

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

EX PARTE 766

**JOINT PETITION FOR RULEMAKING—ANNUAL REVENUE ADEQUACY
DETERMINATIONS**

OPENING COMMENTS OF JOINT CARRIERS

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May 17, 2021

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Exhibit 1: Verified Statement of Chris Neikirk

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INTRODUCTION

Union Pacific Railroad Company (“UP”), Norfolk Southern Railway Company (“NS”), and the U.S. operating affiliates of Canadian National Railway Company (“CN”) (collectively, “Joint Carriers”) thank the Board for opening this proceeding to consider the proposed modernization of annual revenue adequacy determinations proposed in their September 1, 2020 Petition for Rulemaking (the “Proposal”).¹ The Proposal provides an easy-to-implement evidence-based method for monitoring the health of the railroad industry in a more accurate way—one that aligns with congressional mandates, marketplace realities, and sound economics.

One important reality of the U.S. freight rail industry is the need to compete for capital. As Congress knew, attracting and retaining capital from private investors is a critical component to ensuring a sound transportation system in the United States. *See* 49 U.S.C. § 10704(a)(2)(B). The Joint Carriers’ Proposal, supported by leading experts in economics and accounting, proves that a company earning an accounting return equal to its cost of capital (COC) is not “revenue adequate” in the sense that Congress intended. To the contrary, such a company will not be able to attract needed capital in the long-run and is performing significantly below other companies with which it competes for capital.

The Proposal provides much-needed context from S&P 500 data to better understand how railroads are performing compared to their peer companies with which they compete for capital. In this way, the Proposal ensures that real-world data steer the Board’s assessment of railroad financial health. And, by discarding the outdated and arbitrary cutoff for revenue adequacy that the Board currently uses, as well as remedying measurement errors in the Board’s calculation, the

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

Proposal ensures that the Board’s revenue adequacy determination is based on sound economics.

Importantly, the Proposal would be easy to implement and verifiable. If the Board moves forward with the Proposal and chooses a benchmark point and a comparison group, the annual revenue adequacy proceeding would continue to be a simple mechanical exercise—but one designed to provide a more accurate assessment of railroad financial health. To be sure, annual calculations would not be determinative of long-term revenue adequacy, and parties to individual proceedings would remain free to argue about the relevance and accuracy of the annual determinations’ assessment of a railroad’s financial condition. But the Board would have a more robust set of default information that would allow it and other stakeholders to assess the financial health of railroads relative to that of companies with which railroads compete for capital.

Joint Carriers previously submitted extensive comments and testimony about their Proposal, which they will not repeat here. Instead, these opening comments are focused on the six questions that the Board asked parties to address in its December 30, 2020 Decision.² Joint Carriers look forward to reviewing and responding to any comments filed by other parties in this proceeding.

I. Response to Question 1: Joint Carriers’ Proposal Advances Each of the Components of 49 U.S.C. § 10704(a)(2).

The Board asked commenters to address how the Proposal “advance[s] or fail[s] to advance each of the components of 49 U.S.C. § 10704(a)(2).”³ One of the main purposes of the Proposal was to align the Board’s revenue adequacy

² See Decision, *Joint Petition for Rulemaking—Annual Revenue Adequacy Determinations*, EP 766 (STB served Dec. 30, 2020) (“Decision”), slip op. at 3–5.

³ Decision at 3.

determination with the requirements of § 10704(a)(2).⁴ Accordingly, and as explained below, each component of § 10704(a)(2) is advanced by the Proposal.

A. Component One: “Revise as Necessary”

The first component of section 10704(a)(2) requires the Board to “maintain *and revise as necessary* standards and procedures for establishing revenue levels for rail carriers.” 49 U.S.C. § 10704(a)(2) (emphasis added). This language indicates that the Board is free to, and should when “necessary,” revise its standards for measuring and understanding revenue adequacy. It is “necessary” for the Board to revise its revenue adequacy standards when it is presented with evidence that its annual revenue adequacy determinations are both inaccurate and inconsistent with statutory requirements and sound economics. Joint Carriers have presented the Board with just such evidence.

Joint Carriers have shown that the Board’s current methodology for calculating revenue adequacy is riddled with measurement errors that result in a distorted and inaccurate picture of railroad financial health.⁵ Even more significant, Joint Carriers have proven that railroads are not, in fact, “revenue adequate” as defined by section 10704(a)(2), when their accounting returns equal the rail industry’s average cost of capital.⁶ In particular, railroads earning “revenue adequate” returns under the Board’s current methodology are not earning an “economic profit or return,” § 10704(a)(2), but are instead earning, by definition, zero accounting profit—much less any economic profit, which is measured using replacement costs.⁷ Nor would such railroads be able, in the long term, to attract

⁴ See Petition at 8–10.

⁵ Petition at 15–20, 40–46.

⁶ *Id.* at 27–29.

⁷ *Id.* at 25–28.

and retain the capital necessary to support a “sound transportation system” in light of “present and future demand,” § 10704(a)(2), because they would not be able to offer investors a competitive return, as compared to other investment options in the marketplace.⁸

In light of the compelling evidence of significant problems with the Board’s current methodology, section 10704(a)(2) requires the Board to revise its revenue adequacy standards. In this way, the Proposal advances the first component of section 10704(a)(2).

B. Component Two: “Infrastructure and Investment” to “Meet the Present and Future Demand for Rail Services”

The second component of section 10704(a)(2) requires that any measure of revenue adequacy account for the fact that revenue levels must be “adequate, under honest, economical, and efficient management, *for the infrastructure and investment needed to meet the present and future demand for rail services.*” 49 U.S.C.

