment base that would significantly bias the calculation against a finding of revenue adequacy.

The position taken in the Petition that when it applies the current standard, the Board *fails* to “fulfill its statutory duties in accurately measuring and properly promoting railroad revenue adequacy,”³ is a transparent reversal that can be traced

³ Petition at 2.

directly to two (2) developments: Class I railroads' now decade-long record of regularly clearing the agency's revenue adequacy bar, and the Board's current and related consideration of methodologies to give actual effect to the Revenue Adequacy Constraint in the *Coal Rate Guidelines*.⁴ Just focusing on the Railroads that sponsored the Petition, the record of proceedings in the *Ex Parte No. 552* Series shows that from 2010 through 2018, UP was revenue adequate in every year, NS was revenue adequate in seven (7) of nine (9) years, and CN's U.S. subsidiary met the standard in 2014 and 2015. Significantly, the Board's 2019 railroad industry cost of capital finding of 9.34% represents a 24% decline from 2018,⁵ setting the stage for a revenue adequacy finding for 2019 that continues and very likely expands prior years' positive results.

Frustrated in their years-long effort to nullify the Revenue Adequacy Constraint by introducing replacement costs into the investment base calculation,⁶ the Railroads now promote changing the cost of capital comparison to include a premium based on the relationship between unrelated Standard & Poor's 500 companies' returns on *their* investments to the railroads' margins, and inflating the railroad investment base to include accumulated deferred tax liabilities. Not surprisingly, the effect of these

⁴ The Railroads admit at least the latter. *See* Petition at 20 ("In light of the Board's recent interest in revenue adequacy, the Board should consider whether the methodology...is actually measuring railroad revenue adequacy in a reliable and accurate way.").

⁵ *See Railroad Cost of Capital – 2019*, Ex Parte No. 558 (Sub-No. 23) (STB served August 5, 2020).

⁶ This is not to say that the Railroads have given up on that approach. *See* Petition at 29-31.

changes would be to reverse ten (10) years of revenue adequacy findings with respect to some carriers, and very likely ensure that none would reach that level in the years to come.

As explained below, the Railroads' Petition is grounded on a misrepresentation of the role of revenue adequacy in the area of maximum rate regulation, their "Comparison Proposal" is arbitrary and unsupported by the language and purpose of the governing statute, and their deferred tax proposal offers little beyond that which the Board has rejected in the past. WCTL demonstrated in the *Ex Parte No. 722* and *Ex Parte No. 761* proceedings that there are advancements which can and should be made both in the Board's methodology for determining revenue adequacy, and in the proper implementation of the *Coal Rate Guidelines'* Revenue Adequacy Constraint. Those advancements are not a subject of this Reply. WCTL will focus here solely on the Railroads' Petition: a results-oriented attempt to change the rules to guarantee that no carrier – however market dominant it may be as to any particular shipper – will have to encounter that constraint in any meaningful respect. The Petition should be denied.

ARGUMENT

A. The Petition Misrepresents the Role of Revenue Adequacy

As various carriers did in the *Ex Parte No. 722* and *Ex Parte No. 761* proceedings, the Railroads base the core of their arguments on a fundamental misrepresentation of the role of revenue adequacy in rail rate regulation. Throughout the

Petition, there are references to revenue adequacy as “a sign of excessive profits,”⁷ evidence of an “abuse of market power,”⁸ a sign of “anticompetitive conduct or exercise of market power,”⁹ an indicator of “market failure that has permitted railroads to charge noncompetitive rates,”¹⁰ and so forth. As in the past, the Railroads raise the threat of system-wide pricing limitations and an end to industry prosperity as consequences of a finding of revenue adequacy. It is a false premise.

