

BEFORE THE
SURFACE TRANSPORTATION BOARD

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In the Matter of)

PETITION OF THE ASSOCIATION OF)
AMERICAN RAILROADS TO INSTITUTE)
A RULEMAKING PROCEEDING TO ADOPT)
A REPLACEMENT COST METHODOLOGY)
TO DETERMINE RAILROAD REVENUE)
ADEQUACY)

STB Ex Parte No 679

**WESTERN COAL TRAFFIC LEAGUE REPLY IN OPPOSITION TO
PETITION OF THE ASSOCIATION OF THE AMERICAN RAILROADS
TO ADOPT A REPLACEMENT COST METHODOLOGY
TO DETERMINE RAILROAD REVENUE ADEQUACY**

WESTERN COAL TRAFFIC LEAGUE

Of Counsel

Slover & Loftus
1224 Seventeenth Street, N W
Washington, D.C 20036
(202) 347-7170

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William L. Slover
Robert D. Rosenberg
Peter A. Pföhl
Slover & Loftus
1224 Seventeenth Street, N W
Washington, D C 20036
(202) 347-7170

Its Attorneys

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The Western Coal Traffic League ("WCTL" or "League")¹ hereby submits the following reply in opposition to the Petition of the Association of American Railroads ("AAR") to Institute a Rulemaking Proceeding to Adopt a Replacement Cost Methodology to Determine Revenue Adequacy ("Petition") that the AAR filed with the Surface Transportation Board ("STB" or "Board") on May 1, 2008. For the reasons explained below, the Board should not institute the rulemaking proceeding requested by the AAR

¹WCTL is a voluntary association, whose regular membership consists entirely of utility shippers of coal mined west of the Mississippi River that is transported by rail. WCTL members presently ship and receive in excess of 140 million tons of coal by rail each year. WCTL's members are: Alliant Energy, Ameren Energy Fuels and Services, Arizona Electric Power Cooperative, Inc., Austin Energy (City of Austin, Texas), CLECO Corporation, CPS Energy, Kansas City Power & Light Company, Lower Colorado River Authority, MidAmerican Energy Company, Minnesota Power, Nebraska Public Power District, Omaha Public Power District, Texas Municipal Power Agency, Western Farmers Electric Cooperative, Western Fuels Association, Inc., Wisconsin Public Service Corporation, and Xcel Energy.

PREFACE

The AAR has obviously devoted massive resources to the preparation of its petition. Fortunately, because of the petition's inherent defects, it is not necessary to engage in any extended treatment of AAR's proposed new methodologies.² This is so for several different and compelling reasons to which we now turn

I

THE AAR'S PROPOSED USE OF REPLACEMENT COSTS WOULD VIOLATE 49 U.S.C. § 10704(A)(2)

The AAR's Petition pays little attention to the relevant statutory provision addressing revenue adequacy, 49 U.S.C. § 10704(a)(2). This provision provides detailed guidance on the issues which AAR's petition implicates. The provision reads in its entirety as follows:

The 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 efficient management, 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

²Several of the defects are highlighted in Section V, *infra*

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

49 U S C § 10704(a)(2).

The statutory provision is entirely consistent with and indeed mandates the use of historical costs, and its directives to the Board cannot be reconciled with the use of the replacement costs which AAR seeks. Nothing in the provision supports or even mentions the use of replacement costs. Instead, Congress's directive to the Board goes to whether the rail carrier can cover its historical costs, *i.e.*, "total operating expenses, including depreciation and obsolescence," and "assure the repayment of a reasonable level of debt." These items are invariably considered in the context of historical costs, *e.g.*, depreciation, as it is commonly used, and debt relate to amounts that have already been spent for assets.