§ 10702(a)(2) (emphasis added). As Joint Carriers have explained, firms earning accounting returns equal to their cost of capital (*i.e.*, revenue adequate firms under the Board’s current methodology) are not earning revenue levels “adequate ... for the infrastructure and investment needed to meet the present and future demand for rail services.” *Id.* Rather, in order to make the significant capital investments necessary to maintain, improve, and expand the freight rail network, railroads must attract and maintain capital from private investors.⁹ To do this, railroads must compete for the necessary capital with all other private firms—the vast majority of which offer investors returns on investment well beyond their cost of capital (when

⁸ *Id.* at 28–29.

⁹ See Verified Statement of Chris Neikirk (“Neikirk V.S.”) at 1–2.

using the same methodology the Board uses to calculate railroad ROI and cost of capital).¹⁰

The Proposal would advance this component of section 10704(a)(2) by ensuring the Board measures revenue adequacy in a way that reflects the reality that railroads must compete for capital with such private firms and, in turn, must earn competitive returns beyond their cost of capital (again, using the Board’s methodology) to attract and retain the capital necessary “for the infrastructure and investment needed to meet the present and future demand for rail services.”¹¹ 49 U.S.C. § 10704(a)(2). In particular, the Proposal would provide the Board with a benchmarking tool that would enable it to view railroad returns in the context that matters: the market for capital (*i.e.*, the non-railroad companies with which railroads must compete for capital).

C. Component Three: “Plus a Reasonable and Economic Profit or Return (or Both) on Capital”

The third component of section 10704(a)(2) requires revenue adequacy to include revenue levels that are “adequate ... to cover total operating expenses, ... *plus a reasonable and economic profit or return (or both) on capital employed in the business.*” 49 U.S.C. § 10704(a)(2) (emphasis added). As Joint Carriers have explained, the Board’s current measure of revenue adequacy is inconsistent with this component of section 10704(a)(2). In particular, the phrase, “plus a reasonable

¹⁰ Petition at 5; *see* Verified Statement of Professor Kevin M. Murphy & Professor Mark E. Zmijewski (“Murphy & Zmijewski V.S.”), Table 7 (showing that 89% of the S&P 500 companies earn ROIs over their cost of capital when using the Board’s methodology for calculating railroad ROI and cost of capital).

¹¹ Murphy & Zmijewski V.S. ¶ 11 (“Railroads must compete for the necessary capital with the vast number of other private firms, not just in the United States but worldwide. ... Economic efficiency requires that railroads be able to aim for a rate of return greater than their cost of capital.”).

and economic profit or return (or both)” necessarily means a profit or return (or both) *above* the cost of capital.¹²

The Proposal would advance this component of section 10704(a)(2) by bringing the Board’s revenue adequacy methodology into compliance with this statutory requirement. In particular, the Proposal would define annual revenue adequacy as the point at which a railroad’s Adjusted STB ROI exceeds the industry cost of capital by more than the median S&P 500 firm’s ROI exceeded its cost of capital.¹³ In this way, the Proposal allows for both a “reasonable” and “economic” profit or return (or both).

The Proposal supports a “reasonable” economic profit by setting the benchmark at the median. As discussed in more detail below,¹⁴ the median indicates a normal return (indeed, the point of central tendency) in the competitive market in which railroads compete for capital.¹⁵ If a railroad earns “a rate of return net of cost of capital no higher than the ... median S&P firm, then there would be no presumption that [the] railroad[is] earning abnormal returns” unconstrained by competition.¹⁶

The Proposal advances the required “economic” profit by ensuring that revenue adequacy is defined to include returns over and above the cost of capital. By comparing railroad earnings to companies with which railroads compete for

¹² Petition at 27–29.

¹³ *Id.* at 20–21.

¹⁴ *See infra*, section III.

¹⁵ Petition at 21–22.

¹⁶ *Murphy & Zmijewski V.S.* ¶ 32. Of course, earnings equal to, or above, the median S&P 500 firm should not in any event create a presumption of anticompetitive earnings. Rather, earnings above the median for the benchmarking group could be “for procompetitive reasons—greater efficiency, benefits from risky investments, increases in demand that exceeded expected etc.” *Murphy & Zmijewski V.S.* ¶ 84.

capital, it is easy to see why earning returns over the cost of capital is normal, healthy, and expected in competitive markets. As Joint Carriers demonstrated in the Petition, a substantial majority of publicly traded companies in nearly every industry earn returns that exceed their cost of capital.¹⁷

D. Component Four: “Adequate and Continuing Effort to Assist”

The fourth component of section 10704(a)(2) states that the “Board shall make an *adequate and continuing effort to assist* those carriers in attaining revenue levels prescribed under this paragraph.” 49 U.S.C. § 10704(a)(2) (emphasis added). For the reasons explained in this section, the Board’s current definition of revenue adequacy fails to give it accurate guidance about its progress in “assisting” carriers in attaining revenue levels prescribed in section 10704(a)(2).

The Proposal would advance this component of section 10704(a)(2) by ensuring that the Board’s definition of revenue adequacy comports with Congress’s definition of revenue adequacy—namely, revenue levels that are: (i) sufficient to attract and retain equity capital; (ii) sufficient for the significant network investments needed to keep up with demand and support a sound transportation system; and (iii) sufficient to ensure a reasonable economic profit or return (or both) on capital. *See* 49 U.S.C. § 10704(a)(2). The benchmark approach proposed by Joint Carriers would ensure each of these characteristics are included in the revenue adequacy definition.

E. Component Five: “Permit the Raising of Needed Equity Capital”

The fifth component of section 10704(a)(2) requires that revenue adequacy be defined to include revenue levels that “provide a flow of net income plus depreciation adequate to support prudent capital outlays, assure the repayment of a

¹⁷ Petition at 36.

reasonable level of debt, *permit the raising of needed equity capital*, and cover the effects of inflation.” 49 U.S.C. § 10704(a)(2) (emphasis added). This component is similar to the second component and emphasizes Congress’s desire that the Board support railroads’ ability to compete for capital in competitive marketplaces. To support railroads in this way, the Board must aid railroads in earning returns over and above their cost of capital. There is no other way to ensure railroads are able to raise needed equity capital.