Revenue adequacy is not, and never has been considered an indicator of market failure or monopoly power. Whether in the context of the *Coal Rate Guidelines* or the Revenue Shortfall Allocation Methodology (“RSAM”), as a potential rate constraint it only could apply *after* the Board already has made a finding of market dominance under 49 U.S.C. § 10707. It has no application where a railroad does not already possess market power, and under the *Guidelines* its sole effect is as a governor on continued differential pricing on individual captive traffic movements. The Constrained Market Pricing methodology holds that when a railroad is revenue *inadequate*, it should be permitted to satisfy a disproportionate share of its revenue needs through rates charged to its most demand inelastic customers. *Coal Rate Guidelines*, 1 I.C.C.2d at 526-27. Once the goal of revenue adequacy is achieved, the carrier is “not entitled to any higher revenues” from the captive shipper. *Id.* at 535. Significantly, this limitation has no

⁷ Petition at 5.

⁸ *Id.* at 6.

⁹ *Id.* at 16.

¹⁰ *Id.* at 23.

application to the majority of the U.S. railroads' traffic that enjoys competitive transportation options, is exempt, or is covered by transportation contracts, and therefore falls outside the scope of the Board's jurisdiction. Even where the constraint would be applied, the Board's precedents support allowing inflationary rate adjustments,¹¹ and the *Guidelines* themselves allow for a revenue adequate carrier to continue to differentially price captive traffic when it can show a specific need.¹²

Contrary to a driving premise of the Petition, a finding of revenue adequacy under the Board's present standards triggers neither a system-wide restriction on a railroad's pricing, nor a limitation on its ability to earn a return on investment. For decades, the railroad industry has insisted – and the Board essentially has agreed – that most railroad traffic is competitive. Whether revenue adequate or not, a railroad retains the ability to pursue virtually unlimited returns from such traffic through pricing or any other lawful business practice. Even within the admittedly narrow scope of captive traffic, a revenue adequate railroad is unconstrained from improving both profits and return through innovation, efficiencies, and increased productivity. As the Board and its predecessor repeatedly have reaffirmed, the role of revenue adequacy in the realm of rate regulation is limited to constraining a market dominant railroad from continuing to

¹¹ See *Western Fuels Association, Inc., et al. v. BNSF Railway Company*, STB Docket No. 42088 (STB served February 18, 2009) at 30.

¹² *Coal Rate Guidelines*, 1 I.C.C.2d at 536, n.36.

charge a captive shipper disproportionately higher rates as a consequence of its demand inelasticity.¹³

The Railroads' Petition is undermined by its clear misrepresentation of the limited regulatory role played by the Board's revenue adequacy determinations.

B. The Current Revenue Adequacy Test is Not Inconsistent with The Governing Statutory Standard

As noted *supra*, WCTL has participated in virtually every ICC and Board proceeding related to revenue adequacy or the rail industry cost of capital since the 1970s, and has proposed various modifications to the agency's § 10704 standards, as well as made recommendations as to the proper method for implementation of the Revenue Adequacy Constraint under the *Guidelines*. However, WCTL has acknowledged that a test based on the relationship between a properly measured railroad return on investment and a properly calculated rail industry cost of capital (along with other financial indicators) is consistent with the criteria for revenue adequacy prescribed in the governing statute.

For its part, the unified railroad industry has asserted for decades that the ROI=COC test "should be the primary standard of revenue adequacy" under § 10704,¹⁴ and has defended that position steadfastly both before the Board and in debates over proposed Congressional reforms of the rail regulatory regime. Now, with barely an

¹³ *Id.* at 535-36. See also *Major Issues in Rail Rate Cases*, Ex Parte No. 657 (Sub-No. 1) (STB served Oct. 30, 2006) at 7.

¹⁴ *Standards and Procedures for the Establishment of Adequate Railroad Levels*, 359 I.C.C. at 273.

acknowledgement of the about-face, the Railroads' Petition argues that the standard for revenue adequacy that they have championed for so long "is not providing good evidence from which the Board can assess its progress in assisting railroads in achieving revenue adequacy." Petition at 20. Since the railroad industry's interpretation of "assistance" effectively means the absence of any Revenue Adequacy Constraint in the *Guidelines*,¹⁵ the motivation for the Railroads' reversal is rather obvious. Their rationale is contrived.

