

BEFORE THE
SURFACE TRANSPORTATION BOARD

RAILROAD COST OF CAPITAL - 2019) EP 558 (Sub-No. 23)

**PETITION FOR RECONSIDERATION
OF THE WESTERN COAL TRAFFIC LEAGUE**

WESTERN COAL TRAFFIC LEAGUE

Of Counsel:

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

Dated: August 25, 2020

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

Its Attorneys

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Pursuant to 49 C.F.R. § 1110.10, the Western Coal Traffic League (“WCTL”) seeks reconsideration of the decision that the Surface Transportation Board (“STB” or “Board”) served in EP 558 (Sub-No. 23) on August 5, 2020 (the “Decision”).

The Board’s decision involves material error in its exclusion of operating leases from the capital structure and in its stated basis for that exclusion. In stating that basis, the Board’s Decision relied on new evidence, and it is appropriate that WCTL have an opportunity to respond to that new evidence and provide its proper context.

The Board’s Decision states that “GAAP distinguishes between operating leases and finance leases as economically different transactions.” *Id.* at 5. In support, the Decision relies exclusively on two selected portions of “Section C” of FASB’s Update to ASU No. 2016-02. According to the Decision, the first, ¶ BC264, addresses how operating leases “are not ‘debt like’ but, rather operating in nature,” and the second, ¶ BC14, states “that these amounts ‘may not affect certain financial ratios that often are used in debt covenants,’ which implies that operating leases should not be treated as debt.” *Id.* WCTL respectfully submits that the Decision overlooks the context and thus misconstrues the intended meaning of the quoted language and overall purpose of the

Update. Fairly viewed, Section C provides strong support for including operating leases in the capital structure.

The discussion of operating leases not being “debt like” in ¶ BC264 follows the Update’s explanation of the need to list finance and operating leases separately in ¶ BC263: “Although all lease liabilities are measured in the same way, the Board concluded that separate presentation or disclosure should help a user to understand the liability balance to which the lessee’s lease costs, which differ in terms of recognition and presentation for finance and operating leases, relate.” Saying that operating leases differ from finance leases and should be listed separately on the balance sheet is not equivalent to saying that operating leases should be excluded from the capital structure. An earlier passage of the Update, at ¶ BC16b, highlights the economic similarity of operating and finance leases and recognizes the need to change GAAP to facilitate comparability and curtail gaming:

The existence of two very different accounting models in which the assets and liabilities associated with most leases [operating] were not recognized, but were recognized for a minority of leases [capital or finance] leases, resulted in transactions that were **economically similar** being accounted for very differently in the statement of financial positions. **That reduced comparability for users and provided opportunities to structure transactions to achieve a particular accounting outcome.** [Emphasis added.]

The Update thus stresses the similarity of the two types of leases and the need for comparable recognition. The two types of leases have differences, but operating leases are now no longer be excluded in the GAAP statement of financial position, which continues to be the result under the Board’s approach.

The Decision’s characterization of the lack of anticipated impact from the GAAP change in ¶ BC14c similarly ignores the larger context. FASB explains in the main text of ¶ BC14 that:

Regarding access to credit, outreach has demonstrated that **the vast majority of users**, including private company users, **presently adjust an entity’s financial statements for operating lease obligations that are not recognized in the statement of financial position under previous GAAP** and, in doing so, often estimate amounts significantly in excess of what will be recognized under Topic 842. [Emphasis added.]

In other words, the reason that the changed reporting may have no impact (“may not affect certain financial ratios that often are used in debt covenants”) is that the debt covenants already (“presently”) treat operating leases as part of debt. FASB is simply updating GAAP to conform to existing practice, which is to treat operating leases as debt.