The statute also calls for a reasonable profit or return on capital and for "a flow of net income plus depreciation" to "support prudent capital outlays," "permit the raising of needed equity capital and cover the effects of inflation," and "attract and retain capital in amounts adequate to provide a sound transportation system in the United States." All of these precepts are antithetical to the use of replacement costs for all of a carrier's assets. Return and inflation are easily measured through the use of the nominal cost of capital as applied to historical costs, and the adequacy of capital can be and is normally effectively measured when the outlays need to be made, *i.e.*, when assets need to be renewed or replaced. In contrast, use of replacement costing would require that all of a carrier's assets be valued as if they were being replaced annually, even if the assets have long remaining useful lives. Premature replacement of assets is not "prudent" and is also

contrary to the "honest, economical, and efficient management" mandated under the statute

Implicitly recognizing the statute's hostility to its proposals, the AAR devotes substantial effort to claiming that historical costs are somehow arbitrary from an economic or finance perspective and that only replacement costs accurately depict a firm's health. If the AAR were correct, then one would expect to see replacement costs used regularly for both general financial reporting (generally accepted accounting principles or "GAAP") as well as regulatory purposes. But replacement costing is contrary to GAAP, and the AAR does not discuss or identify any other regulatory scheme that relies on replacement costs to determine a regulated firm's viability.

The terms and requirements of the statute clearly preclude the use of replacement costs as sought by AAR.

II

THE AAR PROPOSAL CONFLICTS WITH GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (GAAP)

The AAR's proposal to use replacement costs also runs afoul of another statute, namely, 49 U.S.C. § 11161, which, as a result of the ICC Termination Act of 1995, states that "To the maximum extent practicable, the Board shall confirm [its cost accounting] rules to generally accepted accounting principles."

General accepted accounting principles ("GAAP") require the use of historical costs and not replacement costs. For example, the Board most recently relied in part on the requirement to use GAAP in rejecting WCTL's recommendation that the Board, consistent with the practice of the financial community, treat operating leases as

debt for purposes of determining the railroads' capital (debt-equity) structure STB Ex Parte No. 664, *Methodology to be Employed in Determining the Railroad Industry's Cost of Capital* (STB served Jan. 17, 2008), at 15. In that instance, WCTL provided evidence demonstrating that the financial community (including at least two of the four largest Class I railroads) actually treat operating leases as debt for purposes of determining market capitalization Here, the AAR's failure to demonstrate that the financial community regularly values industries and firms on the basis of their replacement costs is glaring

III

THE AAR'S PROPOSED REPLACEMENT COST METHODOLOGY IS INCOMPATIBLE WITH THE BOARD'S COST OF CAPITAL METHODOLOGY

The statutory concept of revenue adequacy has other moving parts besides the value of railroad assets A most critical one is the cost of capital to the railroad(s) The Board's cost of capital methodology has just undergone a major review and revision, in which the Board has now endorsed and mandated the use of a new methodology for determining the cost of railroad equity which methodology employs a nominal cost of capital which by definition includes a component to reflect and account for inflation

The Final Report of the Railroad Accounting Principles Board ("RAPB," September 1, 1987, Volume II, Detailed Report) recognized that use of current asset valuation in conjunction with the nominal cost of capital would yield a double count of inflation

Asset valuation cannot be isolated from cost-of-capital rate determination A current-cost asset base requires either the use of a real cost-of-capital rate or the recognition of capital

gains or losses for the period of time in which assets are held³ Conversely, a historical-cost asset base requires the use of a nominal cost-of-capital rate to account for inflation in capital costs Since both the asset valuation and the cost-of-capital rate include the impact of inflation, a nominal cost-of-capital rate used in conjunction with a current-cost asset base would result in a double count of inflation in capital costs

RAPB at 60 The double count of inflation is thus a fundamental problem for which the AAR fails to provide a straightforward answer

The RAPB did go on to note that it “believes that current market valuation is preferable to historical valuation from a theoretical economic viewpoint ” *Id* However, the RAPB then noted “that serious practical problems are encountered in applying current market valuation for revenue adequacy determinations” and that a “reliable cost-of-capital rate, required in conjunction with a current cost asset base, is difficult to compute accurately ” *Id* at 60, 61. “Although numerous methods for estimating real cost of capital have been proposed, none appear to provide sufficiently reliable results [cross-reference omitted] Thus, the calculation of an accurate, stable, real cost of capital appears infeasible.” *Id.* at 41. Accordingly, “the RAPB selected the current nominal cost-of-capital rate,” *id* at 61, which then requires use of the historical asset base, or, more specifically, “historical cost net of accumulated depreciation ” *Id* at 60 “For certain regulatory applications, such as Revenue Adequacy , historical cost is more practical than current market value ” *Id* at 41

³The AAR does not propose to recognize any salvage value for the “used” railroad assets. Indeed, the difficulty of calculating that value is what ostensibly leads the AAR to propose use of brand new assets In fact, there is reason to think that a number of used railroad assets do have discernable values For example, a locomotive might be purchased at the end of its lease for fair market value, there are markets for used rail, etc

As the foregoing clearly shows, if AAR's replacement cost methodology were endorsed, the Board would not be able to meet its obligation to determine revenue adequacy without also revising its cost of capital methodology

IV

THE AAR'S PROPOSAL IS A DIVERSIONARY TACTIC

While the AAR and its pleading focus on how the Board could better measure adequate revenues, they conspicuously ignore the fact that revenue adequacy no longer has any practical place in the regulatory scheme. Indeed, in recent years, revenue adequacy has served solely as a foil to permit rail carriers to portray themselves as financially deprived before Congress and this Board.⁴

When first enacted, the Staggers Act envisioned a crucial practical role for revenue adequacy in its provision which permitted ratemaking flexibility for railroads which did not enjoy adequate revenues – the so-called ZORF provisions (former 49 U.S.C. § 10707a (1995)). The ZORF provisions and their revenue adequacy triggers were not favored by the railroads and were eventually eliminated from the regulatory scheme under the ICC Termination Act of 1995, leaving revenue adequacy without a practical role in the regulatory scheme. To be sure, the Board must assist railroads in attaining adequate revenues, but it has no special procedures to implement such assistance.

More importantly, the Board has never addressed the manner in which it will limit the rates and the rate increases of railroads which enjoy revenue adequacy. The

⁴The railroads are notably silent on revenue adequacy when it comes to Wall Street

Board has long been on record that revenue adequacy is a most important constraint in limiting the extent to which railroads can differentially price their services

Carriers do not need greater revenues than [the Revenue Adequacy Constraint] standard permits, and we believe that, in a regulated setting, they are not entitled to any higher revenues. Therefore, the logical first constraint on a carrier's pricing is that its rates not be designed to earn greater revenues than needed to achieve and maintain this "revenue adequacy" level. In other words, captive shippers should not be required to continue to pay differentially higher rates than other shippers when some or all of that differential is no longer necessary to ensure a financially sound carrier capable of meeting its current and future service needs.

Coal Rate Guidelines, 1 I C C 2d 520, 535-36 (1985) (footnote omitted)

Notwithstanding its clear and forceful conviction that carriers with adequate revenues should not be permitted to exploit captive coal shippers, the Board has never articulated the mechanisms of this constraint. Now that it has helped the railroads in attaining revenue adequacy through a series of decisions permitting the carriers to set coal rates with huge revenue/cost ratios, the time has come for the Board to come to the aid of shippers, especially captive shippers of coal, by articulating how it proposes to insulate captive railroad customers from exploitation by revenue adequate railroads. WCTL submits that tinkering with a concept that has no practical application is both a diversion and an inefficient use of resources. The Board should recognize that the revenue adequacy goal has been achieved as a consequence of the Board's past actions and decisions, especially those in coal rate cases. For example, Wall Street is now predicting that Union Pacific's earnings per share will experience a compound annual growth rate of 23% over the next five years and that its stock price may reach \$300 by early 2012.

Union Pacific Corp Conviction Grows in Long-Term Earnings Potential (Morgan Stanley, May 15, 2008). The Board should thus reject the railroads' petition and in its stead and on its own motion propose how it intends to constrain the rates of revenue adequate carriers – balanced administration of the Act requires no less

V

SPECIFIC DEFECTS IN THE AAR'S REPLACEMENT COST PROPOSAL

Even assuming *arguendo* that there were some sound reason to consider using replacement costs to measure the railroads' revenue adequacy (and there is not), the AAR's proposal suffers from a number of defects that should preclude the proposal from receiving any sort of meaningful consideration

