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Daniel R. Elliott, III
Chairman
Surface Transportation Board
395 E Street, N.W.
Washington, DC 20423-0001

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Re: STB EP 705 - Competition in the Railroad Industry

Dear Chairman Elliott:

In response to the Notice of the Surface Transportation Board ("STB" or "Board") in Ex Parte 705,¹ NRG Energy, Inc., ("NRG") urges the Board to: (1) update the current methodology used for calculating revenue adequacy; and (2) exclude acquisition premiums from the asset base of a Class I rail carrier when determining revenue adequacy.

The Board's competition and rate reasonableness policies were developed in the mid-1980s, when the financial condition of the railroad industry was weak. Since that time the industry has consolidated substantially, enabling the railroads to achieve a robust financial position. Today, the railroad industry is considered to be one of the most profitable in America,² yet no Class I railroads were determined to be revenue adequate under the STB's last revenue assessment.³ Accordingly, the Board should update its methodology for determining revenue adequacy by accounting for the dramatic change in the financial health of the railroads and eliminating acquisition premiums from its current cost of capital calculation.

I. REVENUE ADEQUACY

Flaws in the Board's revenue adequacy calculus make it unsuitable for the purpose for which it was created. The current calculation of both the cost of capital and the resulting revenue adequacy allows Class I carriers to benefit from the disconnect between the STB's definition of a financially successful company and the investment community's definition of a financially successful company.

There is a stark contrast between the results presented to Wall Street and the Board's finding that no Class I carrier was revenue adequate in 2009. One carrier reported a record operating ratio in 2009, yet they remained revenue inadequate. Moreover, the rail industry placed in the top five of 53 industries in *Fortune's*

¹ *Competition in the Railroad Industry*, STB EP 705 (Jan. 11, 2011).

² Staff of S. Comm. on Commerce, Sci. & Transp., 111th Cong., *The Current Financial State of the Class I Freight Rail Industry* 1, 14-15 (2010) (citing the Ass'n of Am. R.Rs. *Railroad Ten-Year Trends, 1999-2008* (Feb. 2010) (Report concluded that the four largest U.S. rail carriers have nearly doubled their collective profit margin in the last ten years, and that freight railroads are "now some of the most highly profitable businesses in the U.S. economy.").

³ *R.R. Revenue Adequacy — 2009 Determination*, STB Docket No. EP 552 (Sub-No. 14), slip op. at 1 (served Nov. 10, 2010).

list of most profitable industries in 2009.⁴ Clearly, the Board must revisit its method for determining revenue adequacy.

II. ACQUISITION PREMIUMS

The current practice of including acquisition premiums in a railroad's asset base for calculating revenue adequacy distorts the true financial health of a railroad. An acquisition premium is the difference between the price paid for an asset and the value of the asset. For example, when Berkshire Hathaway, Inc., acquired BNSF Railway, it paid an acquisition premium of \$7 billion above the book value of BNSF.

The Board's revenue adequacy determination is sensitive to acquisition premiums. The Board determines revenue adequacy by comparing the rate of return on investment to the current cost of capital.⁵ Because the Board's revenue adequacy calculus measures return on investment, calculating the investment base is "crucial."⁶ Overvaluing the investment will require a greater return to achieve revenue adequacy. Accordingly, including acquisition premiums in the investment base makes it more difficult to achieve revenue adequacy.

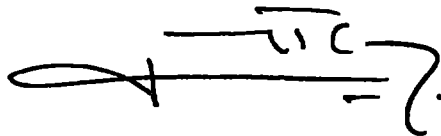
Acquisition premiums skew revenue adequacy determinations by artificially inflating the investment base. These premiums are not tied to the actual value of the assets acquired. Thus, by adding these premiums to the investment base, the railroads are rewarded for transaction inefficiencies and acquiring overpriced assets.

Acquisition premiums also make it more difficult for shippers to challenge a rail rate. Railroads can include acquisition premiums in their variable costs, which are used to determine the R/VC ratio. Since the ratio decreases as variable costs increase, acquisition premiums make it more difficult for shippers to meet the 180% R/VC threshold for challenging a rate.

* * *

For the reasons mentioned above, NRG respectfully requests the Board to consider changing both the calculation of revenue adequacy as well as the practice of including acquisition premiums in the asset base.

Respectfully submitted,



Mauricio Gutierrez
Chief Operating Officer

⁴ Fortune, *Fortune 500 Top Performers: Most Profitable Industries 2009*, <http://money.cnn.com/magazines/fortune/fortune500/2009/performers/industries/profits/> (last visited April 11, 2011).

⁵ *Standards for R.R. Revenue Adequacy*, 364 I.C.C. 803, 807 (1981).

⁶ *Id.* at 811.