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BEFORE THE
SURFACE TRANSPORTATION BOARD

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RAILROAD REVENUE ADEQUACY	)	EP 552 (Sub-No. 22)
— 2017 DETERMINATION	)	

RAILROAD COST OF CAPITAL –	)	EP 558 (Sub-No. 21)
2017	)	

UNIFORM RAILROAD COSTING	)	EP 750
SYSTEM – 2017 CALCULATIONS	)	

COMMENTS OF THE WESTERN COAL TRAFFIC LEAGUE

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COMMENTS OF THE WESTERN COAL TRAFFIC LEAGUE

The Western Coal Traffic League (“WCTL”)¹ submits these comments in response to the notice (“Notice”) that the Surface Transportation Board (“Board” or “STB”) served in the three above-captioned proceedings on July 27, 2018.

I. BACKGROUND

The Board’s Notice presents a proposal to address some of the impacts of The Tax Cuts and Jobs Act, Pub. L. No. 1115-97 (2017).² The legislation, enacted December 22, 2017, reduces the corporate tax rate from 35% to 21% starting with the

¹ WCTL is a voluntary association, whose regular membership consists entirely of shippers of coal mined west of the Mississippi River that is transported by rail. WCTL members currently ship and receive in excess of 125 million tons of coal by rail each year. WCTL’s members are: Ameren Missouri, Arizona Electric Power Cooperative, Inc., Austin Energy (City of Austin, Texas), CLECO Corporation, CPS Energy, Entergy Services, Inc., Kansas City Power & Light Company, Lower Colorado River Authority, MidAmerican Energy Company, Minnesota Power, Nebraska Public Power District, Omaha Public Power District, Western Fuels Association, Inc., and Wisconsin Public Service Corporation.

² The Notice does not specify whether it is a notice of proposed rulemaking or an advance notice of proposed rulemaking.

2018 tax year. However, the cut in the tax rate starting 2018 serves to decrease the deferred tax liabilities (“DTLs”) of the Class I railroads (and others) as of the end of 2017. Under generally accepted accounting principles (“GAAP”), DTLs, which represent tax payment obligations that have been deferred into the future, are valued based on estimated future tax rates.³ Reducing future tax rates thus reduces the current (*i.e.*, 2017) end of year value of the DTLs. The reduction in future DTLs constitutes earnings for 2017 under GAAP.

In its Notice, the Board states that “[t]he significant increases in net income ... attributable to the adjustment in [DTLs] ... may not be truly representative of the carriers’ financial state for 2017” because of the one-time nature of the accounting treatment of the tax cut. Notice at 3-4. Accordingly, the Board proposes “to make corresponding one-time adjustments to its 2017 cost of capital determination, revenue adequacy determination, and URCS calculations” so that they “might more accurately reflect the financial state of the railroad industry in 2017 and facilitate year-over-year comparisons.” *Id.* at 4. In effect, the Notice proposes to remove the reduction in end of year DTLs and the resulting increase net income in 2017 in the three proceedings. The outcome would be identical to what the Class I railroads sought by requesting “extraordinary item” or below-the-line treatment for the impact of the tax cut, which the

³ Statement of Financial Accounting Standards No. 109, *Accounting for Income Taxes* (1992) (FAS 109), superseding Financial Accounting Standards No. 96, *Accounting for Income Taxes* (1987) (“FAS 96”), both issued by the Financial Accounting Standards Board (“FASB”).

Board previously rejected in March 2018 because it did not conform to GAAP. *Id.* at 2 n.4.

II. SUMMARY

As a general principle, the effect of the tax cut should be: (1) to reduce, not increase, regulatory costs; (2) to reduce, not increase, the railroad cost of capital, at least on a before-tax basis; and (3) to increase, not decrease, the railroads' revenue adequacy since taxes are a significant component of railroad costs. Whatever the Board may do as a transition mechanism in 2017 to address the change in DTLs based on the tax cut that takes effect in 2018 should not undermine the long-term pass through of the tax cut into the carriers' regulatory costs and their revenue adequacy.

WCTL agrees that the year-end 2017 DTL and net income values represent a change from the past that warrants review and action where appropriate. Indeed, WCTL addressed the anomalous nature of the 2017 DTLs and earnings values and their impact in the comments it previously submitted in EP 558 (Sub-No. 21).

However, the approach need not, and should not, be identical in all three matters covered by the Board's notice. The reduction in DTLs and associated spike in income is fully "representative" of the railroad industry in 2017, particularly under GAAP, which the Board is directed to rely upon "to the maximum extent practicable." 49 U.S.C. § 11142, 11161, 11164. At the same time, the 2017 spike in earnings does not reflect what is or can be reasonably expected on an annual basis in the future. The appropriate treatment should thus reflect the time period at issue in each analysis and the need for internal coherence in the associated calculations.

Accordingly, the Board's proposal for calculating the return on investment ("ROI") portion of variable costs under the Uniform Railroad Costing System ("URCS") is logical and appropriate. The same federal income tax rate should be used for the gross-up of the cost of equity and to value the DTLs in order to achieve consistency. Since the 35% statutory tax rate applies during 2017 and is proposed for the cost of equity gross-up in 2017, the same tax rate should be used for the DTLs for URCS, as the Board proposes. Otherwise, there would be a fundamental mismatch.

The Board's proposal for the Multi-Stage Discounted Cash Flow model ("MSDCF") portion of the cost of equity is also reasonable, as far as it goes. The MSDCF cost of equity focuses on the cash flows that are expected to occur in the future. The tax cut is a one-time event that is not expected to be repeated. Accordingly, its impact should be excluded from the MSDCF. The Board's proposal does so properly with respect to the initial cash flows for each stage, but not with respect to the associated growth rates, as WCTL previously explained in EP 558 (Sub-No. 21). The appropriate approach is either (a) to discard the MSDCF and rely exclusively on the Capital Asset Pricing Model ("CAPM") for 2017, or (b) to make an appropriate adjustment to the growth rates to remove the impact of the tax cut from both sides of the MSDCF equation.

In contrast, the revenue adequacy portion of the proposal is fundamentally flawed. The GAAP income represents actual earnings and should not be ignored when considering whether the railroads are earning adequate revenues. Revenue adequacy is envisioned as a long-term concept in the *Coal Rate Guidelines*. Insofar as the concern is that 2017 income represents an atypical spike, its long-term significance can be assessed

using a multi-year period, similar to the treatment in the Revenue Shortfall Allocation Method (“RSAM”). Recognizing the impact over time is far superior to pretending the earnings never existed.

III. THE STATUTE DIRECTS THE BOARD TO FOLLOW GAAP TO THE MAXIMUM EXTENT PRACTICABLE

The Board’s governing statute allows it to “prescribe a uniform accounting system” for carriers under its jurisdiction, and directs the Board to “conform such system to generally accepted accounting principles” “[t]o the maximum extent practicable.” 49 U.S.C. § 11142. The Board is also directed to conform its cost accounting rules “[t]o the maximum extent practicable ... to generally accepted accounting principles.” *Id.*, § 11161. Likewise, the Board’s rules for expense and revenue accounting and reporting requirements are to be “consistent with generally accepted accounting principles uniformly applied to such rail carriers.” *Id.*, § 11164.

The Board has adhered closely to GAAP in the past. For example, the Board has included acquisition premium write-ups for merging carriers in its URCS variable costs and in its revenues adequacy determinations because GAAP calls for purchase accounting. *E.g.*, *Western Coal Traffic League—Petition for Declaratory Order*, FD 35506 (STB served July 25, 2013), at 2-3. The Board has also insisted on treating operating leases as an expense and not as debt for capital structure purposes because that, too, is part of GAAP (for now), even though standard financial practice for cost of capital and other purposes is to treat operating leases as debt. *Railroad Cost of Capital—2011*, EP 558 (Sub-No. 15) (STB served Sept. 15, 2012), at 17; *Railroad Cost*

of Capital—2015, EP 558 (Sub-No. 19) (STB served Aug. 5, 2016), at 4-5. In those instances and others, the Board adhered rigorously to GAAP over WCTL’s objections.