As the success of the Staggers Act has made crystal clear, when railroads are free to earn revenues over and above their cost of capital as a reward for procompetitive activity, everyone wins. Railroads are able to attract and maintain capital, which, in turn, leads to investments in the freight rail network, which, in turn, leads to greater efficiencies, enhanced safety, environmental benefits, and a myriad of customer benefits.¹⁸ The Proposal advances this component of section 10704(a)(2) by ensuring that revenue adequacy is defined in a way that promotes railroad returns beyond their cost of capital and, in turn, in raising needed equity capital.

F. Component Six: “Attract and Retain Capital ... to Provide a Sound Transportation System in the United States”

In order for a railroad to be deemed revenue adequate, the final component of section 10704(a)(2) requires that the railroad’s revenues be high enough to “*attract and retain capital* in amounts adequate *to provide a sound transportation system* in the United States.” 49 U.S.C. § 10704(a)(2) (emphasis added). As with components two and five above, it is clear that Congress has directed the Board to define

¹⁸ See, e.g., Comments of the Ass’n of Am. R.Rs., at 14, *Railroad Revenue Adequacy*, STB Ex Parte No. 722 (filed Nov. 26, 2019) (Figure 1 showing that after Staggers Act reforms, rail productivity and volume substantially increased, while average inflation-adjusted revenue per ton-mile decreased).

revenue adequacy in way that supports railroads' ability to attract and retain capital for the sake of investing in the freight rail network.

The Proposal advances this component for many of the same reasons stated above—namely, by defining revenue adequacy as a reasonable (*i.e.*, normal for the marketplace) return over and above the cost of capital, the Proposal would ensure that revenue adequacy is set at a revenue level sufficient to attract and retain capital needed to maintain, improve, and expand the rail freight network, as required by section 10704(a)(2).

In sum, the Proposal advances every component of section 10704(a)(2). Not only that, but it does so in a manner that is economically sound, transparent, and simple to implement.

II. Response to Question 2: The Joint Carriers' Proposal Is the Most Realistic and Economically Sound Way to Measure Revenue Adequacy in Accordance with § 10704(a)(2).

The Board has asked commenters to address whether there might be “other ways in which the Board’s current procedures could be modified to further advance the statutory goals of § 10704(a)(2).”¹⁹ As the freight rail industry has asserted for many years, the Board could advance the statutory goals of § 10704(a)(2) by using replacement costs, instead of accounting values, in the way it calculates revenue adequacy.²⁰ This change would reflect what § 10704(a)(2) requires: revenues sufficient for a reasonable *economic* profit or return (or both) on capital. The economic literature acknowledges that an economic return on investment (ROI) can be determined only by using the current replacement cost of assets.²¹

¹⁹ Decision at 4.

²⁰ Petition at 25–27; see Reply of CSX Transportation, Inc., *Joint Petition for Rulemaking to Modernize Annual Revenue Adequacy Determinations*, EP 766 (filed Sept. 21, 2020), at 3–5.

²¹ Petition at 29–31.

Joint Carriers recognize the Board has held it is too difficult to use replacement costs in its revenue adequacy measure.²² It is for this reason the Proposal sets forth a comparative approach that is able to mitigate measurement errors.²³ This is a next-best realistic option for aligning the Board’s revenue adequacy measure with the requirements of section 10704(a)(2). By applying the Board’s calculations (including the use of book value rather than replacement costs) to other S&P 500 companies, the Board will be able to view its revenue adequacy calculations in the context that matters—the returns of other companies in the marketplace with which railroads compete for capital. This approach is clearly consistent with 49 U.S.C. § 10704(a)(2), which, over and over again, emphasizes Congress’s desire that the Board support railroads’ ability to attract and retain needed capital.²⁴

III. Response to Question 3: The Board Should Use the Median S&P 500 Rate of Return as the Benchmark for Monitoring Revenue Adequacy.

The Board’s query as to why “the median S&P 500 firm’s differential [is] an appropriate benchmark and not, for example, the 25th, 33rd or 75th percentile” is a good question.²⁵ At the end of the day, section 10704(a)(2) does not define what a “reasonable” economic profit means—we only know that it means some *positive* amount of profit that exceeds the cost of capital (when using replacement costs).²⁶ Nor does section 10704(a)(2) define the precise revenue levels needed to attract and retain needed capital to meet demand and ensure a sound transportation system in the United States. Again, we know based on economic literature, expert testimony,

²² *Id.* at 30.

²³ *Id.* at 32.

²⁴ *See supra*, section I.

²⁵ Decision at 4.

²⁶ Petition at 27–31.

and marketplace realities that railroads need to earn returns over and above their cost of capital to achieve this congressional goal. All that to say, the concept of a bright line separating “revenue adequacy” from “revenue inadequacy” is, in and of itself, somewhat arbitrary and impossible to calculate with precision.

But Congress has instructed the Board to draw that line in the annual determinations. In carrying out that duty, the Board should choose a benchmark that is logically related to the goals and requirements of section 10704(a)(2). The Median S&P 500 Differential serves that purpose, because the median indicates the “typical” rate of return in the competitive marketplace (and thus the typical rate of return with which railroads compete for capital).²⁷ In this way, the median advances section 10704(a)(2)’s requirement that revenue adequacy include a “reasonable” economic profit.