While the Board and its predecessor have considered and in some cases adopted modifications to the way that the cost of capital is calculated or that deferred tax liabilities are treated in determining a railroad's investment base (the latter is addressed *infra*), the agency has consistently relied on the carrier-endorsed ROI=COC threshold standard for assessing railroad revenue adequacy since 1981. Over the intervening years, Congress has debated numerous amendments to the Board's enabling statute, and has enacted two significant pieces of legislation, one abolishing the ICC, and another re-authorizing the Board. During the process leading to each, various constituencies (including the railroads) petitioned for changes to § 10704 to alter the way that the Board measured revenue adequacy. However, Congress went on to re-enact the statutory standard for revenue adequacy without substantive change. It is well-established that if Congress – presumably aware of an agency's interpretation of its enabling statute – re-enacts that statute without change, it is deemed to have approved that interpretation. *See*

¹⁵ *See, e.g.*, Ex Parte No. 722, Comments of the Association of American Railroads, Sept. 5, 2014 at 6-15; Comments of NS, Sept. 5, 2014 at 51-70.

Barnhart v. Walton, 535 U.S. 212, 218-20 (2002); *Brotherhood of R.R. Signalmen v. STB*, 628 F.3d 807, 815 (D.C. Cir. 2011). This principle compels rejection of the Railroads’ argument that the current threshold standard for revenue adequacy is inconsistent with 49 U.S.C. § 10704.

The Railroads and their retained witnesses devote considerable space to the claim that § 10704’s use of the words “economic profit” means that the Board is required to add a premium to the industry cost of capital when assessing railroad revenue adequacy.¹⁶ However, they offer no citations to either the legislative history of § 10704 or the implementing decisions of the Board and its predecessor to support the theory, which they present here for the first time in over thirty (30) years of regulatory proceedings directed at giving effect to the statutory standard. As discussed *infra*, the Railroads’ “Comparison Proposal” would artificially and arbitrarily increase the return on investment threshold for revenue adequacy for the admitted purpose of replicating the results of determining a carrier’s investment base using the railroads’ version of replacement costs. It is no coincidence that the proposal is being advanced now that several Class I carriers have achieved long-term revenue adequacy under the test that *the railroads themselves* advocated successfully for decades. With no statutory or precedential support for the Railroads’ new theory, however, the desire to achieve a particular outcome plainly is an insufficient basis for asking the Board to upend a settled regulatory standard.

¹⁶ See Petition at 20-29.

Little imagination is required to conclude that “a reasonable and economic profit or return” in § 10704 is satisfied when a book measurement of investment consistent with generally accepted accounting principles (“GAAP”) is combined with a current nominal cost of capital that encompasses both equity and debt (unlike GAAP, which recognizes only interest expense as paid). The Railroad Accounting Principles Board (“RAPB”) recommended that very approach for that very reason: “[T]he industry-wide cost of capital rate ... represents the return required to attract and retain capital necessary for the provision of a sound rail transportation system in the United States.” RAPB, Final Report (Sept. 1, 1987) at 59. “Conversely, a historical-cost asset base requires the use of a nominal cost-of-capital rate to account for inflation in capital costs.... The RAPB considered current market value and historical cost [meaning GAAP valuation] as the basis for asset valuation. It selected historical cost net of accumulated depreciation.” *Id.* at 60 (footnotes omitted).

C. The Railroads’ “Comparison Proposal” Is Arbitrary And Results-Oriented

The core of the Railroads’ Petition is their “Comparison Proposal,” whereunder the Board would redefine revenue adequacy to mean that a railroad’s return on investment exceeded the industry cost of capital by more than the “median” S&P 500 firm’s return on investment exceeded *its* cost of capital.¹⁷ The proposal is arbitrary, results oriented, and certainly not required by the governing statute.

