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SURFACE TRANSPORTATION BOARD

STB Ex Parte No. 766

JOINT PETITION FOR RULEMAKING —
ANNUAL REVENUE ADEQUACY DETERMINATIONS

COMMENTS OF THE ASSOCIATION OF AMERICAN RAILROADS

By a decision served on December 22, 2020, the Surface Transportation Board opened this proceeding and sought public comment on a petition for rulemaking filed by several Class I railroads. The petition asked the Board to reform and update its procedures for determining which Class I rail carriers are earning adequate revenues each year under 49 U.S.C. § 10704(a)(3) in two respects. First, the petition proposed that the Board determine whether a railroad is revenue adequate by comparing the extent by which its return on investment exceeds the rail industry's cost of capital to the extent by which other companies in the S&P 500 exceed their cost of capital. Second, the petition asked the Board to modernize and simplify how it treats deferred taxes in the annual revenue adequacy determination.

The freight railroad members of AAR account for the vast majority of North American freight railroad traffic, mileage, employees, and revenue. AAR has actively participated in prior proceedings before the Board and its predecessor, the Interstate Commerce Commission, regarding the methodology to be used in assessing the adequacy of railroad revenues under 49 U.S.C. § 10704. AAR has also actively participated in the Board's proceedings relating to the methodology to be used in calculating the railroad industry's cost of capital, an important

element in the Board's assessment of revenue adequacy. Both measures are used by the Board in various ways in the economic regulation of railroads. As such, AAR and its members have a vital interest in ensuring that the Board's annual estimation of which carrier have earned adequate revenues in a year is as accurate as possible.

These comments are organized as follows: first, the concept of adequate revenues is explored in the historical context in which it was added to the statute. Second, the comments show how the Board's current methodology to determine which rail carriers have earned adequate revenues in a given year overstates railroad revenue adequacy in three ways: by using accounting book value, instead of replacement cost, to measure the economic value of railroads' asset bases; by not including a reasonable economic profit; and by not properly accounting for the value of deferred taxes in that measure. Finally, the comments demonstrate that the statutory concept of adequate revenues should not be used to cap railroad rates based on firmwide earnings or returns.

COMMENTS

I. THE CONCEPT OF ADEQUATE REVENUES

The Board's notice focused on the statutory components of 49 U.S.C. § 10704(a)(2) and inquired how the Board can implement the goals of that section. That statutory provision states:

> (2) The Board shall maintain and revise as necessary standards and procedures for establishing revenue levels for rail carriers providing transportation subject to its jurisdiction under this part that are adequate, under honest, economical, and efficient management, for the infrastructure and investment needed to meet the present and future demand for rail services and to cover total operating expenses, including depreciation and obsolescence, plus a reasonable and economic profit or return (or both) on capital employed in the business. The Board shall make an adequate and continuing effort to assist those carriers in

attaining revenue levels prescribed under this paragraph. Revenue levels established under this paragraph should—

(A) provide a flow of net income plus depreciation adequate to support prudent capital outlays, assure the repayment of a reasonable level of debt, permit the raising of needed equity capital, and cover the effects of inflation; and

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

To fully consider the questions raised by the Board's notice, it is necessary to understand the context in which the relevant statutory directive arose.

The dire condition of the nation's railroads prior to regulatory reform in the 1970's and 1980's is well documented.[1] The bankruptcy of the Pennsylvania Central Railroad in June of 1970 was the largest corporate bankruptcy in history at the time and during the 1970s, virtually every major railroad in the Northeast and several major Midwestern railroads, filed for bankruptcy. More than 20 percent of the nation's rail route miles were on railroads operating under bankruptcy protection.[2] Several forces had converged to create this crisis. As inflation rose during the 1960s, the ICC infrequently granted rate increases to railroads and only after protracted administrative proceedings. The combination of the publicly funded interstate highway system, competition from trucks, and heavy-handed regulation by the ICC handicapped the railroads for decades as traffic left the railroads in favor of trucks. Between 1970 and 1979, the rail industry's rate of return on net investment never exceeded 2.9 percent

[1] *See*, *e.g.*, Robert E. Gallamore and John R. Meyer, *American Railroads: Decline and Renaissance in the Twentieth Century* 149-158 (2014); Paul Stephen Dempsey, *The Rise and Fall of the Interstate Commerce Commission: The Tortuous Path from Regulation to Deregulation of America's Infrastructure*, 95 Marquette L. Rev. 1151 (2012); *Railroad Regulation: Economic and Financial Impacts of the Staggers Rail Act of 1980*, United States General Accounting Office (May 1990).

[2] AAR Comments, EP 658, *The 25th Anniversary of the Staggers Rail Act of 1980: A Review and Look Ahead*, at 12 (filed Oct. 12, 2005).

and reached a low of 1.2 percent. The average rate of return had been falling for decades: 4.1 percent in the 1940s, 3.7 percent in the 1950s, 2.8 percent in 1960s, and 2.0 percent in the 1970s. These low returns meant that railroads lacked capital to maintain their infrastructure. In 1976, over 47,000 route-miles had to be operated at reduced speeds because of track conditions. Deferred maintenance was in the billions of dollars and the railroads experienced "standing derailments" — rail cars at rest simply fell off the track due to poor maintenance. Congress faced stark policy options if railroads were to continue in the United States: nationalization or deregulation.

Among the significant deregulatory pieces of legislation passed in the 1970s, the Railroad Revitalization and Regulatory Reform Act of 1976, often referred to as the 4R Act, provided,

> It is the purpose of the Congress in this Act to provide the means to rehabilitate and maintain the physical facilities, improve the operations and structure, and restore the financial stability of the railway system of the United States, and to promote the revitalization of such railway system, so that this mode of transportation will remain viable in the private sector of the economy and will be able to provide energy-efficient, ecologically compatible transportation services with greater efficiency, effectiveness, and economy….[3]

Prior to the 4R Act, rail rates had been set collectively in rate bureaus over a number of routes, and revenue divisions between carriers were based on particular regulatory formulae. General rate increases by groups of carriers for large bodies of rates were considered in Investigation & Suspension dockets by the ICC in prolonged cases and proceedings. Relatively few individual rate cases were considered, as the ICC principally focused on discrimination vis-à-vis other shippers and routes. Rates were often justified based on revenue necessary to

[3] 45 U.S.C. § 801.

cover the costs of the weakest carriers or the highest cost routes. The 4R Act marked a break with that philosophy and began the deregulation process by permitting railroads in competitive markets to raise and lower rates without the ICC's express involvement. The 4R Act directed the ICC to allow pricing freedoms, eliminated minimum rate regulation, and limited maximum rate regulation to instances where the carrier was found to have market dominance over the traffic at issue. And for the first time, the law directed the agency to assist carriers in earning adequate revenues, defining those revenues nearly identically to the current statute.[4]

Despite these reforms, railroad financial performance did not improve immediately. Congress held a symposium in 1977 regarding the agency's implementation of the 4R Act and on how regulations continued to hamper the railroad industry's ability to adjust rates, merge, and abandon obsolete services—all of which were seen as predicates to creating industry financial viability.[5] Despite the 4R Act, twenty-two percent of the U.S. rail system was facing bankruptcy in 1979.[6]

It was in this context that the bipartisan Staggers Act was passed. In signing the legislation, President Carter specifically noted railroads' poor financial returns:

> In recent decades the problems of the railroad industry have become severe. Its 1979 rate of return on net investment was 2.7 percent, as compared to over ten percent for comparable industries. We have seen a number of major railroad bankruptcies and the continuing expenditure of billions of Federal dollars to

[4] Railroad Revitalization and Regulatory Reform Act of 1976, P.L. 94-210, 90 Stat. 31, Sec. 205 (1976).

[5] *Railroads–1977 and Beyond: Problems and Promises: Congressional Symposium before the Subcomm. on Transportation and Commerce of the Comm. on Interstate and Foreign Commerce of the House of Representatives*, 95th Cong. 1 (1977).

[6] Macher, Jeffrey T, John W. Mayo and Lee F. Pinkowitz, "Revenue Adequacy: The Good, the Bad, and the Ugly," *Transportation Law Journal*, vol. 41 no. 2, (2014) (citing *Staggers Rail Act Oversight Hearings before the Subcomm. on Transportation., Tourism, and Hazardous Materials of the Comm. on Energy and Commerce of the House of Representatives*, 100th Cong. 13-14 (1987).

> keep railroads running. Service and equipment have deteriorated. A key reason for this state of affairs has been overregulation by the Federal Government. At the heart of this legislation is freeing the railroad industry and its customers from such excessive control.[7]

Reflecting its concern with the poor industry financial health, the Staggers Act provided a clear signal that market forces should regulate railroads in the first instance, and federal regulation, when necessary, should ensure that rail carriers could earn revenues that were adequate to "promote a safe and efficient rail transportation system." While leaving the concept of revenue adequacy unchanged from definitions established in the 4R Act, the Staggers Act pointed toward specific applications of revenue adequacy on a going-forward basis. The Act directed the ICC to determine annually which rail carriers are earning adequate revenues.

The statutory framing of the concept of adequate revenues remained unchanged for nearly 40 years until 2015, when Congress amended section 10704(a)(2) by inserting the phrase "for the infrastructure and investment needed to meet the present and future demand for rail services and" to the existing statute. That sentence now reads in full, "The Board shall maintain and revise as necessary standards and procedures for establishing revenue levels for rail carriers providing transportation subject to its jurisdiction under this part that are adequate, under honest, economical, and efficient management, for the infrastructure and investment needed to meet the present and future demand for rail services and to cover total operating expenses, including depreciation and obsolescence, plus a reasonable and economic profit or

[7] President Jimmy Carter, Staggers Rail Act of 1980, Statement on Signing S.1946 into Law (Oct. 14, 1980) *available at* The American Presidency Project. https://www.presidency.ucsb.edu/documents/staggers-rail-act-1980-statement-signing-s-1946-into-law.

return (or both) on capital employed in the business." That is, Congress clarified that the Board's standards for revenue adequacy must include revenues that are adequate to not only meet current expenses, maintain their infrastructure, and allow for a return on investment, but also for forward-looking investment necessary to meet future demand needs.

II. ANNUAL REVENUE ADEQUACY DETERMINATION

Thus, the statute has required since 1980 that the agency annually determine which Class I rail carriers are earning adequate revenues, as defined by Congress. The statutory definition of adequate revenues was "consistent with the general thrust of the Carter administration and Congress at that time to eliminate unnecessary regulation and better position governmental resources to complement and enhance the productivity and performance of the transportation sector. It is clear in this context that revenue adequacy was not meant to be an extra arrow in the regulator's quiver, but instead was fashioned to be a metric by which to judge the railroad industry's progress in achieving financial stability and a method by which to gauge how regulatory policies were enabling or hindering that effort."[8]

To make the annual revenue adequacy determination, the agency has adopted a methodology whereby it compares a carrier's return on net investment (ROI) with the rail industry's after-tax cost of capital for that year. If its ROI exceeded the cost of capital, the railroad is considered to have been revenue adequate for that year. The rail industry's current cost of capital is established annually by the Board as the composite of the current cost of financing (both debt and equity), weighted by the percentage of market values provided by each source. Current cost of debt is generally calculated using current market yields on

[8] Mayo, *et al.* at 10.

outstanding debt and current cost of equity is determined using the simple average of two methods: the Multi-Stage Discounted Cash Flow model ("MSDCF") and the Capital Asset Pricing Model ("CAPM").

The Board calculates ROI as net railway operating income divided by the railroad's net investment base. Individual railroad return on investment is determined based on data from the railroad's annual report R-1 schedule 250 filings. This basic formula used to determine whether a carrier is revenue adequate in a given year has been in place since 1981, though both the formula for cost of capital and for revenue adequacy have evolved somewhat over time.[9]

A. The Board's current methodology used in the annual revenue adequacy determinations overstates railroad return on investment.

The agency has correctly found that "[t]he cost of capital is the rate of return required of a firm by current and prospective holders of its securities. If a firm is unable to earn the cost of capital, investors will be unwilling to supply capital to it.... If railroads earn less than adequate rates of return because of inappropriate regulatory action, rather than because they are not providing a desired service, then the standards of the Rail Act and the clear thrust of congressional policy will be thwarted. *The minimum rate of return that will allow railroads to obtain investment funds is the cost of capital*."[10]

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[9] *See Standards for Railroad Revenue Adequacy,* 364 I.C.C. 803, 821 (1981), *aff'd sub nom. Bessemer & Lake Erie R.R. Co. v. ICC,* 691 F.2d 1104 (3rd Cir. 1982), *cert. denied sub nom. Western Coal Traffic League v. United States,* 462 U.S. 1110 (1983); *Use of a Multi-Stage Discounted Cash Flow Model in Determining the Railroad Industry's Cost of Capital*, EP 664 (Sub-No. 1) (STB served Jan. 28, 2009); *Petition of the Western Coal Traffic League to Institute a Rulemaking Proceeding to Abolish the Use of the Multi-Stage Discounted Cash Flow Model in Determining the Railroad Industry's Cost of Equity Capital*, EP 664 (Sub-No. 2) (STB served Oct. 31, 2016); *Petition of the Western Coal Traffic League to Institute a Rulemaking Proceeding to Abolish the Use of the Multi-Stage Discounted Cash Flow Model in Determining the Railroad Industry's Cost of Equity Capital*, EP 664 (Sub-No. 2) (STB served Apr. 28, 2017).

[10] *Standards for Railroad Revenue Adequacy,* 364 I.C.C. 803, 809-10 (emphasis added).

Given the history of the railroad industry prior to the 4R Act and Staggers Act, the annual revenue adequacy determination is intended to be a mechanical snapshot of railroads' financial performance, and nothing more. As such, the agency has rejected attempts to turn the revenue adequacy determination into a protracted, adversarial proceeding with multiple indicators weighed subjectively, noting "[g]iven the problems associated with implementing a multi-indicator standard, and our problems with all of the single indicator standards proposed by the parties, we continue to believe that our ROI/cost of capital standard is the most appropriate method for the determination of railroad revenue adequacy.... The ROI/cost of capital standard is an all-inclusive indicator of financial health because it embraces, albeit indirectly, short run financial considerations as well as the long run financial needs of the railroads."[11] Doing so, in general, meets Congress' intent for the 4R Act of "promot[ing] the revitalization of such railway system, so that this mode of transportation will remain viable in the private sector of the economy" and the Board's duty to assist carriers in earning adequate revenues.

However, the Board's implementation of the revenue adequacy concept systematically overstates the financial health of the railroad industry in three ways: (1) the methodology the Board uses in valuing the railroads' asset bases; (2) the failure to include a reasonable economic return over the cost of capital; and (3) the Board's treatment of deferred taxes.

[11] *Standards for Railroad Revenue Adequacy,* 3 I.C.C.2d 261 (1986).

B. The proper economic measure of the value of a railroad's asset base is replacement cost.

When the Board undertakes to determine each year whether each Class I railroad has earned a rate of return on the economic value of its investments that exceed the rail industry's cost of capital, it must value each carriers' asset base. To do so, the Board evaluates the accounting book value of the railroads' assets, which is the original cost of the asset less any depreciation. However, both economic theory and the statutory language related to revenue adequacy support replacement cost as the better measure of the economic value of railroads' investments. Adequate revenues under section § 10704(a)(2) must include, *inter alia*, revenues that are sufficient to: i) allow for "infrastructure and investment needed to meet the present and future demand for rail services;" and ii) provide for "a reasonable and economic profit or return (or both) on capital employed in the business." Rather than relying on accounting value based on prices when assets were purchased, replacement cost values assets at their current market value.

Even though the Board does not currently use replacement cost, it has repeatedly recognized that the best measurement of the economic value of a railroad's asset base would be the replacement cost of that base, not its accounting book value. The agency has stated that "[w]e continue to believe that replacement cost valuation can be preferable to original cost valuation. While the methods produce equal discounted cash flows, the regular and continuing calculation of depreciation charges and inflation adjustments under the replacement cost method may better reflect the true economic costs associated with an investment. Further, the

replacement cost method is preferable because it comes closer to the competitive result."[12] Nonetheless, the agency has also acknowledged practical challenges with implementing a replacement cost methodology in the annual determination. "While current cost accounting is theoretically preferable to original cost valuation, it cannot be practically implemented in a manner that we can be confident would produce accurate and reliable results."[13] Because of these practical challenges, the agency has relied on accounting methods of valuing the railroad asset base, even though replacement cost is the preferred economic valuation method.

In EP 722, AAR showed that it is uncontroversial today that the current replacement cost of assets is the economically appropriate value to be used for determining return on investment, consistent with the statute's directive to provide for an "economic profit or return."[14] AAR's witness, Professor Kalt, explained that *accounting* rates of return are not probative of whether a railroad is earning an *economic* rate of return that exceeds its cost of capital. As Professor Kalt noted, difficulty in using current replacement cost as a measure "cannot justify the use of economically incoherent rates of return on depreciated historical book value to determine whether a railroad is realizing 'excess revenues."[15] The analysis of another AAR expert witness, Dr. Brinner, concluded that the use of book value versus current replacement costs results in particularly overstated ROI calculations in the case of railroads

[12] *Standards for Railroad Revenue Adequacy,* 364 I.C.C. at 818.

[13] *Standards for Railroad Revenue Adequacy,* 3 I.C.C.2d 261.

[14] "In the calculation of the implicit rental rate of capital used to determine long-run economic profits, capital assets should be valued at replacement cost, which is the long-run cost of buying a comparable-quality asset." Dennis W. Carlton and Jeffrey M. Perloff, *Modern Industrial Organization* 247 (4th ed. 2015).

[15] EP 722, AAR opening comments at 8, Kalt V.S. at 31.

because of the extremely long lives of railroad assets."[16] Moreover, Dr. Brinner showed that the use of current-cost asset values reduces the rate of return for railroads and all comparison industries, but the disparity in the rate of return based on the book value and the current-cost value of assets is particularly great for railroads whose assets are among the longest lived of any industry.[17]

The use of replacement costs rather than accounting costs in contemplating whether revenues are adequate is also consistent with the statutory phrase "present and future demand for rail services." Currently, the Board uses historical cost to value rail assets; however, to meet the present and future demand for rail services, railroads must earn returns on the economic value of their investment. The rail network is not static. Investment needed to meet future demand is funded by revenues earned in the present. In determining whether a carrier is earning adequate revenues, the Board should consider the full economic value of the asset base.

C. The current methodology fails to provide a reasonable economic profit.

Section 10704(a)(2) states for a carrier's revenues to be considered adequate, those revenues must be sufficient to not only cover infrastructure costs and operating expenses, but also to earn a "a reasonable and economic profit or return." 49 U.S.C. § 10704(a)(2).[18] The term "reasonable and economic profit or return" must mean a profit (or return) above the cost

[16] *Id.* at 8, Brinner V.S. at 14-26.

[17] *Id.* at 8-9.

[18] As discussed above, because the Board assesses revenue adequacy using "accounting" profits/returns based on the book value of a carrier's assets, the Board's revenue adequacy calculations say nothing about the level of "economic" profit or return the STB is supposed to assist railroads in earning.

of capital, not equal to the cost of capital (as the Board currently measures revenue adequacy). For example, in *Bailey v. Allgas, Inc*., the Eleventh Circuit explained that "[e]conomists regard capital's opportunity cost as a cost and define economic profit as the return to investors above and beyond what is necessary to induce them to invest."[19] Likewise, the Transportation Research Board has stated that "zero economic profits" means "break even."[20] And the Antitrust Division of the Justice Department has recognized that accounting returns do not reflect "true economic rates of return."[21] The reference to "plus a reasonable" economic profit or return naturally implies some positive amount of profit.[22] Taken in the context of the statutory language, that positive amount of profit is over and above (i.e., "plus") the amount of revenues needed "for the infrastructure and investment needed to meet present and future demand for rail services and to cover total operating expenses," and not merely equal to it.

D. The Board's exclusion of credits for deferred taxes artificially lowers the value of the railroad asset base and leads to problems when tax laws change.

In addition to the measurement error introduced by using accounting measures of value of the asset bases, the Board's treatment of taxes in the revenue adequacy determination also distorts that calculation. The Board currently deducts deferred tax reserves from the net investment base in the revenue adequacy calculation and has since 1986, though the agency

[19] *Bailey v. Allgas, Inc.*, 284 F.3d 1237, 1252 n.21 (11th Cir. 2002) (emphasis omitted).

[20] National Academies of Sciences, Engineering, and Medicine 2015. *Modernizing Freight Rail Regulation*. Washington, DC: The National Academies Press. https://doi.org/10.17226/21759, at 125.

[21] U.S. Dep't of Justice, Competition and Monopoly: Single-Firm Conduct under Section 2 of the Sherman Act, Chapter 2 (IV)(A) (2008).

[22] *See, e.g., In re Coca-Cola Co*., 117 F.T.C. 795, 950 n.93 (1994) ("Economic profit accounts for the opportunity costs of all the assets that a firm uses in its business, while accounting profit reflects a firm's explicit historical expenditures.").

took a different approach previously.[23] The issue arises because of the Board's use of accounting book value discussed above and the accounting concept of accelerated depreciation. Before the Internal Revenue Code of 1954, taxpayers were generally limited to deductions for depreciation computed on the straight-line method. The straight-line method spreads the cost of a depreciable asset evenly over its useful life. Congress changed the law to permit most businesses, including railroads, to take greater amounts of depreciation in the early years of a new asset's life by using "accelerated" depreciation methods.

Accelerated depreciation does not increase the total depreciation that may be deducted over the asset's life. It simply allows increased deductions from taxable income in the early years of an asset's life, relative to amounts computed from straight-line depreciation, at the cost of reduced deductions in later years of the asset's life. Taxes are decreased in the early years of an asset's life but increased in its later years. Accelerated depreciation thereby defers taxes from early years to later years of an asset's life. Accelerated depreciation thus postpones the payment of taxes beyond the time such taxes would be payable if straight-line depreciation were used.

In the revenue adequacy determination, the agency subtracts credits on the carrier's balance sheet reflecting the railroad's deferred tax liability (if any) from the asset base. In so doing, the railroad is denied the benefit of accelerated depreciation in its valuation. The time value of the deferred taxes to the railroad in the revenue adequacy context is zero, ignoring the

[23] *Standards for Railroad Revenue Adequacy*, 3 I.C.C.2d 261 (1986), *aff'd sub nom. Consolidated Rail Corp. v. United States*, 855 F.2d 78 (3rd Cir. 1988) ("*Conrail*").

tax incentive of accelerated depreciation enjoyed by many other companies with whom the railroads compete for capital as the ICC has recognized in the past.[24]

1. The agency decided in 1986 to treat railroads like fully regulated utilities with regard to the treatment of deferred taxes in the revenue adequacy calculation.

The agency adopted this approach in 1986 and expressly decided to treat railroads like fully regulated utilities with regard to deferred taxes in the revenue adequacy determination. The ICC considered "three alternative procedures for recognizing the cost-free nature of deferred taxes. One would exclude accumulated deferred tax reserves from the net investment base, effectively eliminating any railroad expectation of pricing to earn a return on that part of the investment base obtained with cost-free deferred tax funds. (This alternative, called the "utility method," is the method used by most state regulatory agencies.) The second, called the "flow-through" approach, would exclude deferred tax expense in the calculation of net railway operating income (NROI), thus increasing a railroad's NROI and its resulting ROI. The third would treat accumulated deferred tax reserves as a zero-cost component of the railroads' capital structure when determining the composite cost of capital."[25]

In selecting the utility approach in 1986, the ICC was reversing its prior 1981 approach of including the value of deferred taxes in the asset base for the revenue adequacy calculation.[26] Both approaches were affirmed by the U.S. Court of Appeals for the Third Circuit. However,

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[24] *See Conrail,* at 90 (citing *Standards for Railroad Revenue Adequacy* 3 I.C.C.2d at 272).

[25] *Standards for Railroad Revenue Adequacy*, 3 I.C.C.2d at 276.

[26] *Standards for Railroad Revenue Adequacy*, 364 I.C.C. 803 (1981), *aff'd sub nom. Bessemer & Lake Erie Railroad Co. v. I.C.C.*, 691 F.2d 1104 (3rd Cir. 1982) ("Bessemer"). The ICC's 1981 decision was, in turn, a departure from its initial pre-Staggers decision to exclude deferred taxes from the net investment base. *Standards and Procedures for the Establishment of Adequate Railroad Revenue Levels*, 359 I.C.C. 270 (1978).

both courts recognized that the utility approach is inconsistent with the realities of the capital marketplace where most railroads compete. The *Bessemer* court recognized this fact, relying on the ICC's 1981 reasoning that excluding deferred taxes from the investment base would create a disincentive for railroads to invest in rail assets. *Bessemer*, 691 F.2d at 1116. The *Bessemer* court explained that: "[F]or all businesses accelerated depreciation is a source of funds which may be reinvested. If the railroad industry were to be put in the position that unlike unregulated industries it could not earn a rate of return on investment of such funds, it would be at a competitive disadvantage in seeking equity capital, and it would be encouraged to invest the funds generated from accelerated depreciation elsewhere than in the railroad business."[27]

Similar to *Bessemer*, the subsequent ruling by the *Conrail* court largely confirmed the ICC's 1981 reasoning notwithstanding the ICC's reversal, but the court ultimately concluded that the ICC could nonetheless, consistent with the statute, modify its revenue adequacy formula.[28] The *Conrail* court noted, "[g]iven the competition between the railroads and unregulated firms for capital, the railroads are substantially disadvantaged by being deprived of the opportunity to earn a return on the [deferred tax] funds in comparison to the unregulated firms, and therefore the incentive to all investors, including the railroads, is to invest in the unregulated firms...."[29] The court went on, recognizing the inequity in the ICC's decision:

> [S]o long as unregulated businesses provide a return on those assets while railroads do not, the incentive will be to invest in unregulated non-rail assets…. In comparison to unregulated businesses, the regulated railroad will yield an

[27] *Bessemer*, 691 F.2d at 1116.

[28] *Conrail*, 855 F.2d at 93.

[29] *Conrail* at 90.

> overall lower rate of return, due to the lowered rates resulting from the lower standard of revenue adequacy, which in turn results from the exclusion of the deferred tax funds from the investment base in calculating the standard. The ultimate result, then, is a disincentive to invest in rail assets due to the higher overall rate of return on non-rail assets. Therefore, we reject the claim that the exclusion will not create a disincentive to invest in rail assets.[30]

However, the *Conrail* court ultimately concluded that the decision to exclude deferred taxes was within the agency's discretion and adequately explained. But in adopting this utility method, even the ICC had noted that it "would affect each railroad differently, depending on the individual railroad's tax and investment situation and could "result in lower allowable rates of return for those railroads that have made the largest investment in new rail property."[31] Simply put, excluding deferred taxes from the net investment base, which signals that railroads are not expected to earn a return on that portion of their capital, creates a disincentive for further investment in railroad assets, which not only puts railroads at a disadvantage in the capital marketplace, but also runs counter to 10704(a)(2)'s direction that revenues be adequate for "infrastructure and investment needed to meet the present and future demand for rail services."[32]

2. <u>The agency's approach creates problems when the tax laws change.</u>

In addition to under-valuing the railroad's assets and thus overstating returns, the agency's treatment of deferred taxes also creates challenges when corporate tax rates change,

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[30] *Conrail* at 91-92.

[31] 3 I.C.C.2d at 277.

[32] 49 U.S.C. § 10704(a)(2). Further, as the ICC observed, "[f]or all businesses accelerated depreciation is a source of funds which may be reinvested. If the railroad industry were to be put in the position that unlike unregulated industries it could not earn a rate of return on investment of such funds, it would be at a competitive disadvantage in seeking equity capital, and it would be encouraged to invest the funds generated from accelerated depreciation elsewhere than in the railroad business." *Conrail* at 89 quoting ICC.

as illustrated in 2017. Changes to the corporate tax rate in the *Tax Cuts and Jobs Act of 2017* caused the need to revalue the credits associated with deferred taxes. Because the Board includes the effect of deferred taxes in Net Railway Income but excludes them from the asset base, the Board concluded that a one-time accounting adjustment was required to avoid distorting effects on measurement of the financial performance of the railroads.

Generally Accepted Accounting Principles require companies to recognize the effect of tax law changes in the period of enactment. As such, deferred income tax assets and liabilities as of year-end 2017 were required to be revalued using the new corporate tax rate. Because of this accounting, and irrespective of the actual financial impacts of the corporate tax rates, the revaluation of deferred tax credits resulted in a significant one-time non-cash reduction to income tax expense and, accordingly, significantly higher net income and net railway operating income for 2017.[33] The result was that the Board's standard procedures for revenue adequacy would have resulted in net income and net railway operating income that was 2 to 3 times higher in 2017 than in 2016 in the revenue adequacy determination. To address this issue, the Board instituted a proceeding, took public comment, and ultimately decided a one-time adjustment to the cost of capital determination, revenue adequacy determination, and URCS calculations in 2017 was necessary to remove the accounting impacts of the *Tax Cuts and Jobs Act* on rail carriers' deferred tax liability. The Board concluded that such an adjustment would "ensure that the Board's 2017 determinations and calculations are representative of the

[33] Some railroads' affiliates also revalued their deferred tax liabilities to reflect the lower federal corporate tax rate, which resulted in those railroads recognizing a non-cash benefit included in Operating Expenses (All Other Equipment Accounts) and Equity in Undistributed Earnings.

financial state of the railroad industry in 2017."[34] Such changes would likely be necessary as tax laws could change in the future. For example, changes in corporate tax policy are currently being debated in Congress as possible funding sources for infrastructure and other legislation. Given the questionable validity of excluding the value of deferred taxes for revenue adequacy purposes discussed above, this added complexity is unwarranted.

III. THE BOARD'S GOVERNING STATUTE AUTHORIZES THE BOARD TO MEASURE REVENUE ADEQUACY AS A GOAL TO BE INCENTIVIZED, NOT A VIOLATION TO BE PUNISHED.

As the foregoing makes clear, Congress has directed the agency to determine which carriers are earning adequate revenues each year and assisting all carriers towards that level.[35] From the beginning, in carrying out this statutory directive, the agency has used the comparison of ROI to COC to establish a *minimum* level of adequate revenues. The ICC explained in 1979 that its initial study of railroad revenue adequacy "was designed to compute a *minimum* adequate revenue level for the Nation's class I railroads; the methodology...is not necessarily appropriate for the determination of the maximum fair revenue issues involved in individual rate proceedings."[36] Likewise, in 1981, when the ICC adopted the current standard for its annual revenue adequacy measurement, the ICC properly concluded that earning a rate of return equal to its cost of capital was "the *minimum* necessary to attract and maintain capital in the railroad, or any other, industry…. If a firm is unable to earn the cost of capital, investors will be

[34] *Railroad Revenue Adequacy – 2017 Determination*, EP 552 (Sub-No. 22) *et al.* (STB served Dec. 6, 2018).

[35] Section 10704(a)(2) calls on the agency to affirmatively promote adequate revenues for every carrier, noting that "[t]he Board *shall* make an adequate and continuing effort to assist those carriers in attaining revenue levels prescribed under this paragraph." (emphasis added).

[36] *Adequacy of Railroad Revenue – 1978 Determination*, 362 I.C.C. 199, 201 (1979) (emphasis added).

unwilling to supply capital to it."[37] Notably, the statute provides no suggestion that those levels should be used as a cap on railroad earnings. None of the other statutory provisions that refer directly or indirectly to revenue adequacy justify using the annual revenue adequacy determination as a tool to drive down rail rates.

Subsections 10704(a)(2)(A) and (B) explain that adequate revenue levels must "permit the raising of needed equity capital" and "attract and retain capital in amounts adequate to provide a sound transportation system." Using a determination that return on investment equals the industry's cost of capital to cap rates disadvantages railroads relative to other firms in the economy competing for capital, contrary to Congress's goals. As the *Bessemer* court noted, the ICC viewed section 205 of the 4R Act (section 10704's predecessor) as intended to address "the opportunity to attain revenue levels which would reverse the long decline in the railroad industry. The specific objectives listed in section 205 *should not in [the ICC's] view be read as limitations on revenue*."[38]

A second statutory provision that references adequate revenues, section 10701, deals specifically with rates and rate reasonableness cases. Section 10701(d)(2) instructs the Board to consider "the policy of this part that rail carriers shall earn adequate revenues" in determining maximum reasonable rates. That is, the statute sets out an affirmative obligation

[37] *Standards for Railroad Revenue Adequacy*, 364 I.C.C. at 810 (1981) ("The *minimum* rate of return that will allow railroads to obtain investment funds is the cost of capital.") (emphasis added); *see also Railroad Revenue Adequacy – 1988 Determination*, 6 I.C.C.2d 933, 940 (1990) ("[W]e use the current cost of capital standard, which represents the *minimum* return necessary to attract and maintain capital in the railroad, or any other, industry.") (emphasis added); *Procedures to Calculate Interest Rates*, 9 I.C.C.2d 528, 532-33 (1993) ("[A]ny industry, including the railroad industry, must earn a rate of return *at least* equal to its own cost of capital in order to remain viable over the long run.") (emphasis added).

[38] *Bessemer,* 691 F.2d at 1112 (emphasis added).

on the agency as it relates to revenue adequacy, not a restraint on rates or an independent basis for regulating rates. Any other reading would impermissibly alter the statute, to add the notion that rail carriers shall earn adequate revenues, *but no more*. Such a reading would be directly contrary to Congress' intent, creating a "a knife-edge turning point between the clear Congressional mandate for regulators to 'assist' carriers in achieving adequate revenue levels and a regulatory policy to ensure that railroads are unable to earn anything more than exactly this level."[39]

Additionally, section 10101 sets for the national rail transportation policy (RTP) and, unsurprisingly, is concerned that regulation does not impede a safe, efficient private-sector freight rail network. The RTP factors, contained in 49 U.S.C. § 10101, are not independent sources of regulatory authority but rather express the policies that are to guide the STB's exercise of authority granted elsewhere in the statute.[40] In other words, the general provisions in § 10101 do not trump other the specific provisions in the statute.[41] Nevertheless, the RTP

[39] Macher, Jeffrey T, John W. Mayo and Lee F. Pinkowitz, "Revenue Adequacy: The Good, the Bad, and the Ugly," *Transportation Law Journal*, vol. 41 no. 2, 122-23 (2014).

[40] *See CSX Transp., Inc.—Abandonment Exemption—in LaPorte, Porter, & Starke Ctys., Ind.*, AB 55 (Sub-No. 643X) et al., slip op. at 6 (STB served May 31, 2017) ("[T]he RTP does not create an independent basis for Board action in the absence of a violation of a substantive provision in the Interstate Commerce Act.") (citations omitted).

[41] *See Perez-Guzman v. Lynch*, 835 F.3d 1066, 1075 (9th Cir. 2016) (the "canon [of *generalia specialibus non derogant—i.e.*, "the specific governs the general"] provides that a 'narrow, precise, and specific' statutory provision is not overridden by another provision 'covering a more generalized spectrum' of issues. *Radzanower v. Touche Ross & Co.*, 426 U.S. 148, 153–54, 96 S.Ct. 1989, 48 L.Ed.2d 540 (1976). When two statutes come into conflict, courts assume Congress intended specific provisions to prevail over more general ones, *see Fourco Glass Co. v. Transmirra Prods. Corp.*, 353 U.S. 222, 228–29, 77 S.Ct. 787, 1 L.Ed.2d 786 (1957), the assumption being that the more specific of two conflicting provisions 'comes closer to addressing the very problem posed by the case at hand and is thus more deserving of credence,' Antonin Scalia & