

SERVICE DATE – DECEMBER 30, 2020

SURFACE TRANSPORTATION BOARD

DECISION

Docket No. EP 766

JOINT PETITION FOR RULEMAKING—ANNUAL REVENUE ADEQUACY
DETERMINATIONS

Digest:¹ The Board opens a rulemaking proceeding to consider a petition by several Class I railroads to change the Board’s procedures for annually determining whether Class I rail carriers are revenue adequate. The Board seeks public comment on the petition and several specific related issues.

Decided: December 22, 2020

On September 1, 2020, Union Pacific Railroad Company (UP), Norfolk Southern Railway Company, and the U.S. rail operating affiliates of Canadian National Railway Company (collectively, Joint Carriers) filed a joint petition for rulemaking to change the Board’s procedures for determining which Class I rail carriers are earning adequate revenues under 49 U.S.C. § 10704(a)(3).

The Board annually determines each Class I railroad’s revenue adequacy in successive subdockets under Docket No. EP 552, most recently in Railroad Revenue Adequacy—2019 Determination, EP 552 (Sub-No. 24) (STB served Oct. 1, 2020).² Under the Board’s procedures, “a railroad is considered revenue adequate under 49 U.S.C. § 10704(a) if it achieves a rate of return on net investment (ROI) equal to at least the current cost of capital for the railroad industry.” Id. at 1.

The Joint Carriers propose two changes to the Board’s procedures for annually determining revenue adequacy. First, the Joint Carriers propose that the Board determine whether a railroad is revenue adequate by comparing the extent by which its ROI exceeds the rail industry’s cost of capital to the extent by which companies in the S&P 500 exceed their cost of capital—in short, to examine railroads in comparison with the larger universe of S&P 500

¹ The digest constitutes no part of the decision of the Board but has been prepared for the convenience of the reader. It may not be cited to or relied upon as precedent. See Pol’y Statement on Plain Language Digests in Decisions, EP 696 (STB served Sept. 2, 2010).

² In that decision, the Board found five carriers (BNSF Railway Company, CSX Transportation, Inc. (CSXT), Norfolk Southern Combined Railroad Subsidiaries, Soo Line Corporation, and UP) revenue adequate in 2019. R.R. Revenue Adequacy—2019 Determination, EP 552 (Sub-No. 24), slip op. at 2.

companies (the Comparison Proposal). (Pet. 3, 8.) The Joint Carriers contend that railroads compete against other firms for capital, and that the financial health of the railroad industry “must be considered in relation to the competition railroads face in the capital markets from other, unregulated firms.” (*Id.* at 3.) More specifically, the Joint Carriers argue that the Board should define annual revenue adequacy to mean that a railroad’s “Adjusted STB ROI”³ exceeds the rail industry cost of capital by more than the median S&P 500 firm’s ROI exceeds its cost of capital. (*Id.* at 20-21.) Under the Comparison Proposal, the Board would direct the Association of American Railroads to submit “Adjusted STB ROI” and cost of capital calculations for every S&P 500 company, and the Board “would calculate the median difference between the Adjusted STB ROI and the cost of capital for all companies in the S&P 500, except for banking and real estate companies.”⁴ (*Id.* at 21.) As part of the Comparison Proposal, the Joint Carriers also propose including non-goodwill intangible assets in the railroads’ and S&P 500 companies’ asset bases. (*Id.* at 35.)

The second proposal from the Joint Carriers is that the Board change how it treats deferred taxes in the revenue adequacy determination (the Deferred Taxes Proposal). Rather than the Board’s current “utility method,” which removes annual deferred taxes from net operating income and removes accumulated deferred taxes from a company’s investment base, the Joint Carriers propose a flow-through approach, under which annual deferred taxes and accumulated deferred taxes would not be removed from net operating income and the investment base, respectively. (*Id.* at 38.) The Joint Carriers state that the practical effect would be “an annual measurement that is on a cash basis, where the impact of any deferred taxes is captured by the measurement of financial health if and when those taxes come due.” (*Id.* at 38-39.)