¹⁷ *Id.* at 20-21. The Railroads also propose to modify the return on investment calculation by including non-goodwill tangible assets (which they acknowledge are

The Railroads propose to arbitrarily compare their returns on investment with those of companies that by definition are among the most profitable in the country (which is how they end up on the S&P 500 list in the first place). This obviously biases the outcome of the comparison in the railroads' favor, as the "target" return is drawn from a high-return sample of U.S. firms. Additionally, while the Railroads claim that their proposal reflects the reality that carriers compete with other firms for invested capital, they propose to exclude financial services and real estate firms, as well as railroads, from the comparison group. The stated reason for the exclusions is that "the nature of their business causes them to have different capital structures from other firms."¹⁸ However, the S&P 500 also includes more than 150 health care, information technology and communications services firms, all of which have different capital structures than railroads. Moreover, hundreds of firms in the S&P 500 are not capital intensive, and do not have a focus on returns on invested capital as a primary measure of financial health. Calculating their returns on investment using the Board's revenue adequacy standard – a large and complex undertaking that would have to be done annually – produces a meaningless comparison that serves only to make railroads appear to be less healthy than they actually are.

In the Petition, the Railroads essentially admit that this result is the goal of their proposal. They acknowledge that it remains their preference that the Board shift to

negligible for railroads), and removing deferred taxes and deferred tax liabilities from the calculation, the latter of which is addressed *infra*.

¹⁸ *Id.* at 35.

using their version of replacement costs in the revenue adequacy determination, before justifying their proposal on the grounds that it will accomplish a similar result: show each Class I carrier to be far away from achieving revenue adequacy.¹⁹ This is apparent from their Table 4,²⁰ which shows that under the Comparison Proposal, every railroad – including those that regularly have been found to be revenue adequate in recent years – would fail to meet the new threshold. *See also* Petition at 33 (“Under this analysis, each of the Class I railroads earned an ROI net cost of capital substantially below the median S&P 500 company in each of the studied years.”).

The Railroads claim that their Comparison Proposal is consistent with the governing statute. However, nothing in § 10704 supports measuring railroad revenue adequacy through comparisons with an ever-changing group of unrelated firms in unrelated industries. As WCTL demonstrated in 2014 in *Ex Parte No. 722*, the investment community’s perception of the railroads’ financial health was robust and forward-looking, with increased dividends, lower operating ratios, higher returns on equity and rising stock prices all confirming the positive results of the Board’s annual revenue adequacy findings under the current standards.²¹ Since that time, financial results for all Class I railroads have materially improved. Section 10704 calls for an objective measure of the degree to which a railroad’s revenues are sufficient to cover all

¹⁹ *Id.* at 29-31.

²⁰ *Id.* at 22.

²¹ *Ex Parte No. 722*, Joint Opening Comments of the Western Coal Traffic League, *et al.*, Sept. 5, 2014 at 11-12.

operating costs, repay debt, permit the raising of needed capital, and earn a reasonable return or profit. 49 U.S.C. § 10704(a)(2). The evidence of record over the past decade or more shows that most of the Class I carriers have achieved these revenue goals. The Railroads' Comparison Proposal would distort this clear picture by introducing a metric that does not appear anywhere in the statute: performance relative to an elite group of unrelated firms with business and capital structures that differ widely from one another and from the railroads'. There is no sound reason why the Board should entertain such a results-oriented policy change.