If the Board is interested in using revenue adequacy data to determine whether railroad revenue levels indicate anticompetitive activity, using the median S&P 500 rate of return is a logical starting point. As the professors have explained, “[i]f the railroads earn a rate of return net of cost of capital no higher than the ... median S&P firm, then *there would be no presumption* that railroads are earning abnormal returns and can set rates without constraint from competition, or that shippers’ current protections under the Board’s SAC and related proceedings are not sufficient.”²⁸

While the Board could rightly conclude that a railroad whose ROI net cost of capital exceeded that of the median S&P 500 company was “revenue adequate” for

²⁷ Petition at 22, 32; Verified Statement of Gary Grosz (“Grosz V.S.”) at 2 (“comparing Union Pacific’s return on investment against the median return on investment of S&P 500 companies is a reasonable approximation of the competition that Union Pacific faces for investment”).

²⁸ Petition at 22; Murphy & Zmijewski V.S. ¶ 32 (emphasis added).

that year, there is no economic justification for presuming anticompetitive conduct in such a situation. There are many pro-competitive reasons why a firm can earn an above-average rate of return “that do[es] not signal market failure but instead more likely reflect[s] the opposite.”²⁹ Anticompetitive conduct can be determined only “after evaluating supply and demand conditions for a particular shipper and shipments (taking into account that a railroad must charge rates above variable cost to some shippers in order to be healthy in the long run).”³⁰

In the end, the STB has to select a non-arbitrary demarcation from this benchmark data. As the Board has reasoned in other rulemakings, “[i]n the absence of any better evidence,” it is reasonable for the Board to use the Median S&P 500 Differential as an approximate *starting point* for measuring revenue adequacy.³¹ If the revenue adequacy findings are ever used by the Board as a basis for regulatory action (despite the fact that such a course would be inconsistent with the statute and poor regulatory policy), parties would remain free to challenge the Board’s revenue adequacy findings in individual proceedings.³² At that point, parties could debate more complex and targeted ways of adjusting any imprecisions in the Board’s revenue adequacy measure. However, when it comes to merely monitoring railroad financial health, using the Median S&P 500 Differential is the most reasonable starting point for understanding what railroad revenues actually mean

²⁹ Murphy & Zmijewski V.S. ¶ 34; *see id.* ¶ 35 (“Finding that a railroad has achieved or exceeded the profitability of other competitive firms does not tell us that particular rail transportation rates are above or below a competitive level.”).

³⁰ Murphy & Zmijewski V.S. ¶ 35.

³¹ *Simplified Standards for Rail Rate Cases*, EP 646 (Sub-No. 1) (STB served Sept. 5, 2007), slip op. at 31.

³² *See, e.g., Consumers Energy Co. v. CSX Transp., Inc.*, NOR 42142 (June 15, 2015) (“agency precedent . . . states that the annual determinations are not necessarily conclusive evidence of a railroad’s financial condition in rate reasonableness proceedings”).

in the real world. “In the absence of any better evidence,” the point of central tendency in the data (*i.e.*, the median) is a reasonable benchmark for revenue adequacy.³³

In the end, the STB should be guided by competitive market data:

The goal of the Staggers Act—to rely on competition to the maximum extent possible to discipline rates and services provided by the railroad industry—provides guidance in interpreting a measure of revenue adequacy. The relevant question is *what rate of return is consistent with a competitive market and how does the profitability of the railroads compare with competitive market outcomes?*³⁴

In other words, the Board should look at the returns earned by companies in the marketplace—particularly companies with which railroads compete for capital—to determine what a “reasonable” economic profit looks like in a competitive market.³⁵

It should not be forgotten that the concept of revenue adequacy, as defined by section 10704(a)(2), is merely a monitoring tool for taking the temperature of railroad financial health. While firms earning less than the benchmark would be deemed “revenue inadequate” based on section 10704(a)(2)’s definition of revenue adequacy, that does not necessarily mean anything of regulatory significance. The same is true for firms that achieve “revenue adequacy” as defined by section 10704(a)(2). What is significant from a regulatory standpoint is: (i) whether, over time, *industry-wide* railroad rates of return are declining to such a degree as to suggest inappropriate regulatory interference; or (ii) whether, over time, *industry-wide* railroad rates of return are increasing in way not clearly consistent with

³³ *Simplified Standards for Rail Rate Cases*, EP 646 (Sub-No. 1) (STB served Sept. 5, 2007), at 31.

³⁴ *Murphy & Zmijewski V.S.* ¶ 31 (emphasis added) (internal footnote omitted).

³⁵ *Cf. Major Rail Consolidation Procedures*, 5 S.T.B. 539, 548 (2001) (noting that “returns on investment earned by major railroads ... are typically below those achieved by the industries they serve” and citing a *Fortune* magazine study that “rated returns on assets and on equity for major railroads as worse than **the median industry group**”) (emphasis added).

competition and potentially suggestive of anticompetitive activity unaddressed by the Board's existing tools and remedies.³⁶ The Board's monitoring authority under section 10704(a)(2) should be focused on these two questions—not on whether a firm is below or above the revenue adequacy cut-off point, which, without more analysis, tells the Board nothing of significance.³⁷

IV. Response to Question 4: The S&P 500 Benchmark Group Provides the Most Robust Data for Monitoring Revenue Adequacy.

The Board asked whether the S&P 500 Industrials or S&P 500 Customer benchmarking group, or an alternative benchmarking group, would be appropriate.³⁸ Joint Carriers maintain that using the S&P 500 Benchmark Group, as proposed, is the best approach. The S&P 500 Benchmark Group³⁹ would provide the Board with the broadest and most robust data for understanding railroad financial health. Any subset smaller than the S&P 500 Benchmark Group would exclude companies with which railroads compete for capital, and thereby exclude highly relevant context.

As the Board knows well, the freight rail industry is the most capital-intensive industry in North America. Customers and the wider economy alike

³⁶ Murphy & Zmijewski V.S. ¶¶ 31–32.

³⁷ See Murphy & Zmijewski V.S. ¶¶ 11, 22–27, 32, 44.

³⁸ Decision at 4.

³⁹ The S&P 500 Benchmark Group includes all S&P 500 companies, excluding railroads, financial institutions, and real estate companies. See Murphy & Zmijewski V.S. ¶ 63 & n.59. As explained in the Proposal, financial institutions and real estate companies have markedly different capital structures from most other companies that make them less useful comparators. See *id.* Joint Carriers note, however, that including financial institutions and real estate companies in their analysis does not materially impact the results. See Petitioners' Response to Replies, *Joint Petition for Rulemaking to Modernize Annual Revenue Adequacy Determinations*, EP 766 (filed Oct. 13, 2020) ("Response to Replies"), Supplemental Verified Statement of Professor Kevin M. Murphy & Professor Mark E. Zmijewski ("Murphy & Zmijewski Supp. V.S.") ¶¶ 4–6 & n.4.

depend on railroads to make consistent—and significant—capital investments in their networks. North American railroads reinvest roughly 20% of their operating revenue into infrastructure and make annual capital expenditures in the tens of billions of dollars.

As Congress has emphasized in section 10704(a)(2), attracting and retaining capital to ensure a sound transportation system in the United States is critical.⁴⁰ However, private investors have many choices in the marketplace. To both “attract and retain capital,” § 10704(a)(2)(B), railroads must compete “with the vast number of other private firms, not just in the United States but worldwide.”⁴¹ In other words, railroads compete for capital with *all* companies—not merely a subset of companies with similar characteristics.

For example, Chris Neikirk, Vice President and Treasurer for NS, explains that NS “competes with all companies for investor capital,” including “companies in the S&P 500.”⁴² For example, the “top three equity owners of NS stock” are “investors in the market at large” who “make investment decisions based on the likelihood of a strong return” regardless of company, industry, or level of regulation.⁴³ NS investors “do not limit their comparison group to other railroads or companies with similar capital structures” but, rather, “consider all alternative investment options in the market.”⁴⁴ Likewise, market analysts who cover NS “evaluate NS’s performance in the broader economy,” which “aligns with the way investors decide where to invest.”⁴⁵ The S&P 500, which is an important

⁴⁰ 49 U.S.C. § 10704(a)(2)(B).

⁴¹ *Murphy & Zmijewski V.S.* ¶ 11.

⁴² *Neikirk V.S.* at 3, 5.

⁴³ *Id.* at 3–4.

⁴⁴ *Id.* at 5.

⁴⁵ *Id.* at 4.

benchmark for the investor community, “is a realistic representative of the companies with which Norfolk Southern competes for capital.”⁴⁶

Similarly, Gary Grosz, Vice President and Treasurer for UP, explains that “Union Pacific competes with virtually every S&P 500-listed company for investment dollars when seeking investors for a debt or equity offering.”⁴⁷ When assessing potential investment opportunities, investors evaluate a company’s financial metrics “on a company-by-company basis without limiting their evaluation strictly to railroads or industrial companies ... [or] whether a company operates in a regulated environment.”⁴⁸ Rather, UP must “compare favorably on these metrics against all other investment opportunities, which are largely represented by companies in the S&P 500.”⁴⁹

In sum, the rail industry competes for capital with (at least) *all* publicly-traded firms, inclusive of the entire S&P 500. As the professors have explained, “[c]omparing the railroads’ financial performance to other firms with whom the railroads compete for capital is a reasonable proxy for whether railroads are earning sufficient returns to attract the capital needed to invest and maintain their systems in the long run.”⁵⁰ Thus, the most appropriate comparison group for measuring revenue adequacy is the S&P 500 Benchmark Group, as Joint Carriers initially proposed.

The Board also asked whether it is “appropriate to compare regulated entities like railroads with a group that includes a significant number of non-regulated entities, and—if not—[whether] there [is] a set of regulated companies that could be

⁴⁶ *Id.* at 5–6.

⁴⁷ Grosz V.S. at 1.

⁴⁸ *Id.*

⁴⁹ *Id.*

⁵⁰ Murphy & Zmijewski Supp. V.S. ¶ 4.

used as a comparison group.”⁵¹ The short answer is that there is no economic justification for limiting the comparison group based on whether companies are regulated or unregulated. Capital flow knows no such boundary. As just established, railroads compete for capital with *all* companies, regardless of the extent such companies are regulated.⁵²

Moreover, every company in the S&P 500 is regulated to some extent. Energy companies are subject to environmental regulations, telecommunications companies are subject to FCC regulations as well as public utility regulation, pharmaceutical companies are subject to FDA regulations, etc. Any attempt to draw a line between “regulated” and “unregulated” firms would inevitably be arbitrary.

Indeed, railroads are primarily *unregulated* companies—just as Congress intended. The vast majority of freight rail traffic is outside the Board’s jurisdiction, either because the traffic is exempted, because it moves pursuant to private contract, or because it moves pursuant to rates below 180 R/VC. Thus, it makes no sense to restrict the comparison group to “regulated” companies (whatever that might mean) when railroads themselves are primarily unregulated. Rather than resembling a “regulated” public utility, railroads much more resemble the typical “unregulated” private firm that is nevertheless subject to some applicable regulations.⁵³

⁵¹ Decision at 4.

⁵² See *Murphy & Zmijewski V.S.* ¶ 11; *Grosz V.S.* at 1–2; *Neikirk V.S.* at 3–4.

⁵³ See *Western Coal Traffic League—Pet. for Declaratory Order*, STB Finance Docket No. 35506 (July 24, 2013) (“Congress deliberately chose to move away from a public utility model of regulation for the railroad industry.”).

V. Response to Question 5: Changes Within the S&P 500 Are an Asset, Not a Liability, to the Benchmark Method.

The Board need not be concerned with the “changing constituency of the [S&P 500].”⁵⁴ Using S&P 500 data that reflects its changing constituency is the equivalent of cooking with fresh ingredients. Because the S&P 500 constituency is regularly refreshed, the Board’s data will reflect up-to-date market realities.