WCTL does not maintain that GAAP must govern in all instances, but the Board should have a solid reason for any deviations. “Where the GAAP cost reasonably cannot be viewed as a meaningful regulatory measure of value, other measures of value may be used.” Railroad Account Principles Board, *Railroad Accounting Principles Final Report* (Sept. 1, 1997), Vol. 2 at 39. When the Board can address a matter in two ways, one which entails compliance with GAAP, and the other which overrides GAAP, the approach that complies with GAAP appears generally more consonant with the statute. However, the Board’s proposal skews away from GAAP without adequate justification in some areas, particularly revenue adequacy.

IV. THE NOTICE’S URCS PROPOSAL IS SOUND

The Notice proposes to adjust the calculation of the ROI component of URCS variable costs such that: (a) end of year DTLs would be calculated using a 35% income tax rate; (b) the increased (or non-reduced) DTLs would continue to serve as an offset to the investment value represented by the net book value of the asset for purposes of calculating ROI; and (c) ROI would be calculated utilizing a before-tax cost of capital also grossed-up using a 35% tax rate. Notice at 5.

It is preferable to use the same tax rate for calculating DTLs and grossing-up the cost of equity for use in calculating ROI in the interests of consistency and

integrity. Since the 35% tax rate applies for all of 2017, it is approach to use the 35% tax rate both for both calculating DTLs and grossing up the cost of equity for taxes.⁴

Under the circumstances, the Notice's proposal to use a 35% tax rate in URCS for both valuating DTLs and grossing-up the cost of equity maintains consistency and represents the most straightforward approach.

V. THE PROPOSAL FOR THE COST OF CAPITAL IS CONSTRUCTIVE, BUT IT SHOULD ALSO ADDRESS THE MSDCF GROWTH RATE

The proposal would make a similar change for calculating the cost of equity under the MSDCF. The deferred taxes and associated net income (earnings) of the four carriers that constitute the composite sample for purposes of calculating the cost of equity under the MSDCF would be adjusted to remove the impact of the tax cut on end of year 2017 values. In this manner, the Notice seeks to align the 2017 values with those for 2012-2016 in order to “smooth” the cash flow inputs for the MSDCF. Notice at 3-4.⁵

Conversely, failing to make the change would cause the MSDCF to reflect anomalous values for 2017, which is of concern because the MSDCF “smoothing” relies

⁴ The Board has justified use of the 35% statutory tax rate for grossing up the cost of equity on the grounds that the 35% “closely approximates the observed rail industry’s [effective] tax liability,” taking state taxes into account. *Simplified Standards for Rail Rate Cases—Taxes in Revenue Shortfall Allocation Method*, EP 646 (Sub-No. 2) (STB served Nov. 20, 2008), at 6 & n.4 & Appendix 1. However, the reduction in DTLs caused the railroads’ effective tax rates to turn *negative* in 2017: -59.8% for BNSF, -74.2% for CSX, -72.8% for NS, and -40.4% for UP, according to pp. 11, 100, 45, and 22 of their respective 10-Ks for 2017. The presence of negative effective tax rates begs the question whether and why there should be any tax gross-up for the cost of equity in 2017.

⁵ The proposed change is only for 2017. The values as altered by the tax cut would apply starting 2018. Notice at 4 n.9.

on five-year averages to develop the initial cash flows for each stage of the model. The atypical values would then remain in the averages for four more years. *Id.* at 4 n.9. The increase in earnings and the decrease in deferred taxes (which turned negative in 2017 due to the tax cut) largely offset each other in the first two stages of the MSDCF. However, there is no offset for the third stage because it is defined to reflect only earnings, not some broader measure of cash flow as in the first two stages. Accordingly, the proposed change would be particularly useful to the extent it removes the massive surge that otherwise occurs in the initial cash flow for the terminal stage of the MSDCF. WCTL estimates that the adjustment would reduce the cost of capital by a modest amount in 2017.

It is appropriate to make the proposed change for the cost of capital, even though it is not appropriate to make a similar change for revenue adequacy (discussed *infra*), because of the different nature and purpose of the two determinations. Revenue adequacy under the Board's comparison of the rate of return on net investment to the industry average cost of capital (the ROI=COC test) assesses how the railroads have actually performed based on the most recent historical data. Ignoring \$22 billion (\$13 billion for the four carriers in the cost of capital composite sample) in that context is nonsensical. In contrast, the MSDCF entails estimating the cash flows that investors expect the railroads will generate in the future. "DCF models estimate the expected rate of return based on the present value of the cash flows that the company is expected to generate." *Use of a Multi-Stage Discounted Cash Flow Model In Determining The Railroad Industry's Cost of Capital*, EP 664 (Sub-No. 1) (STB served Aug. 11, 2008), at

2. Basing those future cash flows on a one-time, non-cash, historical event that is not expected to be repeated necessarily skews that calculation and amounts to deliberate error. Accordingly, the Board's MSDCF proposal is reasonable and appropriate, as far as it goes.

The gap in the Notice's approach is that it addresses only the initial cash flow side of the MSDCF, but ignores the model's growth rate side. As WCTL previously explained in its earlier comments in EP 558 (Sub-No. 21), the MSDCF utilizes analysts' forecasts for the growth rate in earnings as the proxy for growing the initial cash flows.⁶ The analysts forecast the growth in earnings; those projected earnings encompass the gains from the reduction in DTLs that result from the tax cut; and the forecasts thus incorporate the very factor that the Board's proposal seeks to eliminate from the cash flows themselves.

The mismatch between the definition of cash flows and the growth rate is then exacerbated by the combination of the structure of the MSDCF and the high growth rates. Because the MSDCF has no transition mechanism, it assumes that what is projected to occur during the first years will be repeated during the second five years and the start of the third stage. The tax cut is a one-time event, but the growth rates as applied by the model assume that it will be repeated.

⁶ The MSDCF defines the cost of equity as the discount rate at which the net present value of the future cash flows matches the market capitalization of the firm's equity. Notice at 3 n.7.

The growth rate issue can be addressed in two basic ways. The first is to rely exclusively on the Capital Asset Pricing Model (“CAPM”), at least for 2017, as WCTL has previously recommended.⁷ The second is to correct the growth rates in some manner to mitigate the impact of the tax cut. That adjustment might be done by: (a) manual adjustment of the end of 2017 growth rates based on some ratio; (b) use of growth rates as of an earlier date in the year, when the tax cut, or the anticipation thereof, did not figure so prominently in the growth rate estimate;⁸ or use of the average of the growth rates as of the end of 2016 (beginning of 2017) used in the 2016 MSDCF and the end of 2017 values, which would approximate a value for the middle of the year.

To summarize, the proposal in the Notice is useful in that it addresses the MSDCF cash flows, but it is necessary to address the growth rates that are also affected by the tax cut.

VI. THE SPIKE IN RAILROAD EARNINGS IN 2017 SHOULD NOT BE IGNORED FOR REVENUE ADEQUACY PURPOSES, BUT CAN BE RECOGNIZED OVER A MULTI-YEAR BASIS

The proposal would make two changes regarding the revenue adequacy calculation for 2017. First, the proposal would restate the accumulated deferred income tax credits (DTLs) and tax-adjusted net investment base (net book value minus DTLs) at the beginning and at the end of 2017 on a consistent basis reflecting the 35% tax rate.

⁷ While WCTL is challenging use of the MSDCF in general (Notice at 4 n.8), its earlier comments focused on the problems arising from the 2017 tax cut. In other words, the Board could utilize only the CAPM in 2017 and return to the hybrid method in 2018.

⁸ WCTL does not have direct access to the data in order to develop such a value.

The end of year values would not reflect the reduced DTLs and the increased tax-adjusted net investment base. Second, and more significantly, the proposal would ignore the non-cash income resulting from the reduction in the DTLs. The AAR's August 16, 2018 submission indicates that income resulting from the DTL adjustment amounts to approximately \$22 billion for the Class I railroads in 2017.

Absent the proposed adjustment, the increase in net income will dwarf the impact of the reduction in DTL-adjusted net investment base for determining revenue adequacy for 2017. As a result, all the Class I carriers will likely be revenue adequate in 2017 by a substantial margin without the proposed adjustment. In contrast, no more than a few carriers will likely achieve revenue adequacy if the proposal in the Notice is adopted.

The enormity of the margin does not make the analysis incorrect or misleading. The fact that the increased earnings results from taxes that the carriers will not have to pay in the future does not make them any less real. To quote from Warren Buffet's letter to Berkshire Hathaway stockholders in the 2017 annual report:

The \$65 billion gain [in Berkshire's income] is nonetheless real – rest assured of that. But only \$36 billion came from Berkshire's operations. The remaining \$29 billion was delivered to us in December when Congress rewrote the U.S. Tax Code.⁹

⁹See <http://www.berkshirehathaway.com/letters/2017ltr.pdf> at 3. BNSF accounts for over \$7 billion, or about one-quarter, of Berkshire Hathaway's \$29 billion.

The Board's stated concern is that the 2017 revenue adequacy flows from a one-time occurrence, *i.e.*, the tax cut, that does not represent the industry's financial state in 2017. Two responses are in order. The first is that the tax cut itself will persist, at least until the law is changed,¹⁰ and lower taxes will continue to translate into larger net earnings and ROI. Furthermore, the "lumpy" nature of the 2017 income arises because, at least in retrospect, an excessive amount of future tax liability was recognized in earlier years. Those earlier years cannot and should not be restated, but the income realized in 2017 should not be ignored.

The second is that the lumpy nature of the 2017 earnings can be addressed by assessing revenue adequacy on a multi-year basis. Consider, for example, a carrier whose ROI exceeded the cost of capital by 9 percentage points in 2017, but also had a revenue adequacy shortfall of 2 percentage points in each of the four following (or preceding) years, for a total of 8 negative percentage points. The carrier might be viewed as being revenue adequate in only one year out of five. The more meaningful assessment is that the carrier exceeded the cost of capital by a cumulative 1 percentage point over the five-year period. The multi-year approach conforms to how "revenue adequacy is a long-term concept that calls for a company, *over time*, to *average* return on investment equal to its cost of capital." *Coal Rate Guidelines, Nationwide*, 1 I.C.C.2d 520, 536 (1985) (original and added emphasis).

¹⁰ Some other aspects of the new tax law are scheduled to expire or be phased-out, but even that is subject to change. Also, the law allows some 2017 investments to be expensed, rather than depreciated.

For that very reason, the Board calculates its Revenue Shortfall Allocation Method (“RSAM”) ratios “by applying a multi-year average (we use a 4-year averaging period), so as to smooth out annual variations and minimize the impact of any year that may have been aberrational for that carrier.” *Rate Guidelines—Non-Coal Proceedings*, 1 S.T.B. 1044, 1032-33 (1996).¹¹ While the length of the measuring period and the standard for measuring revenue adequacy may be under consideration in EP 722, *Railroad Revenue Adequacy*, any multi-year period would spread the impact of the reduction in DTLs over time.

In contrast, the proposal in the Notice would cause \$22 billion in railroad earnings to disappear in an instant, never to be seen again when deciding if the railroads are generating adequate revenues or what markup, if any, is needed for determining RSAM ratios. The eradication of \$22 billion in railroad earnings is an affront to common sense and cannot be reconciled with the directive to conform to GAAP to the maximum extent practicable, particularly when the agency has elected to rely on the ratio of earnings to investment in assessing revenue adequacy to the effective exclusion of other factors.¹²

¹¹ The RSAM ratios are obviously linked to the ROI=COC test for revenue adequacy and would presumably also be affected by adoption of the proposal, yet RSAM is not included in the Board’s Notice. RSAM ratios are also used to determine market dominance under the Board’s limit pricing methodology.

¹² *E.g.*, *Consumers Energy Co. v. CSX Transp., Inc.*, NOR 42142 (STB served Aug. 2, 2018), at 21 (explaining that the annual ROI=COC test “incorporates the § 10704 statutory criteria” and “was specifically designed to operationalize” them).

While WCTL disagrees with the proposal to ignore the non-cash income resulting from the reduction in DTLs, WCTL agrees that the beginning and end of year balances for DTLs should be calculated the same way for revenue adequacy purposes for the sake of consistency. In that regard, the agency's practice has been to adjust the beginning of year values to match the tax rate basis for the end of year values, and not vice versa as suggested by the Board's Notice at 5 n.11.

In *Railroad Revenue Adequacy—1988 Determination*, 6 I.C.C.2d 933 (1990), we determined that we would adjust the beginning of year accumulated deferred tax balance [to reflect SFAS 96 and the Tax Reform Act of 1986). . . . Adjusting the beginning of year accumulated deferred tax account placed both the beginning and end of year balances for accumulated deferred income taxes under the same accounting principles.¹³

Restating the beginning of year DTL balances to reflect how the end of year DTLs are calculated using the new tax rate further buttresses the need to recognize the associated increase in earnings, as it is the restatement of the DTLs that give rise to the associated increase in earnings.¹⁴

¹³ *Railroad Revenue Adequacy Determination—1993 Determination*, 10 I.C.C.2d 189, 190 n.2 (1994) (continuing the procedure to account for changes resulting from FAS 106 (postretirement benefits other than pensions), FAS 109 (accounting for income taxes), and FAS 112 (postretirement benefits)).

¹⁴ The Notice also references *Railroad Revenue Adequacy—1986 Determination*, 3 I.C.C.2d 966 (1987). Notice at 3 n.6. But the agency in that determination noted that the choice of treatment would not cause any carrier to become revenue adequate and reiterated that the proper account treatment was to include the special charges above-the-line. 3 I.C.C.2d at 968. The 1986 Determination provides no basis for ignoring the earnings that would make all the carriers revenue adequate in 2017, and for some time beyond.

In short, the substantial income that the railroads earned in 2017 as a result of the tax cut should not be ignored for purposes of determining whether the carriers are revenue adequate. Consistent with agency precedent, the DTLs at the beginning of the year should be adjusted to match how the DTLs at the end of the year were calculated. Any concerns regarding whether the atypical nature of the 2017 income is not representative are best addressed by considering revenue adequacy over a multi-year basis.

VII. CONCLUSION

For the reasons stated, the Board's proposal is appropriate for URCS variable cost purposes, useful, but in need of improvement, for cost of capital, and very deficient for revenue adequacy. The treatment need not, and should not, be identical in each instance because each matter has its own purpose, time perspective, and related calculations and analyses for which internal consistency and integrity are needed.

For URCS purposes, DTLs and the gross-up should utilize the same tax rate in order to achieve consistency, as the Board proposes. Since 35% is the tax rate that applies for 2017, that tax rate should be used for both parts of the ROI calculation. For the MSDCF, the proposal recognizes that the one-time effects of the tax cut are not appropriate for the future cash flow inputs. However, the impact of the tax cut should be removed not only from the cash flows, but also from the earnings (cash flow) growth rates. For revenue adequacy purposes, the proposal errs by ignoring \$22 billion of the net income that the Class I railroads actually earned in 2017. To the extent the income may appear excessive in one year, the excess can be recognized over time, consistent with the

long-term nature of the revenue adequacy constraint and the Board's existing RSAM methodology.

Respectfully submitted,

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Dated: September 5, 2018

Its Attorneys

CERTIFICATE OF SERVICE

I hereby certify that on this 5th day of September 2018, I have caused true and accurate copies of the foregoing Comments of the Western Coal Traffic League to be served upon all parties on the service lists in EP 552, 558 (Sub-No. 21), and EP 750 by first class mail, postage prepaid, or by more expeditious means.

/s/ Robert D. Rosenberg