Some of the most glaring defects are

- 1 Failure to identify and remove assets that will not be replaced in perpetuity
"The revaluation task is complicated by the need to identify and revalue existing assets which will not be replaced " RAPB at 61 Notwithstanding their perceived capacity constraints, the Class I railroads continue to reduce their trackage ⁵ With replacement costs, the railroads and their customers would likely learn to do without a significant portion of railroad assets A national railroad system designed from scratch today would look very different from the existing configuration

⁵According to the AAR publication, *Railroad Facts* (2007 edition, the most recent currently available), the Class I Railroads owned 167,312 miles of track in 2004 and 162,056 miles of track in 2006 The decline amounts to 3.14% over two years, which equates to a compound annual rate of 1.558% Over ten years, the trackage would shrink by over 16% ($1.01558^{10} = 1.167$).

- 2 Use of brand new assets will improve productivity, and the use of new assets and old productivity presents a mismatch. “Use of replacement cost for asset valuation and reported operating expenses based on existing assets violates the Data Integrity and Causality Principles. These operating expenses do not represent the use of the replacement assets and, therefore, do not reflect a causal relationship.” RAPB at 41
- 3 If replacement assets were utilized, depreciation (which the AAR adds to net income) would need to be adjusted accordingly. “Depreciation expense associated with current valuation must be derived to reflect the composition and life expectancy of a current cost asset base.” RAPB at 60
- 4 The AAR’s approach is ostensibly based on Simplified Stand-Alone Cost (“SSAC”), but the Board recognized in adopting SSAC that it would likely produce higher maximum rates than regular Stand-Alone Cost, *e.g.*, SSAC makes no effort to adjust for inefficiency, and the Board never suggested or implied that the approach could be used to value an entire railroad for revenue adequacy purposes. The AAR then exacerbates the bias inherent in SSAC by selecting only portions of the SSAC procedures to use in its proposed replacement cost procedure. Calculating the annual replacement cost of assets then becomes an extraordinarily complicated exercise that will severely strain the resources of all involved. The further irony is that this intricate, complicated approach comes from railroads that stridently

oppose anything simple as requiring fuel rate surcharges to track actual increases in fuel costs as "reregulation "

However, the biggest substantive problem in the proposed use of replacement costs is that it would impute a return on investments that the railroads have not yet made and, in many cases, will never make. If it were "economical" and "efficient" for the railroads to replace all their assets, they would do so. The fact that they have not done so, but instead regularly make what they elsewhere depict as substantial capital expenditures to maintain, renew, replace, and expand their assets, and in so doing are able to grow their traffic, revenues, and profits indicates that their actions are reasonable.⁶ Moreover, their ongoing success confirms that they are achieving "the revenue level necessary .. to compete equally with other firms for available financing in order to maintain, replace, modernize, and, where appropriate, expand facilities and services." *Coal Rate Guidelines*, 11 C.C. 2d at 535

By this measure, which is also the measure that Congress specified in 49 U.S.C. § 10704(a)(2), the railroads have achieved revenue adequacy. The AAR's petition is then an exercise in denial and diversion. The Board should deny the AAR's petition and instead turn its attention to developing a meaningful revenue adequacy constraint under constrained market pricing.

⁶The railroads' capital expenditures typically exceed their depreciation by a substantial margin, meaning that, on balance, railroad assets are getting younger not older, notwithstanding the use of historical costs. Oliver Wendell Holmes's *The Deacon's Masterpiece, or The Wonderful "One-Hoss Shay"* may be a fine poem, but it does not accurately depict railroad assets.

CONCLUSION

For the reasons stated, the Board should deny the AAR's Petition and instead commence proceedings, ideally through an Advance Notice of Proposed Rulemaking, on application of the revenue adequacy constraint

Respectfully submitted,

WESTERN COAL TRAFFIC LEAGUE

Of Counsel

**Slover & Loftus
1224 Seventeenth Street, N.W.
Washington, D C 20036
(202) 347-7170**

Dated May 21, 2008

**William L Slover
/s/ Robert D Rosenberg
Peter A Pfohl
Slover & Loftus
1224 Seventeenth Street, N.W
Washington, D C 20036
(202) 347-7170**

Its Attorneys