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**BEFORE THE
SURFACE TRANSPORTATION BOARD**

STB Ex Parte No. 646 (Sub-No. 2)

**SIMPLIFIED STANDARDS FOR RAIL RATE CASES – TAXES IN REVENUE
SHORTFALL ALLOCATION METHOD**

**COMMENTS OF THE
ASSOCIATION OF AMERICAN RAILROADS**

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The Association of American Railroads (“AAR”) submits these comments in response to the Board’s June 27, 2008 Notice in Ex Parte No. 646 (Sub-No. 2), *Simplified Standards for Rail Rate Cases – Taxes In Revenue Shortfall Allocation Method*. AAR was a participant in the proceedings that led to the Board’s adoption of the current Revenue Shortfall Allocation Method (“RSAM”) in *Simplified Standards for Rail Rate Cases*, Ex Parte No. 646 (Sub-No. 1) (STB served Sept. 5, 2007) (“*Simplified Standards*”).

The Board’s June 27, 2008 Notice requested comments on a proposed adjustment to the RSAM, one of three benchmarks used in small rate cases to assess the reasonableness of a challenged rate. The proposed adjustment would correct an error in the current RSAM formula, which fails to account properly for the effect of a railroad’s federal and state tax obligations.

For the reasons set out below, AAR believes that the Board should correct the RSAM formula so that the elements of that formula are all expressed consistently on a pre-tax basis. AAR further believes that the railroads’ statutory tax rates should be used to account for the

railroads' tax obligations. AAR describes a straightforward adjustment that can be made to correct the existing error.

I. Background

The RSAM was originally adopted by the Board in *Rate Guidelines – Non-Coal Proceedings*, 1 S T B 1004 (1996). The purpose of the RSAM is to identify the average markup that a railroad would need to charge “potentially captive” traffic – i.e., traffic moving at R/VC ratios above 1.80 – to earn adequate revenues. That original RSAM formula calculated the necessary markup based on the revenues that a railroad needed to earn from potentially captive shippers to recover the railroad’s total Uniform Rail Costing System (“URCS”) fixed costs. The RSAM formula included a provision for the taxes that must be paid on the revenue that the railroad needed to earn and was thus internally consistent in this regard. In *Simplified Standards*, the Board modified the RSAM formula. The Board’s new RSAM formula calculates the necessary markup based on the revenues that a railroad needs to earn from potentially captive shippers to achieve revenue adequacy as determined by the Board in the annual revenue adequacy proceedings under 49 U.S.C. §10704(a)(2). See *Simplified Standards*, slip op. at 20.

The RSAM is expressed as a ratio of revenue to variable cost. The current numerator of the RSAM ratio – revenue – is the sum of the total revenues earned by the railroad on traffic that has an R/VC ratio over 1.80 plus the amount of the computed shortfall necessary for the railroad to achieve revenue adequacy. The denominator is the total variable costs of traffic that has an R/VC over 1.80. The formula is set out below:

$$\text{RSAM} = (\text{REV}_{>1.80} + \text{REV}_{\text{short/overage}}) / \text{VC}_{>1.80}$$

In a rate reasonableness case involving the Three Benchmark Methodology, the RSAM ratio is compared to the average R/VC of all traffic that has an R/VC ratio over 1.80, and the ratio of

RSAM to $R/VC_{>180}$ is used to adjust the R/VC ratios of traffic in the comparison traffic group used to determine the maximum reasonable rate

The Board's new RSAM and Three Benchmark Methodology were finalized in September 2007 and first applied in the *DuPont/CSX* cases¹ See *E I DuPont de Nemours & Co v CSX Transportation, Inc*, STB Docket Nos 42099, 42100, and 42101 (STB served June 30, 2008) In those cases, CSX pointed out that the RSAM formula contained an error in the treatment of taxes See, e g, Opening Evidence of CSX Transportation, Inc, *DuPont v CSX*, STB Docket No 42099, at 22-24 (filed February 4, 2008) Specifically, the numerator of the RSAM formula is supposed to reflect the total revenues that a railroad needs to earn – before taxes – from traffic that has an R/VC ratio over 1.80 to become revenue adequate But the formula calculates that revenue need using the after-tax revenue shortfall calculated in annual revenue adequacy determinations As a result, the RSAM formula understates the revenues needed by a revenue inadequate railroad by failing to account for the amount of revenue that a railroad needs to pay its tax obligations