For example, when a company drops out of the S&P 500, that company is no longer a formidable competitor with Class I railroads for market capital.⁵⁵ Excluding that company’s data at the point it drops out of the S&P 500 does not skew the data but, rather, reflects market realities. In the same way, when a company is added to the S&P 500, that signals the company is a real competitor for capital whose data should be included in the Board’s comparative analysis. Thus, despite some changes in constituency, the S&P 500 remains a reliable index for the markets in which railroads compete for capital. Indeed, the S&P 500 remains accurate and reliable precisely because its membership changes slightly as the markets move and as companies change.⁵⁶

For these reasons, attempting to correct for companies entering and leaving the S&P 500 would be needlessly complex. One major benefit of using the S&P 500 as the comparison group is its defined boundaries, which would ensure that the annual revenue adequacy determinations remain simple and straightforward. Of course, parties to individual proceedings would be free to advocate for adjustments if they believed that churn in the S&P 500 had a material impact. But that sort of complicated statistical inquiry is inappropriate for the annual determination—a

⁵⁴ Decision at 4.

⁵⁵ See *Grosz V.S.* at 2 (explaining that the smallest companies removed from the S&P 500 “are generally no longer the major companies Union Pacific must compete with for investment”).

⁵⁶ See *Murphy & Zmijewski Supp. V.S.* ¶ 4.

starting point used for monitoring purposes where the agency has preferred a more mechanical application of established rules.

VI. Response to Question 6: The Utility Method Is Inappropriate for the Railroad Industry and Results in Inaccurate and Misleading Data.

With regard to the Utility Method of calculating deferred taxes, the Board first asked whether the ICC’s reasoning for adopting the utility method “remain[s] valid.”⁵⁷ As Joint Carriers have explained, the ICC’s rationale for adopting the Utility Method was never “valid” to begin with.⁵⁸ The Utility Method is a valuation method used for public utilities—which railroads clearly are not. As the Department of Transportation correctly observed in the 1980s, railroads (and their private investors) expect a return on all assets, regardless of how they are financed.⁵⁹ The “double benefit” theory on which the ICC based its decision to use the Utility Method applies only in the public utility context where firms are guaranteed a rate of return and permitted to immediately charge higher rates to cover the future deferred taxes.⁶⁰ It makes no sense to apply this theory to railroads, which do not have guaranteed returns and establish their rates based on market forces.⁶¹ The Third Circuit rightly recognized this problem when it observed that the ICC’s approach would disadvantage railroads in their ability “to *compete* for capital with unregulated firms which do retain the second benefit of an opportunity to earn a return on those funds.”⁶²

⁵⁷ Decision at 5.

⁵⁸ Petition at 13–14, 40–46.

⁵⁹ *See Standards for Railroad Revenue Adequacy*, 3 I.C.C.2d 261, 271 (1986) (“*Standards II*”); Petition at 38.

⁶⁰ Petition at 44–45.

⁶¹ *Id.*

⁶² *Consolidated Rail Corp. v. United States*, 855 F.2d 78, 90 (3d Cir. 1988) (emphasis in original); see Petition at 14, 46–47.

In any event, the Utility Method is certainly not valid today. As Joint Carriers have explained, the Utility Method produces absurd results that not only fail to reflect the economic reality of the firm, but also skew the average return figure higher than the actual average return.⁶³ Nearly every economist who has testified on this issue has agreed that a flow-through approach, rather than the Utility Method, is appropriate for the railroad industry.⁶⁴ In particular, the professors have explained that using a flow-through approach to calculate deferred taxes “is consistent with basic valuation principles.”⁶⁵

Second, the Board asked whether it is appropriate to analogize shippers served by a single railroad to utility customers.⁶⁶ It is not. Nothing about regulating railroads should be analogized to public utilities—even when it comes to solely-served shippers.⁶⁷ Congress has already defined the remedies the Board can offer solely-served shippers, and none of those remedies involve treating railroads like public utilities.⁶⁸ Congress was clear that the Board should “treat[] the American railroad industry as any other business.”⁶⁹

⁶³ Petition at 40–44.

⁶⁴ *Id.* at 38–39.

⁶⁵ *Id.* at 39; see Murphy & Zmijewski V.S. ¶¶ 57–58.

⁶⁶ Decision at 5.

⁶⁷ See *Western Coal Traffic League—Pet. for Declaratory Order*, STB Finance Docket No. 35506 (July 24, 2013) (“Congress deliberately chose to move away from a public utility model of regulation for the railroad industry.”).

⁶⁸ See 49 U.S.C. § 10707.

⁶⁹ *Burlington N. R.R. Co. v. Pub. Util. Comm’n of Texas*, 812 F.2d 231, 235 (5th Cir. 1987) (citing 126 Cong. Rec. 28,431 (1980) (statement of Rep. Staggers)); see 49 U.S.C. § 10101(1)–(2) (“it is the policy of the United States government ... to allow, to the maximum extent possible, competition and the demand for services to establish reasonable rates” and “to minimize the need for Federal regulatory control over the rail transportation system”).

Third, the Board asked whether the Utility Method conforms to GAAP.⁷⁰ The DOT's answer to this question in *Standards II* remains correct today—GAAP offers no guidance on how to calculate the return on invested capital. Neither the Utility Method nor DOT's preferred flow-through method are required by GAAP. And, as the professors have explained, it is the flow-through approach, not the Utility Method that is “consistent with basic valuation principles.”⁷¹

Fourth, and finally, the Board asked whether the Utility Method results in a more accurate representation of railroad profitability. As Joint Carriers have shown at great length, the Utility Method results in absurd results and a distorted picture of railroad financial health.⁷² This was illustrated most plainly in 2017 when changes in corporate tax rates would have resulted in dramatic changes to revenue adequacy results with no correspondence to actual economic performance—had the STB not manually manipulated the Utility Method back to reality. Moreover, because the Utility Method removes deferred taxes from a railroad's investment base (rather than addressing deferred taxes as they show up in the company's cash flow), it artificially inflates returns, distorting the picture of railroad financial health the Board is tasked with measuring.⁷³ Using the Utility Method to calculate deferred taxes is the exact opposite of evidence-based and data-driven regulatory action. Far from increasing accuracy, the Utility Method produces indefensibly arbitrary results.⁷⁴

⁷⁰ Decision at 5.

⁷¹ Murphy & Zmijewski V.S. ¶ 57.

⁷² See Petition at 40–46.

⁷³ See Petition at 42–44; Response to Replies at 14.

⁷⁴ See Petition at 40–46.

CONCLUSION

For the reasons herein, and those set forth in the Proposal, Joint Carriers urge the Board to adopt the Proposal, as proposed, which would advance every component of 49 U.S.C. § 10704(a)(2), align with sound economics, reflect marketplace realities, and be transparent and simple to implement.

Respectfully submitted,

/s/ Raymond A. Atkins

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May 17, 2021

EXHIBIT 1

Verified Statement of Chris Neikirk

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

STB Ex Parte No. 766

***JOINT PETITION FOR RULEMAKING —
ANNUAL REVENUE ADEQUACY DETERMINATIONS***

VERIFIED STATEMENT OF CHRIS NEIKIRK

My name is Christopher R. Neikirk. I currently serve as Vice President and Treasurer for Norfolk Southern Corporation, a role I assumed in June 2020. My department is responsible for Corporate Finance, Treasury Operations, and Investor Relations. In my current role, my responsibilities include managing Norfolk Southern's capital structure, investments, and relations with our investors. Immediately prior to my current position, I served for eight years as Assistant Vice President Finance. I hold a Bachelor's of Arts in Economics from The College of William and Mary and a Masters of Business Administration from the University of North Carolina.

Given my current role and experience with NS investors, I am intimately familiar with which companies NS competes with for capital.

**I. ATTRACTING AND RETAINING INVESTORS ARE CRUCIAL TO NS's
CAPITAL INVESTMENTS**

The railroad industry is one of the most capital-intensive industries in the U.S. On a yearly basis, Norfolk Southern makes significant capital investments in an effort to increase capacity, implement new and advanced technology, improve service,

and maintain and expand the NS network. In addition, a significant amount of capital is required annually to maintain our vast infrastructure. This consistent, strategic investment in the NS network benefits shippers by allowing NS to offer higher quality service and network fluidity to its customers system-wide.

In 2020 alone, and in the face of COVID-19 pandemic-related headwinds, NS funded \$1.5 billion in capital improvement projects, including investments in technology, track and rail infrastructure and in modernizing our locomotive fleet. NS deployed advanced technologies to enhance safety, increased productivity to better serve our customers, and assisted 86 businesses in opening new or expanded rail-served facilities on our network to serve a diverse mix of business sectors. Each of these projects requires considerable capital investment and would not be possible without the continued support of NS's investors.

To continue making important capital investments to its rail network, NS must not only attract but also retain debt and equity investors. Investors consider a multitude of factors when making investment decisions, but one of the guiding principles investors look to is whether a company's economic returns exceed its cost of capital, that is, whether the company is making some form of economic profit. Without assurance that a company is able to earn or exceed its cost of capital (based on economic returns), it becomes difficult for an investor to make a good faith decision to entrust a company with its capital.

NS's investors are critical to the services NS provides. NS's success in attracting and retaining investors directly impacts its ability to invest in its rail

network. Whether NS has sufficient assets to serve its customers and build its business relies largely on those investors.

II. NS COMPETES WITH ALL COMPANIES FOR CAPITAL

NS competes with all companies for investor capital, not just with other companies in the transportation and logistics industry. As is commonly the case, most owners of NS stock and debt are either mutual funds or institutional shareholders. These investors are committed to making sound investment decisions for their respective owners and clients, and they consider investments in all companies in pursuit of that goal. The financial health of a company is a critical part of that consideration.

A. NS Investors, Like All Investors, View the Market Broadly

NS investors are not just railroad investors; they are investors in the market at large, with diversified holdings outside of the transportation and logistics industries. As of this writing, the top three equity owners of NS stock are The Vanguard Group, Inc., JP Morgan Asset Management, and BlackRock Institutional Trust Company, N.A. These large institutional investors make investment decisions based on the likelihood of a strong return, not their preference for a particular industry or company. Similarly, our debtholders, which include The Vanguard Group, Inc., Prudential Financial, Inc., and BlackRock, Inc., among many others, are also focused on NS's ability to earn attractive and consistent returns. In my experience, most investors seek a diversified portfolio that achieves favorable financial returns.

The vast majority of our investors' diversified holdings focus on a company's returns and return potential compared to a wide universe of investment options. These holdings span the technology, pharmaceutical, financial, and energy markets, among others. The outstanding debt and equity of NS, and even the rail industry in total, is quite small when compared to the outstanding debt and equity of the S&P 500, and even smaller compared to a more comprehensive investment universe. It is this extremely large set of investment options that diversified investors consider when they decide where to allocate their investments.

As such, NS competes with all of these firms for capital, regardless of how, and to what extent, they are regulated. Ultimately, our investors seek to place their investments with companies that will produce a favorable return on that investment, regardless of whether they manufacture wind turbines or transport them.

Our investors' view of the market is similarly reflected by the analysts who cover our business. Investment researchers cover all industries, not just transportation. For example, the 29 sell-side analyst firms that cover our company analyze not just surface transportation, but companies from all forms of industries, including financial institutions, utilities, technology companies, and the healthcare industry. Rather than limiting their analyses to comparisons with other railroads or transportation companies, their reports cover a variety of industries and businesses and evaluate NS's performance in the broader economy. This approach aligns with the way investors decide where to invest. When considering which stock to buy, investors want insights into a company's performance in the market, not in an

industry-specific vacuum. Most analysts cover the market broadly to meet that need, reflective of the investor community's overall goals.