D. There is No Need to Change the Treatment of Deferred Tax Liabilities

For nearly thirty-five (35) years, the Board and its predecessor have used what the Railroads describe as the “utility” method for treating deferred tax liabilities. That approach accurately reflects the income tax that railroads are able to defer through accelerated or bonus depreciation on their capital expenditures. *Standards for Railroad Revenue Adequacy*, 3 I.C.C.2d 261 (1986) (“*Standards*”), *aff’d sub nom. Consol. Rail Corp. v. United States*, 855 F.2d 78 (3d Cir. 1988). The Railroads argue instead for a “flow-through” approach that ignores those substantial tax deferrals and pretends that the railroads pay tax that they actually avoid. There is no valid reason to entertain their proposal. It is a solution in search of a non-existent problem, and yet another manifestation of their desire to enjoy ever increasing returns while evading any element of regulatory oversight linked to their overall profitability.²²

²² The Railroads assert that their “Petition does not focus on the debate over whether and how the Board might apply a ‘revenue adequacy constraint,’” but later

Deferred tax liabilities in railroad companies arise primarily because: (a) railroads make capital expenditures to sustain and expand their networks; (b) railroads take advantage of accelerated and so-called “bonus” depreciation on those capital expenditures compared to book depreciation under GAAP; (c) accelerated and bonus depreciation enables railroads to defer income taxes that would otherwise be due; and (d) the deferred tax liabilities recorded on the balance sheet represent the estimated tax liability that has been deferred. Deferred tax liabilities offset the funds that railroads otherwise would need to make their capital expenditures, and operate as an interest-free loan from other taxpayers, who are a reasonable proxy for railroad customers. Moreover, as long as railroads continue to invest, expand, and/or experience inflation, and accelerated/bonus depreciation remains, their deferred tax liabilities will not disappear as new deferrals will be generated annually.

If the flow-through method has any attraction at all, it is its simplicity, but inaccuracy and distortion often accompany simplicity, as is the case here. The flow-through method intentionally ignores the reality that railroads uniformly pay taxes below the corporate tax rate, and those tax savings provide a substantial benefit. For example, in 2015, BNSF Railway, CSX Transportation, the Kansas City Southern, NS, and UP paid income tax rates of 23.3%, 25.6%, 10.4%, 26%, and 27.4%, respectively, all well

reveal their latent intent in stating that “the annual revenue adequacy findings are slowly creeping into rate setting.” Petition at 2, 48. Of course, the Revenue Adequacy Constraint was adopted thirty-five (35) years ago and has been applied, albeit not to railroad rates. *Coal Rate Guidelines*; *CF Indus., Inc. v. Koch Pipeline Co.*, 4 S.T.B. 637 (2000), *aff’d sub nom. CF Indus., Inc. v. STB*, 255 F.3d 816 (D.C. Cir. 2001).

below the statutory 35% tax rate. See <https://www.railwayage.com/regulatory/trump-tax-cuts-good-for-railroads-probably-not/> (Apr. 27, 2017).

The Railroads are correct that changing the tax rate alters the value of accumulated deferred tax liabilities, as GAAP reflects an estimate of the taxes to be paid in the theoretical future. Petition at 42, 49. Tax rates change only rarely, however, and the Board adopted the railroads' preferred treatment (*i.e.*, ignored it) for purposes of the last change in 2017. The Railroads effectively are arguing that they should be allowed to eat their cake (have the tax cut ignored in the 2017 revenue adequacy determinations) and have it too (use the prospect of tax changes as a reason to jettison the utility approach). It is far more reasonable to expect that the Board would treat a future corporate tax change similarly, if one occurs.

Nonetheless, the reduction in deferred tax liabilities in 2017 created massive income for the railroads. Mr. Warren Buffett recognized this reality when he wrote to his fellow shareholders. "A large portion of our gain did *not* come from anything we accomplished at Berkshire. The \$65 billion gain is nonetheless real – rest assured of that. But only \$36 billion came from Berkshire's options. The remaining \$29 billion was delivered to us in December when Congress rewrote the U.S. Tax Code." Berkshire Hathaway Inc., Annual Report for 2017, at 3 (Chairman's Letter) (original emphasis). Mr. Buffett was equally clear in recognizing the value of deferred tax liabilities. "Besides, Berkshire has access to low-cost, non-perilous sources of leverage that allow us to safely own far more assets than our equity alone would permit: deferred tax liabilities and [insurance premium] 'float,' Better yet, this funding to date has

often been cost-free. Deferred tax liabilities bear no interest.” *Id.* at 20. That is the financial reality that the ICC recognized in *Standards*²³ and that the Railroads seek to deny or obscure with their flow-through proposal.