The Update further explains that FASB’s purpose in making the change is to make the information available for use in assessing information -- including specifically for the capital structure. In particular, ¶ BC4 of the Update explains:

Given the objective of general purpose financial reporting [specified in ¶ BC2 as to “provide information that is useful in making business and economic decisions”], the Board also considered the objective of the leases project, which is to increase the decision usefulness and comparability among organizations by recognizing lease assets and lease liabilities on the statement of financial position and disclosing key leasing information. **For example, users of financial statements are interested in obtaining information about a lessee’s leasing activities, in general, to assess the cash flows, returns, and capital structure of the lessee** and to assess the lessee’s ability to meet financial commitments. Most users already make adjustments that are often based on incomplete information to a lessee’s reported statement of financial position to capitalize operating leases when

operating leases are significant to the lessee. [Emphasis added.]

The FASB Update states in ¶ BC8 that “Topic 842 provides transparent and economically neutral information about the assets and liabilities that arise from leases, **which is in contrast to the incomplete information provided about leases in previous GAAP that did not recognize the assets and liabilities that arise from most leases**” [emphasis added]. The Update further adds in ¶ BC8b that the new reporting requirements will “[i]mprove understanding and comparability of lessees’ financial commitments **regardless of the manner they choose to finance the assets used in their businesses**” [emphasis added]. In other words, FASB changed the reporting so that how entities choose to finance their assets -- equity, debt, operating lease, or finance lease -- should not hinder comparisons and in recognition that the previous treatment, such as excluding operating leases from matters such as the capital structure, led to incomplete and economically biased perceptions.

Accordingly, WCTL respectfully submits that ASU 2016-02 cannot fairly be read as requiring or even supporting the proposition that operating leases are to be excluded in assessing the capital structure of a covered entity. The purpose of ASU 2016-02 is to facilitate and support their inclusion.

Moreover, the railroads themselves have by their own actions recognized that operating leases should be considered as part of the capital structure. UP and NS, which together comprise over 69% of the composite sample for 2019, both treat operating leases as part of invested capital for purposes of determining long-term compensation for

their top executives. Starting in 2006, UP's annual reports have presented a ROIC (return on invested capital) calculation that includes the sum of equity, debt, and operating lease liabilities as invested capital. UP then adds: "We believe this measure is important to management and investors in evaluating the efficiency and effectiveness of our long-term capital investments, and we currently use ROIC as a performance criteria in determining certain elements of equity compensation for our executives." *See* UP Annual Report for 2006 at 29 (showing UP's ROIC calculation), www.up.com/investors/attachments/annuals/2006/annual_report.pdf. UP has included the same or nearly identical language in its subsequent annual reports and related text in its proxy statements.

NS similarly describes its ROAIC (return on average invested capital) for purposes of executive compensation at page 50 of its Proxy Statement for 2020. *See* <https://www.nscorp.com/content/nscorp/en/investor-relations/financial-reports/proxy-statements/2020-proxy-statement.html>. NS explains how the numerator and denominator are both "adjusted for the effect of capitalizing Norfolk Southern's operating lease obligations." NS began doing so in 2016.

In short, the railroads themselves, like investors, treat operating leases as part of the capital structure for purposes of achieving sound capital management. FASB itself recognizes that the same is true for users of financial statements generally and has been so for some time, and has acted to facilitate and standardize that practice. WCTL is asking the Board to do nothing more than conform to mainstream practice. To continue to do otherwise is to elevate form over substance, to continue to develop an opportunity

cost of capital for the railroad industry that intentionally deviates from investor perceptions and expectations, and thereby to persist in material error.

Respectfully submitted,

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/s/ Robert D. Rosenberg
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Dated: August 25, 2020

Its Attorneys

CERTIFICATE OF SERVICE

I hereby certify that on this 25th day of August 2020, I have caused true and accurate copies of the foregoing Petition for Reconsideration of the Western Coal Traffic League to be served upon all parties on the service list in EP 558 (Sub-No. 23) by first class mail, postage prepaid, or by more expeditious means.

/s/ Robert D. Rosenberg