B. The S&P 500 Is an Important and Appropriate Comparison Group

As explained, when assessing the value of investing in NS, investors consider a broad, heterogeneous comparison group. They do not limit their comparison group to other railroads or companies with similar capital structures. Rather, investors consider all alternative investment options in the market. This includes companies in the S&P 500, a stock market index that includes 500 of the largest publicly-traded companies in the United States. In reality, we compete for debt and equity capital with many more companies than the S&P 500, but the index is well-known and represents a sufficiently diversified basket of investments. Even individual shareholders will often compare the performance of stocks they hold to the S&P 500; its importance as a benchmark is well-established. Internally, we regularly compare our stock performance to the S&P 500 in addition to our peers. In addition, we compare our debt yields with all companies from all industries. However, the S&P 500 is sufficiently diversified and commonly cited with robust comparative financial measurements.

The S&P 500 is featured prominently in market guides, which offer data on equity returns and earnings per share growth. One of the top NS shareholders, JP Morgan Asset Management, publishes guides to the market. *See, e.g.,* JP Morgan, Market Insights, Guide to the Market, 2Q 2021, available at <https://am.jpmorgan.com/content/dam/jpm-am-aem/global/en/insights/market->

[insights/guide-to-the-markets/mi-guide-to-the-markets-us.pdf](https://www.fishbase.org/insights/guide-to-the-markets/mi-guide-to-the-markets-us.pdf). These guides are illustrative, identifying certain high-level considerations that investors take into account in their decision-making process. This example highlights the particular relevance of the S&P 500 to the investor community.

* * *

For all of these reasons, it is appropriate to compare the Class I railroads' financial health and ability to compete for capital with that of other companies with which NS competes for capital. However, in light of the fact that attempting to compare Class I railroads to every single capital competitor presents a real logistical challenge, the S&P 500 is a useful facsimile. Because the S&P 500 is a realistic representative of the companies with which Norfolk Southern competes for capital, I believe that the proposed approach—to use the median S&P 500 rate of return as a benchmark for whether railroads are earning sufficient returns to attract the capital we need—is a reasonable one.

VERIFICATION

I, Christopher R. Neikirk, verify under penalty of perjury that I serve as Vice President and Treasurer of Norfolk Southern Corporation, that I have read the foregoing document and know its contents, and that the same is true and correct to the best of my knowledge and belief.

Executed on: May 17, 2021

A handwritten signature in cursive script, reading "Christopher R. Neikirk", is positioned above a horizontal line.

Christopher R. Neikirk

EXHIBIT 2

Verified Statement of Gary Grosz

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

EX PARTE 766

JOINT PETITION FOR RULEMAKING—ANNUAL REVENUE ADEQUACY DETERMINATIONS

VERIFIED STATEMENT OF GARY GROSZ

My name is Gary Grosz. I am Vice President and Treasurer for Union Pacific Railroad Company. I have held this position for two years and I have worked in Union Pacific's Finance department for nearly 40 years. In my current role, I have primary responsibility for overseeing Union Pacific's public and private financing transactions and strategic initiatives related to financing decisions. As part of these responsibilities, I am charged with assisting Union Pacific in obtaining investments from outside parties through debt and equity offerings. I am submitting this statement based on my experience working for Union Pacific.

Union Pacific competes with virtually every S&P 500-listed company for investment dollars when seeking investors for a debt or equity offering. Investors evaluate potential investments by first looking at a company's financial metrics. This typically includes a company's profitability, revenue, asset value, liabilities, debt rating, and any other metrics that the investor may find useful. Investors will evaluate these metrics on a company-by-company basis without limiting their evaluation strictly to railroads or industrial companies. Investors also do not limit their investment options based on whether a company operates in a regulated environment. While the regulatory environment might factor into an investment decision, it is the company's financial metrics that generally drive investment decisions. In order to obtain investment dollars, Union Pacific must compare favorably on these metrics against all other investment opportunities, which are largely represented by companies in the S&P 500. There is

no reasonable basis to limit a comparison group only to railroads, industrial companies, or utilities because investors do not limit themselves in that way when comparing investment options.

Given how investors evaluate their investment options, comparing Union Pacific's return on investment against the median return on investment of S&P 500 companies is a reasonable approximation of the competition that Union Pacific faces for investment. The S&P 500 provides a reasonable comparison group because it is the most widely available sampling of companies with which Union Pacific competes for capital. Using the median of the S&P 500 companies also provides a reasonable comparison because it will exclude the outliers, meaning the comparison benchmark will not be skewed too high or too low. Union Pacific is generally not competing for investment against the very largest or very smallest companies, so using the median S&P 500 provides a non-arbitrary comparison group.

The occasional reconstitution of the S&P 500 also makes it a reasonable comparison group. Companies generally leave the S&P 500 when they become too small to meet the criteria for inclusion. Reconstitution ensures that the S&P 500 will remain a reasonable comparison group by removing the smallest companies, which are generally no longer the major companies Union Pacific must compete with for investment.

If Union Pacific is not able to earn a return on investment that compares favorably to other S&P 500-listed companies then it will be more difficult for Union Pacific to attract investment. Based on my experience, comparing Union Pacific's return on investment to the median return among S&P 500 companies would provide a reasonable comparison because it approximates the actual comparisons performed by outside investors.

VERIFICATION

I declare under penalty of perjury that the foregoing statement is true and correct to the best of my knowledge, belief, and information. Further, I certify that I am qualified and authorized to file this statement.

Executed on May 17, 2021.



Gary Grosz