

BEFORE THE  
SURFACE TRANSPORTATION BOARD

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STB Ex Parte No. 722

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RAILROAD REVENUE ADEQUACY

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REPLY OF THE ASSOCIATION OF AMERICAN RAILROADS  
TO THE PETITION BY WESTERN COAL TRAFFIC LEAGUE

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On August 24, 2022, the Western Coal Traffic League (“WCTL”) filed a Petition for Administrative Action (“Petition”) in this docket.<sup>1</sup> WCTL requests that the Board propose new rules to implement the revenue adequacy constraint for rate cases. The Association of American Railroads (“AAR”) opposes the petition, summarizes, and reiterates its previously briefed position that the Board should abandon the revenue adequacy constraint. First, the statute does not authorize the Board to use a carrier’s revenue adequacy as a basis to constrain rates. Second, well-established economic principles reject the use of earnings regulation as a sound basis for government intervention. Finally, the Board’s annual revenue adequacy determination substantially overstates railroad return on investment. In summary, there is no compelling justification for the Board to proceed with crafting a proposed rule of general applicability. For these reasons AAR supports closing the instant proceeding.

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<sup>1</sup> Western Coal Traffic League, Petition for Administrative Action, *Railroad Revenue Adequacy*, EP 722 (filed Aug. 24, 2022).

1. *The Statute Does Not Authorize Utilization of Revenue Adequacy as a Constraint.*

Since the Board instituted this proceeding in 2014, AAR has consistently argued that the statute does not support a revenue adequacy constraint on rates.<sup>2</sup> Congress viewed revenue adequacy of the railroads as a goal to be achieved, not a ceiling on rates for regulators to impose. When considering challenges to a rate's reasonableness, the Board must "recognize[e] the policy of this part that rail carriers shall earn adequate revenues."<sup>3</sup> Indeed, section 10704 states the "Board shall make an adequate and *continuing effort to assist* those carriers in attaining revenue levels prescribed under this paragraph."<sup>4</sup> Congress' plain-language instruction to the Board is to "assist" railroads in achieving revenue adequacy. Neither statutory section says anything about capping individual rates once revenue adequacy is achieved.<sup>5</sup>

The legislative history of the Railroad Revitalization and Regulatory Reform Act of 1976 ("4R Act") and Staggers Rail Act of 1980 ("Staggers") make clear that what Congress was concerned about with regard to revenue adequacy was ensuring that carriers would achieve it.<sup>6</sup> Nowhere in the law or legislative history did Congress grant the authority for the agency

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<sup>2</sup> See Comments of AAR, *Railroad Revenue Adequacy*, EP 722, 20-42 (Sept. 5, 2014) ("2014 Comments"); Comments of AAR, *Hearing on Revenue Adequacy*, EP 761, et al., 20-35 (Nov. 26, 2019); ("2019 Comments"); Supp. Comments of AAR, *Hearing on Revenue Adequacy*, EP 761, et al., 3-21 (Feb. 13, 2020) ("2020 Supp. Comments"); Comments of AAR, *Joint Petition for Rulemaking—Annual Revenue Adequacy Determinations*, EP 766, 19-23 (May 17, 2021) ("EP 766 Comments").

<sup>3</sup> 49 U.S.C. §10701(d).

<sup>4</sup> 49 U.S.C. §10704(a)(emphasis added).

<sup>5</sup> The revenue adequacy constraint is an agency creation. See *Coal Rate Guidelines – Nationwide*, 1 I.C.C. 2d 520 (1985) ("*Coal Rate Guidelines*"), *aff'd sub nom. Consolidated Rail Corp. v. U.S.*, 812 F.2d 1444 (3rd Cir. 1987). The proposal in *Coal Rate Guidelines* did not include a revenue adequacy constraint. However, the final decision deviated from the proposal without explanation or support. See 2014 Comments at 32-37.

<sup>6</sup> See EP 766 Comments at 3-7 (outlining the history and context for the deregulatory actions of Congress); see also 2014 Comments, V.S. Joseph Kalt at 6-12 (providing economic context of the pre-Staggers era).

impose a revenue adequacy constraint, which would represent an entirely different policy objective.<sup>7</sup>

2. *Regulating Rates Based on Firm-Wide Earnings is Not Supported by Economic Theory.*

Modern economic theory does not support the use of a measure of firm-wide earnings to regulate individual rates.<sup>8</sup> Such “old-style” rate-of-return regulation has generally been abandoned.<sup>9</sup> From an economic perspective, such regulation disincentivizes firms to innovate and serve customers better.<sup>10</sup> The threat of enhanced rate regulation once a firm reaches a return on investment equal to its cost of capital would drive that firm to avoid efficiency enhancements or slow innovations, so as to not trigger regulation. These perverse incentives would lead to diminished investment and distorted commercial actions.<sup>11</sup> The impact will be to gradually reduce the robustness of the rail network over time and precipitate a decline in the quality of rail service. Rejecting the concept of rate-of-return regulation, the Transportation Research Board explained earnings regulation “can incentivize excessive capital-to-labor ratios

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<sup>7</sup> See S. Rep. No. 94-499, at 52 (1975) (“The Committee believes that it is important for the [ICC] to determine expeditiously adequate revenue levels for the carriers and to assist carriers in attaining such levels.”); S. Rep. No. 96-470, at 6 (1979) (“Almost all agree that something further must be done to improve the financial health of the nation’s railroads or the industry will continue to falter with the likely alternative being only an increasingly heavy burden on the consumer and taxpayer.”); H.R. Rep. No. 96-1035, at 54 (1980) (“Previous admonitions by the Congress that the Commission assist carriers in earning adequate revenue levels . . . have not achieved their goals.”); H.R. Rep. No. 96-1430, at 80 (1980) (The agency “is given the mandate to place greater emphasis on the need for carriers to have adequate revenue levels.”).