On September 21, 2020, the Board received three replies to the petition, one each from CSXT, the Western Coal Traffic League (WCTL), and a group of several shippers.⁵ CSXT supports the petition, while WCTL and the Joint Shippers oppose it.

CSXT urges the Board to grant the petition because doing so “would provide a more accurate picture of railroad financial performance.” (CSXT Reply 2.) CSXT also urges the Board to consider the use of replacement costs when determining long-term revenue adequacy and argues that the Board should abandon the revenue adequacy constraint in determining whether individual rates are reasonable. (*Id.* at 3-8.)

WCTL argues that the petition misrepresents the role of revenue adequacy and is an attempt by the Joint Carriers to avoid being found revenue adequate and thus potentially subject

³ The petition also proposes certain modifications to the calculation of ROI, as discussed below. (See also Pet. 35-36.)

⁴ The Joint Carriers state that banking and real estate companies were excluded from the comparison groups because they have different capital structures than other firms; railroads were also excluded. (Pet. 35.)

⁵ The shippers are: The American Chemistry Council, Corn Refiners Association, American Fuel & Petrochemical Manufacturers, The National Industrial Transportation League, The Chlorine Institute, and The Fertilizer Institute (collectively, Joint Shippers).

to the revenue adequacy rate constraint. (WCTL Reply 4-5.) Regarding the Comparison Proposal, WCTL asserts that many S&P 500 firms have different capital structures than railroads and hundreds are not capital intensive. (*Id.* at 12.) WCTL also argues that the Comparison Proposal would result in revenue adequacy determinations at odds with the investment community's perception of railroads' financial health. (*Id.* at 13 (citing Joint Opening Comments of WCTL 11-12, Sept. 5, 2014, R.R. Revenue Adequacy, EP 722).) Regarding the Deferred Taxes Proposal, WCTL argues that the flow-through approach ignores tax deferrals and the fact that railroads pay taxes below the corporate rate. (*Id.* at 14-16.) WCTL also questions the relevance and accuracy of the Joint Carriers' examples of the utility and flow-through methods. (*Id.* at 17.)

The Joint Shippers argue that the Comparison Proposal would “render all Class I railroads revenue-inadequate and likely maintain that status for decades to come.” (Joint Shippers Reply 4.) They contend that the current annual revenue-adequacy determination already sets a conservatively high bar, (*id.* at 4-8), and assert that the Joint Carriers' rationales for the Comparison Proposal do not actually support the proposal, (*id.* at 11-12 (stating that the Joint Carriers' arguments “assume a role for revenue adequacy as a measure of market power, competitive failure and monopoly profits that Congress never intended”)).

On October 13, 2020, the Joint Carriers filed a motion for leave to respond to the reply comments, along with a response addressing WCTL's and the Joint Shippers' arguments against both proposals.⁶

The Board will open a rulemaking proceeding to further consider the Joint Carriers' petition and the issues that it raises.⁷ The Board invites comment on the issues raised in the petition generally as well as on the following specific questions:

General Considerations

1. With specificity, in what ways do each of the Joint Carriers' proposals advance or fail to advance each of the components of 49 U.S.C. § 10704(a)(2)?⁸

⁶ Under 49 C.F.R. § 1104.13(c), a reply to a reply is not permitted. However, in the interest of a more complete record, the Board will grant the Joint Carriers' motion and accept their reply into the record. See City of Alexandria—Pet. for Declaratory Order, FD 35157, slip op. at 2 (STB served Nov. 6, 2008) (allowing a reply to a reply “[i]n the interest of compiling a full record”).

⁷ The Board has also received testimony and comments in two informational dockets related to revenue adequacy. See Hearing on Revenue Adequacy, Docket No. EP 761; R.R. Revenue Adequacy, Docket No. EP 722.