The Railroads’ various supporting claims for the supposed faults in the utility approach and virtues in their flow-through approach all lack foundation or relevance. In particular, rather than present any actual data, they craft two purely hypothetical examples intended to compare the two methods in order show distortions resulting from the utility method. The first, Exhibit A (Petition at 41), shows two railroads in a single year, one with deferred tax liabilities and the other without. The other, Appendix A (*id.* at 43-44), covers eight (8) years and contrasts the utility and flow-through methods of a railroad when deferred tax liabilities accumulate over the first four (4) years and then disappear over the last four (4). Both examples rest on a false premise and show nothing about railroads. A railroad cannot exist without making capital expenditures and generating deferred tax liabilities in the process (unless a railroad declines to use accelerated depreciation, which never occurs). Accordingly, “Railroad B” in Table A is no railroad at all, and the railroad depicted in Appendix A could not go four (4) years (Years 5-8) without making capital expenditures and deferring taxes. In the real world, deferred tax liabilities do not disappear, but instead are generated annually. The Railroads have not provided an iota of empirical evidence that railroads ever pay more

²³ “Deferred tax reserves are clearly a no-cost source of capital. To assume that the railroads need a return on that capital in order to achieve revenue adequacy is especially inappropriate....” *Standards*, 3 I.C.C.2d at 272.

than the corporate tax rate. The Railroads have presented a straw man from which they draw spurious conclusions.

The same is true of the oblique reference to levelized rates for utilities. Petition at 44-45. The Board does not calculate levelized rates for railroads. Instead, variable costs are recalculated annually based on the most recent investment, depreciation, deferred tax liabilities, and other factors.²⁴ The Railroads come closer to firmer ground in asserting that “[t]he railroad industry is fundamentally different from public utilities” (*id.* at 45), but they focus on the wrong aspects of market forces and regulation. Railroads are different because the bulk of their traffic is not subject to regulation because it falls below the jurisdictional threshold, is not otherwise captive, has been exempted, or moves by contract. Railroad regulation is limited to the captive segment, traffic for which there is no effective competition. 49 U.S.C. § 10707. For that segment, unconstrained market prices can produce unreasonable results, in contravention of 49 U.S.C. § 10702(1), for which the Revenue Adequacy Constraint would be relevant.

The Petition then segues to a discussion of the many supposed benefits of the flow-through approach, but those benefits are all illusory. The Railroads first claim that the flow-through better matches the Board’s monitoring with the railroads’ real-world performance (Petition at 46), but they tie their claim to Appendix A. As explained *supra*, Appendix A has nothing to do with the economics of real-world railroads.

²⁴ Similarly, the DCF and MMM models used in the Stand Alone Cost Constraint yield different stand-alone cost levels each year. Deferred tax liabilities are a significant component of SAC and are a major reason why a DCF model is required.

Appendix A also ignores the fact that deferred tax liabilities free up the funds that would have been used to pay income taxes and allows them to be used for other purposes.

The Railroads' second claim is that deferred tax liabilities do not equate to an "interest-free loan" because "the opportunity costs of making investments with those funds is the same" as with other internally generated funds and there are a "number of ways a railroad can generate internal funds to re-invest." *Id.* at 46-47. Those claims are red herrings. While railroads can and do generate funds in other ways, deferred tax liabilities come about from capital timing expenditures and the timing differences between book and tax accounting, and their effect is to reduce the net outlay required for capital expenditures, meaning physical assets.²⁵ Furthermore, Mr. Buffett's characterization of deferred tax liabilities as a zero-cost source of leverage is far more credible, and the Railroads do not present any company witnesses to claim otherwise.