<sup>8</sup> See 2014 Comments at 37-42, V.S. Joseph Kalt at 35-40, V.S. Roger Brinner at 26-33; Supp. Comments of AAR, *Railroad Revenue Adequacy*, EP 722, at 2-6 (Aug. 6, 2015) (“2015 Supp. Comments”); 2019 Comments, V.S. Joseph Kalt at 38-49.

<sup>9</sup> See 2019 Comments at 20-23, V.S. Joseph Kalt at 52-56; see also Macher, et al., *Revenue Adequacy: The Good, the Bad and the Ugly*, 41 Transp. L.J. 85, 122-124 (2014).

<sup>10</sup> See 2014 Comments, V.S. Roger Brinner at 32-33; 2019 Comments at 20-23, V.S. Joseph Kalt at 52-53.

<sup>11</sup> See 2014 Comments, V.S. Roger Brinner at 26-30 (explaining firms will invest in projects where the return on investment meets or exceeds the cost of capital); see also 2019 Comments at 23; Macher at 123-124.

and lessen the motivation for asset replacement and the pursuit of innovation. ... would be at odds with the deregulatory thrust of the Staggers Rail Act reforms... [and constitutes a] misguided view that a single yes/no indicator of railroad profitability can be used to regulate rates.”<sup>12</sup> More investment and incentives to innovate are necessary to meet current and future demand for railroad service, not less.

3. *The Board’s Methodology Overstates Railroad Revenue Adequacy.*

Finally, the Board’s current methodology for measuring railroad revenue adequacy annually overstates return on investment because of its treatment of deferred taxes and the use of book value of assets.<sup>13</sup> To calculate revenue adequacy, the Board must value each carriers’ asset base. However, the Board excludes the value of deferred taxes from the rail carrier’s asset base, which artificially lowers the value of the asset base. A lower asset base results in a substantial increase in railroad return of investment, thereby overstating a railroad’s revenue adequacy.<sup>14</sup> Simply put, excluding deferred taxes signals that railroads are not expected to earn a return on that portion of their capital, creating a disincentive for further investment in railroad assets.

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<sup>12</sup> Transportation Research Board, *Modernizing Freight Rail Regulation*, at 100-101, 130 (2015). Citing the “misguided view” that rate-of-return regulation could be utilized to regulate rates, TRB found the annual revenue adequacy determination “no longer provide[d] meaningful information for policy making.” *Id.* at 130.

<sup>13</sup> See 2014 Comments at V.S. Joseph Kalt at 27-35, V.S. Roger Brinner at 14-26; 2015 Supp. Comments at 8-10; 2019 Comments at 38-41; V.S. Joseph Kalt at 27-38; EP 766 Comments at 8-19. AAR has also noted that section 10704(a)(2) requires revenues must be sufficient to not only cover infrastructure costs and operating expenses, but also to earn “a reasonable and economic profit or return.” 49 U.S.C. § 10704(a)(2). The phrase “reasonable and economic profit or return” must mean a profit or return above, not equal to, the cost of capital. See EP 766 Comments at 12-13.

<sup>14</sup> See 2019 Comments at 39-40; V.S. Joseph Kalt at 28-29.

Additionally, to value the carrier's asset base the Board does not use replacement cost of those assets (i.e., their current market value), but instead evaluates the accounting book value of the railroads' assets (i.e., the original cost of the asset less any depreciation). The agency has recognized that "replacement cost valuation can be preferable to original cost valuation ... because it comes closer to the competitive result" yet the practical challenges of implementing replacement cost in the annual determination has kept the agency from doing so.<sup>15</sup> As to railroads, the use of book value instead of replacement costs to value assets results in overstated return on investment because of the particularly long lives of railroad assets.<sup>16</sup> To meet the present and future demand for rail services, railroads must earn returns on the economic value of their investment. Any useful revenue adequacy analysis would have to take the economic value of investments into account.

## CONCLUSION

In sum, the Board should abandon the revenue adequacy rate constraint concept. As the statute requires the Board to monitor the financial health of the industry, it should fix the measurement errors with the annual revenue adequacy determination. Gauging the reasonableness of a particular rate based on system-wide financial health – even if accurately measured – is an antiquated and discredited form of rate regulation that cannot be reconciled with the Staggers Act or modern economic theory. As such and for the reasons stated above,

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<sup>15</sup> *Standards for Railroad Revenue Adequacy*, 364 I.C.C. 803, 818 (1981); see *Standards for Railroad Revenue Adequacy*, 3 I.C.C.2d 261 (1986) ("While current cost accounting is theoretically preferable to original cost valuation, it cannot be practically implemented in a manner that we can be confident would produce accurate and reliable results.").

<sup>16</sup> See 2014 Comments, V.S. Roger Brinner at 18-26; 2019 Comments at 38-39, V.S. Joseph Kalt at 27-28.

AAR opposes the petition and urges the Board to close this proceeding.

Respectfully submitted,

A handwritten signature in blue ink, appearing to read 'K. Kirmayer', with a stylized, cursive script.

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