⁸ Under 49 U.S.C. § 10704(a)(2),

[t]he Board shall maintain and revise as necessary standards and procedures for establishing revenue levels for rail carriers providing transportation subject to its jurisdiction under this part that are adequate, under honest, economical, and

2. Are there other ways in which the Board's current procedures could be modified to further advance the statutory goals of § 10704(a)(2)?

The Comparison Proposal

1. As noted above, the Joint Carriers propose that Class I carriers be considered revenue adequate only if their ROI exceeds their cost of capital by more than the median S&P 500 firm's ROI exceed its cost of capital. Why is the median S&P 500 firm's differential an appropriate benchmark and not, for example, the 25th, 33rd, or 75th percentile? Does the Joint Carriers' proposal assume that below-median S&P 500 firms do not earn adequate revenues, and, if so, why is that assumption appropriate (or inappropriate)?

2. WCTL and the Joint Shippers criticize the proposal to use the S&P 500 as a comparison group. (See WCTL Reply 12; Joint Shippers Reply 9-10.) The Joint Carriers express openness to using a different comparison group and note that similar results are reached if railroads are compared to the S&P 500 Industrials sector group or a group of S&P 500 railroad customers. (See Joint Carriers Response 11-12.) Would any of these alternative comparison groups be an appropriate benchmark? Are there other comparison groups that might be appropriate? Is it appropriate to compare regulated entities like railroads with a group that includes a significant number of non-regulated entities, and—if not—is there a set of regulated companies that could be used as a comparison group?

3. A company is typically removed from the S&P 500 index if its market capitalization falls below a certain threshold. Does the changing constituency of the index pose a problem with respect to the Joint Carriers' proposed methodology?

The Deferred Taxes Proposal

In Standards for Railroad Revenue Adequacy, 3 I.C.C.2d 261 (1986), the Board's predecessor, the Interstate Commerce Commission (ICC), based its decision to adopt the utility method on several grounds, including analogizing captive rail shippers to utility customers, favoring an approach that conforms to Generally Accepted Accounting Principles (GAAP), and

efficient management, for the infrastructure and investment needed to meet the present and future demand for rail services and to cover total operating expenses, including depreciation and obsolescence, plus a reasonable and economic profit or return (or both) on capital employed in the business. The Board shall make an adequate and continuing effort to assist those carriers in attaining revenue levels prescribed under this paragraph. Revenue levels established under this paragraph should—

(A) provide a flow of net income plus depreciation adequate to support prudent capital outlays, assure the repayment of a reasonable level of debt, permit the raising of needed equity capital, and cover the effects of inflation; and

(B) attract and retain capital in amounts adequate to provide a sound transportation system in the United States.

determining that removing the effect of deferred taxes led to a more accurate representation of railroad profitability. See id. at 272-75; Consol. Rail Corp. v. United States, 855 F.2d 78, 93 (3rd Cir. 1988) (affirming the ICC's decision and finding that the "adjustment of its formula in the interests of accuracy is rational"). Does the ICC's reasoning for adopting the utility method remain valid, specifically with respect to analogizing captive shippers to utility customers, determining whether the utility method continues to conform with GAAP today, and finding that the utility method led to a more accurate representation of railroad profitability?

Additionally, the Joint Carriers will be requested to file workpapers sufficient to replicate the analysis underlying their proposals and to make those workpapers available, upon request, to other participants in this proceeding, under an appropriate protective order.

Interested persons may file comments by March 1, 2021. If any comments are filed, replies will be due by March 31, 2021.

It is ordered:

1. A rulemaking proceeding is initiated, as discussed above.
2. Comments are due March 1, 2021; replies are due March 31, 2021.
3. The Joint Carriers are requested to file workpapers sufficient to replicate the analysis underlying their proposals and to make those workpapers available, upon request, to other participants in this proceeding, under an appropriate protective order.
4. Notice of this decision will be published in the Federal Register.
5. This decision is effective on its service date.

By the Board, Board Members Begeman, Fuchs, and Oberman.