

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

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EX PARTE 766

JOINT PETITION FOR RULEMAKING
TO MODERNIZE ANNUAL REVENUE ADEQUACY DETERMINATIONS

REPLY OF CSX TRANSPORTATION, INC.

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CSX Transportation, Inc. (“CSXT”) supports efforts by the Board to promote “evidence-based decisionmaking,”¹ including ways to adopt a more sound and sensible measurement for monitoring the health of the railroad industry. The Joint Petition for Rulemaking² is a positive step in that direction. It is a reasonable way to address well-known measurement flaws in the Board’s revenue adequacy determinations, while also responding to the recognized need for railroads to earn above their cost of capital – just like the peer companies with which railroads compete for capital. CSXT respectfully requests that the Board grant the Petition and initiate a rulemaking to consider the proposals put forward by the Petition.

While CSXT unreservedly supports the Petition, CSXT urges the Board not to lose sight of two other important considerations in this area. First, the Board cannot forget why replacement costs are so important in any long-term evaluation of the financial health of the railroads. We believe that replacement costs are feasible to determine and need to be taken into account in any long-term revenue adequacy determination in light of the Board’s charge from Congress to accurately monitor the financial health of the railroad industry. Second, the Board should formally reject any use of systemwide railroad revenue adequacy as a constraint on rates.³ Congress established revenue adequacy not as a cap on railroad revenue but as an aspirational goal.

I. The Board Should Grant the Petition and Consider a Comparative Approach to Annual Revenue Adequacy Determinations.

The Board should open a rulemaking to consider a comparative approach to annual revenue adequacy determinations, as proposed in the Petition. The comparative approach

¹ STB Fiscal Year 2020 Budget Request at 10.

² Joint Petition for Rulemaking to Modernize Revenue Adequacy Determinations, Ex Parte 766 (filed Sept. 1, 2020) (“Petition”).

³ See Comments of the Association of American Railroads, *Hearing on Revenue Adequacy*, Ex Parte 761 (filed Nov. 26, 2019), at 32–34.

proposed in the Petition would modernize the way the Board measures and understands revenue adequacy and would provide a more accurate picture of railroad financial performance.

Congress has charged the Board with assessing revenue adequacy on an annual basis, but the methodology for doing so has not changed in a generation. And the flaws in the Board's methodology are well-established. Some of these are measurement errors derived from the use of accounting measures for calculating return on investment ("ROI") and the distorted approach to deferred taxes. Moreover, a methodology that defines "revenue adequacy" as earnings that exceed the cost of capital by \$0.01 is at odds with Congress's recognition that railroads need to be allowed to earn a reasonable margin above the cost of capital if they are to attract necessary capital for investments.⁴

The methodology set forth in the Petition is a reasonable way to address these flaws. While use of accounting measures to calculate railroad ROIs is inherently inaccurate, if the Board compares those ROIs to those of other companies using the same methodology, it will have a more objective tool for assessing what railroad earnings mean. As Petitioners' data show, the fact that a railroad earns an ROI over the industry cost of capital does not mean anything other than that the railroad is performing like "any other business" with which it competes for capital. See Pet. at 3 (noting that Congress intended with Staggers to "treat[] the American railroad industry as any other business").

In short, the proposed approach would give the Board a rigorous, data-supported way to assess how railroads are performing relative to businesses with which they compete for capital and thus would result in a more accurate picture of the financial health and competitive nature of the railroad industry. The Board should open a proceeding to adopt the Petition's sensible approach to modernize the Board's revenue adequacy measurement.

⁴ See Pet. at 12–20.

II. Replacement Costs Remain an Important Consideration in Evaluating a Railroad's Financial Health.

While CSXT strongly supports the Petition, the Board should not forget that replacement costs are important to accurately evaluate railroad financial health. While the experts supporting the Petition recognize that “ideally” revenue adequacy determinations would measure replacement costs rather than accounting values,⁵ the difficulty with annually estimating replacement costs for all S&P 500 companies makes the use of accounting book values more practical for applying a comparative approach to annual revenue adequacy determinations. But the Board’s use of accounting net book values for annual determinations should not foreclose it from exploring ways to instead use replacement costs in any proceeding that seeks to determine railroad financial health on a long-term basis. The agency has recognized that using replacement costs is theoretically preferable to its current method for determining ROI using accounting measures.⁶ But it has held that using replacement costs to determine ROI is too difficult to achieve. *See* Pet. at 13. While determining ROI based on replacement costs may have its challenges, there are good reasons for the Board to explore viable ideas for how to do so in any proceeding where it is asked to determine whether a railroad is revenue adequate on a long-term basis.

As Petitioners and their experts explained, “[t]here is no way in which one can look at accounting rates of return and infer anything about relative profitability.”⁷ CSXT could not

⁵ Written Testimony of Prof. Kevin Murphy, Ph.D., et al., *Hearing on Revenue Adequacy*, Ex Parte 761 (filed Nov. 26, 2019) (“[A] revenue adequacy measurement ideally would assess the expected future rate of return on the replacement cost of a railroad’s assets, which better reflects the expected rate of return on incremental investment, not the rate of return on the accounting book value reflected on a balance sheet. For these reasons, there is no basis for the Board to determine that an ROIC above the cost of capital means that a firm is “revenue adequate” and absolutely no basis to assume that an ROIC at those levels should be a trigger for regulatory constraints.”).

⁶ *See, e.g., Standards for Railroad Revenue Adequacy*, 364 I.C.C. 803, 818 (1981) (cited in Petition at 13).

⁷ Pet. at 17; *see also* Pet. at 15–18; Written Testimony of Prof. Kevin Murphy, Ph.D., et al., *Hearing on Revenue Adequacy*, Ex Parte 761 (filed Nov. 26, 2019).

agree more. Railroads are different from the norm, in that they require substantial long-term infrastructure investments. The Board should not lose sight of the capital-intensive nature of the industry and the long-lived assets required for railroads to serve their customers. As CSXT observed in Ex Parte 761, “with the kind of durable and long-lived capital found in the rail industry, non-economic accounting measures of depreciated original book costs readily yield economically nonsensical conclusions as to the adequacy of revenues and returns.”⁸ Due to the Board’s current use of book costs, “its annual findings do not accurately gauge either: (i) whether a given carrier has earned adequate revenues; or (ii) whether the Board is discharging its responsibility to allow carriers to earn adequate revenues over the long term.”⁹ For example, CSXT demonstrated in 2019 that its replacement costs exceeded its net book value by over \$50 billion.¹⁰ A difference of \$50 billion (and that is only with regard to one railroad) reflects a fundamental inaccuracy that does not serve Congress’s purpose that the Board accurately monitor the financial health of the rail industry.

Moreover, the Board’s use of accounting costs to measure railroad ROI fails to reflect how investors assess the rail industry’s financial health. “[C]urrent investors are not interested in the original historic cost of rail assets” or “the depreciated original costs of those assets.” CSXT Opening Comments, EP 722, at 3. Instead, investors look at “the cost at which they could purchase those assets in a competitive market”—i.e., replacement costs. *Id.*

While determining ROI using replacement costs in the 1980s may have been infeasible, there are now multiple realistic ways to accomplish that goal. As CSXT pointed out in Ex Parte 722, Stand Alone Cost proceedings demonstrate that replacement costs can be reliably estimated by the Board using evidence developed by rail carriers and shippers. *Id.* at 20–22. In short, the perceived “practical difficulties” that may have existed for the ICC decades ago no longer

⁸ *Id.* at 16; see Opening Comments of CSX Transportation, Inc., *Railroad Revenue Adequacy*, Ex Parte 722 (filed Sept. 5, 2014) (“CSXT Opening Comments”), at 2, 11.

⁹ CSXT Opening Comments at 2.

¹⁰ CSXT Exhibits, *Hearing on Revenue Adequacy*, Ex Parte 761 (filed Dec. 10, 2019), at slide 4.

“justify the use of historical depreciated costs of assets in a long-term revenue adequacy analysis.” *Id.* at 26.

To be clear, CSXT fully supports the Petition without alteration or change and we recognize that the Petition’s comparative approach would require the use of accounting book values so that there can be apples-to-apples comparisons to non-railroads in the S&P 500 for the purpose of the annual determination. But the Board should not lose sight of the fundamental importance of replacement costs when evaluating the long-term financial health of a railroad, particularly in the context of a potential rate constraint.

III. The Concept of a Systemwide Revenue Adequacy Constraint Should Be Formally Abolished.

The Board should formally abandon the outdated and disproven notion that systemwide revenue adequacy (however measured) should be used as a constraint on the rate for a particular rail movement. It is not an economically valid concept. Indeed, Petitioners’ data empirically disprove it altogether by showing that there is nothing improper about railroads earning returns that exceed their cost of capital. *See* Pet. at 5 (“there is nothing unusual about a company earning an ROI above its cost of capital,” as “*a substantial majority of major public companies in nearly every industry is ‘revenue adequate’ under the Board’s current definition—but by margins that dwarf those achieved by any railroad.*”).

Any measure of revenue adequacy is irrelevant to what rate a specific customer should pay. As CSXT explained in the *Consumers* rate case, “the Board has recognized that system-wide revenue adequacy metrics are irrelevant to the reasonableness of a particular rate,” with the D.C. Circuit agreeing when it noted that “a test of ‘system-wide revenue need’ ... provides no guidance on the rates [a customer] should be charged for the particular facilities and services [the customer] uses.”¹¹

¹¹ CSXT Reply Vol. III, NOR 42142, at IV-5 (filed Mar. 7, 2016) (quoting *BNSF Ry. Co. v. STB*, 453 F.3d 473, 481 (D.C. Cir. 2006)).

Modern-day economists, as well as modern-day regulators, have rejected the notion of constraining rates based on earnings.¹² For example, Professor Joseph Kalt of the John F. Kennedy School of Government at Harvard University explained to the Board last year that “neither *book accounting* nor *economic* revenue adequacy can reliably identify above-competitive pricing.”¹³ Leading economists, including Professor David Sappington, Eminent Scholar in the Department of Economics of the University of Florida, Professor Jeffrey Macher, Professor of Strategy, Economics and Policy in the McDonough School of Business at Georgetown University, and Professor Kevin Murphy, the George J. Stigler Distinguished Service Professor of Economics at the University of Chicago Booth School of Business, all agree with Professor Kalt that using revenue adequacy as a basis for taking regulatory action, including constraining rates, would be economically unfounded and a grave policy mistake.¹⁴ What more does the Board need, as an evidence-based agency, to abandon the notion of a revenue adequacy constraint?

In addition to leading economists counseling the Board to abandon the notion of a revenue adequacy constraint, the data in the Petition, explained by Professors Murphy and Zmijewski, make clear that the rationale for a revenue adequacy constraint described in *Coal Rate Guidelines* has been empirically disproven. See Pet. at 5 (“Professors Murphy and Zmijewski show there is nothing unusual about a company earning an ROI above its cost of capital.”). It makes little sense for Congress to express an intent that the Board permit to the maximum extent possible competition as “the best control on the ability of railroads to raise rates,” while simultaneously subjecting railroads to limits on earning revenue above their cost of capital. See *id.* at 3, 10–11. As entities who must compete for capital with unregulated

¹² See Comments of the Association of American Railroads, Ex Parte 761 (filed Nov. 26, 2019), at 21.

¹³ AAR Exhibits, Ex Parte 761 (filed Dec. 10, 2019), at slide 6.

¹⁴ See Comments of the Association of American Railroads, Ex Parte 761 (filed Nov. 26, 2019), at 21–23; Verified Statement of Professor Kevin M. Murphy, Opening Comments of Union Pacific, *Railroad Revenue Adequacy*, Ex Parte 722 (filed Sept. 5, 2014), at 25–34.

businesses, railroad revenue adequacy should always be judged against the “unregulated marketplace[,]” which overwhelmingly earns returns over its cost of capital. *See id.* at 11.