Lest there be any doubt, consider the reasoning of the RAPB:

Unlike debt and equity sources of funds, deferred tax credits are a zero cost source of funds. Since the purpose of a revenue adequacy determination is to ascertain whether a railroad entity is earning revenues sufficient to attract and retain capital, that portion of the investment base which is financed through deferred taxes should not be included in the ROI.

RAPB, Final Report, Volume II at 59.

²⁵ As the ICC observed, "there is no market value for deferred tax reserves." 3 I.C.C.2d at 274 n.15.

The Railroads' third claim is that "the flow-through approach provides optimal incentives for [private] capital investment." *Id.* at 47-49. The claim is rather perverse coming from firms that have all intentionally reduced capital investment as part of their adoption of Precision Scheduled Railroading ("PSR") and inflicted considerable distress on their customers in the process. Putting that aside, the benefits come from the government and the tax system, not private capital investment. "Even with a deferred tax adjustment, the railroads will still be able to take full advantage of the tax law which allows them to defer the payment of some income taxes. The adjustment in no way requires the railroads to forfeit any cash flow benefits which they are entitled to under the tax law and allows them to invest the proceeds as they see fit." *Standards*, 3 I.C.C.2d at 273.

Most railroad traffic is not subject to rate regulation in the first place, so the claim that the utility method "penalize[es] a railroad that invests in new rail property"²⁶ is facially absurd. Railroads only obtain tax deferral by investing, and the deferral reduces the amount that the railroads have to invest in order to obtain the benefit of the asset. Furthermore, if railroads have adequate incentive to invest in competitive traffic, such as intermodal, as they already do, then surely they have even greater incentive to invest in handling more profitable captive traffic.

²⁶ Petition at 48.

The Railroads’ fourth claim regarding avoiding “future artificial fluctuations”²⁷ when tax policy changes repeats their earlier claim and is addressed *supra*. Tax changes are rare, but if they do happen, they can be addressed at the time, as was the case with the 2017 tax cuts. The Railroads’ flow-through alternative ignores the fact that deferred tax liabilities consistently enable them to pay lower taxes than indicated by the nominal corporate rate. As between the two options, only the utility method makes sense, especially if only a modest portion of rail traffic is subject to regulation.

The Railroads’ final claim of “simplicity”²⁸ is simply facile. Of course, it is convenient for railroads to get a revenue adequacy measure benefit from taxes that they do not really pay, just as it would be convenient for them to receive a return on the replacement cost of assets that have not been, and may never be replaced. That hardly makes their preferred treatment sound, fair or reasonable. As with their other arguments for substituting the flow-through approach for the utility method, the only actual justification offered is their own welfare.

CONCLUSION

The Railroads’ Petition is a barely disguised, new effort to move the revenue adequacy goal posts as the Board considers giving real effect to the *Guidelines’* Revenue Adequacy Constraint, now that multiple carriers have met the § 10704 standard over multiple years. The changes to the Board’s annual revenue adequacy determinations

²⁷ *Id.* at 49.

²⁸ *Id.*

that the Railroads seek are unsupported in law or agency precedent, and would bias the regulatory process against the interests of captive shippers, who the *Guidelines* and the Revenue Adequacy Constraint are designed to protect. The Petition should be denied.

Respectfully submitted,

William L. Slover
/s/ Kelvin J. Dowd
Robert D. Rosenberg
Slover & Loftus LLP
1224 Seventeenth Street, NW
Washington, D.C. 20036
202.288.1474

Dated: September 21, 2020

Attorneys for the
Western Coal Traffic League

**MEMBERS OF
WESTERN COAL TRAFFIC LEAGUE**

Ameren Missouri

Arizona Electric Power Cooperative, Inc.

CLECO Corporation

CPS Energy

Entergy Services, Inc.

Evergy, Inc.

Lower Colorado River Authority
Austin Energy (City of Austin, Texas)

MidAmerican Energy Company

Minnesota Power

Nebraska Public Power District

Western Fuels Association, Inc.