DuPont did not dispute CSX's claim that the RSAM formula was flawed Instead, DuPont argued that the flaw should not be corrected because the Board's treatment of taxes in its URCS calculations may have an offsetting impact on the error in the RSAM calculations In addition, DuPont argued that if any adjustment to the RSAM were to be made, it would not be appropriate to use the railroads' statutory tax rates DuPont also argued that it would not be appropriate to change the formula for calculating RSAM, which was the result of notice and comment rulemaking, in the context of an individual rate case See, e g Complainant's Reply Evidence, *DuPont v CSX*, STB Docket No 42099 at 27-30 (filed March 5, 2008)

¹ The RSAM formula adopted by the Board was introduced for the first time in the Board's final decision in *Simplified Standards*

The Board declined to address the merits of the arguments made by CSX and DuPont on changes to the RSAM formula, concluding that it was not proper to collaterally attack the mechanics of the Board's Three Benchmark Methodology (including the RSAM formula) or the Board's URCS calculations in an individual rate case. Instead, the Board indicated that it was instituting a new rulemaking proceeding, the present proceeding, to obtain comments on whether and how to change the RSAM formula to reflect taxes.

The Board's June 27, 2008 Notice initiating this proceeding asks interested persons to address 4 specific issues:

First, does the treatment of taxes in URCS make the adjustment to RSAM unnecessary, as DuPont suggested? Second, if an adjustment is appropriate, should the statutory, effective or marginal tax rate be used? Third, should the Board use the railroad's individual tax rate or an industry average tax rate? Finally, how should the appropriate tax rate be applied to calculate a pre-tax revenue shortfall?

June 27, 2008 Notice, slip op. at 3.

For the reasons set out below, AAR believes that the Board should correct the obvious flaw in the current RSAM formula without regard to DuPont's claims about the proper treatment of taxes in URCS. AAR further believes that a railroad's statutory tax rate should be used to adjust the revenue shortfall used in the RSAM formula to account for the railroad's federal and state tax liabilities. AAR presents a straightforward formula that can be used to implement such an adjustment.

II. The RSAM Calculations Are Clearly Incorrect And Should Be Changed To Reflect The Proper Treatment Of Railroad Tax Obligations.

There is no serious dispute that the RSAM formula has a flaw in the treatment of a railroad's tax obligations. The RSAM formula is supposed to reflect the total revenues that a railroad must earn before paying taxes in order to achieve revenue adequacy as determined by

the Board in the annual revenue adequacy proceedings. It is clear that the RSAM must be expressed on a pre-tax basis. The RSAM R/VC ratio is compared to an $R/VC_{>180}$, which is also based on pre-tax revenues, and the resulting RSAM/ $R/VC_{>180}$ ratio is applied to the R/VC ratios of comparison traffic, which are also based on pre-tax revenues. For these comparisons to make any sense, they must all be on the same pre-tax basis.

But the current RSAM mixes pre-tax and after-tax amounts to produce an R/VC ratio that is not meaningful. As noted above, in calculating the numerator of the R/VC ratio, the current RSAM adds to the *pre-tax* revenues earned on traffic with an R/VC over 1.80 the *after-tax* revenue shortfall calculated by the Board in annual revenue adequacy proceedings. Such a calculation fails to identify accurately the amount of revenues that a railroad must earn, before taxes, to achieve revenue adequacy – the stated objective of the RSAM calculation.

For a revenue inadequate railroad, the current RSAM formula understates the revenues that must be earned to achieve revenue adequacy because it fails to account for the additional revenues that must be earned to pay taxes. To produce a meaningful pre-tax revenue requirement, the after-tax shortfall must be adjusted to account for the railroad's tax liability on the additional revenues that a railroad must earn to achieve revenue adequacy.

In the *DuPont/CSX* cases, DuPont argued that the Board should decline to correct this flaw in the RSAM calculation because the Board's treatment of taxes in its URCS calculations offsets to some extent the effects of the RSAM flaw. DuPont argued that the Board's URCS calculations overstate a railroad's return on investment costs by multiplying the railroad's net investment base by a pre-tax weighted average cost of capital based on the federal statutory tax rate.

DuPont's URCS argument is a red herring. The Board's URCS methodology is not at issue in this proceeding, nor should it be. This proceeding addresses the validity of the Board's RSAM formula. Regardless of the merits of DuPont's concerns about the treatment of taxes in URCS, those concerns would not justify failing to correct a separate flaw in the Board's RSAM formula. It would be irrational to decline to correct an indisputable error in the treatment of taxes in the RSAM calculation simply because the Board's treatment of taxes in a different calculation produces an undefined and potentially offsetting effect. The Board's RSAM formula should be corrected so that it reflects the revenue requirement that the RSAM was designed to identify.

III. The Adjustment To RSAM Should Be Made Using The Statutory Tax Rate.

For the RSAM to be a meaningful benchmark, the revenues in the numerator of the RSAM ratio, including the revenue shortfall, must be stated on a pre-tax basis. Since the Board calculates the revenue shortfall on an after-tax basis, the revenue shortfall must be adjusted to include an allowance for taxes. The adjustment should be made based on the statutory tax rate.

Corporate taxes, like personal taxes, are progressive, *i.e.*, the tax rate increases as income increases. The corporate federal tax rate increases from 15% on the first dollar of income earned to 35% on income greater than \$10 million. Corporations earning more than \$18.3 million pay a flat 35% federal income tax rate. Any incremental revenue above \$18.3 million therefore incurs tax liability at the statutory tax rate of 35%. State tax rates are similarly progressive.

The actual amount of taxes paid by a railroad in a particular year may be affected by loss carryforwards or carrybacks, but the railroad's tax liability for a particular year is defined by the statutory tax rate. Loss carryforwards and carrybacks affect only the timing of tax payments, not the amount of tax liability. To ensure that a railroad earns sufficient revenues to cover its revenue adequacy shortfall, the railroad must earn an amount equal to its tax liability on the

incremental revenue. A railroad's tax liability is determined by the statutory tax rate, and therefore the statutory tax rate should be used to identify the pre-tax revenue shortfall

IV. The RSAM Adjustment Should Be Railroad Specific To Account For Different State Tax Liabilities.

The federal statutory tax rate applicable to railroads is 35%. That statutory tax rate is the same for all railroads, therefore the adjustment to the RSAM calculation to account for a railroad's federal tax liability does not have to be railroad-specific

However, the state statutory tax rates vary. Moreover, the amount of a railroad's state tax liability depends on the states in which individual railroads operate and the extent of a railroad's operations in individual states. In SAC analyses, the Board determines a state tax rate for the SARR by weighting the state tax rates of relevant states by the number of SARR route miles in each state. AAR believes that the same approach based on a railroad's route miles in a particular state should be used to produce a railroad-specific weighted-average state tax rate for use in adjusting the RSAM. Such an approach is simple to apply and produces consistent results across all railroads.

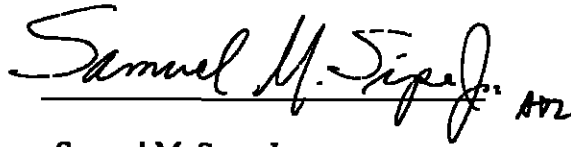
V. A Straightforward Adjustment Can Be Made To Ensure That The RSAM Accurately Reflects A Railroad's Revenue Shortfall.

A straightforward adjustment can be made to the Board's after-tax revenue adequacy shortfall to convert it to a pre-tax amount. The tax adjustment formula is best applied to the Board's calculated after-tax revenue adequacy shortfall by dividing the shortfall by one minus the combined Federal and state statutory tax rate in the following manner:

$$\text{Shortfall} / (1 - (\text{State Tax Rate} + (1 - \text{State Tax Rate}) * \text{Federal Tax Rate}))$$

The resulting pre-tax shortfall can then be added directly to R/VC_{>180} revenues in the existing RSAM formula to determine the RSAM for a particular railroad.

Respectfully submitted,

A handwritten signature in black ink, reading "Samuel M. Sipe, Jr." with a stylized flourish at the end.

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