CSXT agrees with Petitioners that Section 10704 obligates the Board to support the rail industry earning “revenue *above and beyond* the cost of capital.” Pet. at 10. This is because private investments in the rail network require revenues that exceed the cost of capital. CSXT explained in Ex Parte 761 that it makes investment decisions that anticipate returns above the cost of capital—just like any other U.S. business.¹⁵ Regulating railroad earnings on a systemwide basis would undermine private investment in the rail industry and the incentives that drive railroads to improve. This would not be consistent with Congress’s intentions to support a flourishing and competitive freight rail industry.

As railroads earn higher profits via increased efficiency, better management, and higher value services—all of which are incentivized by competition—railroads re-invest substantial amounts of those profits into the rail network, to the benefit of rail customers and the public.¹⁶ An artificial constraint on railroad profits based on system-wide revenue adequacy would not mean more competitive rates; rather, it would mean artificial distortions to market forces, less outside investment in the rail network, and less incentive for railroads to improve their efficiency, safety, reliability, and rates. *See* CSXT Opening Comments, Ex Parte 722, at 32 (“even if the Board were to develop a new revenue adequacy methodology properly based on replacement costs, evaluating and prescribing individual rail rates based on a system-wide revenue adequacy finding would create a strong risk of generating internal cross-subsidies, resulting in regulatory (rather than market-based) election of winners and losers, and distortions of markets and resource allocations”). And such a constraint would be particularly damaging to

¹⁵ CSXT Written Comments, Ex Parte 761 (filed Nov. 26, 2019), at 2.

¹⁶ *See generally*, CSXT Exhibits, Ex Parte 722 (filed July 22, 2015); July 22, 2015 Hearing Transcript, Ex Parte 722, at 193–207; CSXT Exhibits, Ex Parte 761 (filed Dec. 10, 2019), at slide 5 (noting that CSXT invested \$22 billion in the business from 2009–2018, 66% of Operating Cash Flows).

the rail industry, which requires higher capital investment. CSXT Exhibits, Ex Parte 722, at slides 6–9.

As CSXT explained at the Ex Parte 722 hearing, higher returns lead to more investment opportunities, and growth investments made by railroads create public benefits. See CSXT Exhibits, Ex Parte 722, at slide 13; July 22, 2015 Hearing Transcript, Ex Parte 722, at 274–75 (Mr. Eliasson explaining that CSXT is able to raise the capital it needs to re-invest in the network because CSXT has “the ability to earn a return above our costs of capital”); CSXT Exhibits, Ex Parte 761, at slides 2–3 (showing that future strategic investments exceed cost of capital and that improved performance encourages investment). CSXT further explained this point to the Board in Ex Parte 722: “If profits are ... capped and CSX [is not] allowed to earn more than the cost of capital, investors will demand less investment in the rail network and more immediate returns so that their money can be invested elsewhere where it has better risk/reward available. Why put your money in a business whose profits are capped at an ‘adequate’ level, without any protection for times when profits fall below that level? Many rational investors would conclude it is better to take their money out and invest it in another business” or to have CSXT invest in non-rail investments for them.¹⁷

In sum, a revenue adequacy constraint not only “contravenes rail law and policy established” since Staggers, but “could roll back much of the progress and improvements made during that time and impede further investments and improvements necessary to meet transportation needs and challenges in the coming years,” including the rail industry’s need to compete with the technological innovations of the trucking industry.¹⁸ For the above reasons, it is time for the Board to formally abolish any notion of a revenue adequacy constraint.

¹⁷ CSXT Letter, Ex Parte 722 (filed Aug. 6, 2015); Dec. 12, 2019 Hearing Transcript, EP 761, at 140–55, 160–67 (CSXT Testimony); see also Dec. 13, 2019 Hearing Transcript, EP 761, at 47–61 (Testimony of Mr. Scott Group).

¹⁸ CSXT Opening Comments, Ex Parte 722, at 32.; see CSXT Reply, Ex Parte 722, at 6; *see also* CSXT Reply Vol. III, NOR 42142, (filed Mar. 7, 2016), at IV-1 through IV-22.

CONCLUSION

For the foregoing reasons, the Board should grant the Joint Petition and open a proceeding to consider a comparative approach to its annual revenue adequacy determinations. The Board also should explore how to use replacement costs in any assessment of long-term railroad financial health and should formally abolish any notion of a revenue adequacy constraint.

Respectfully submitted,

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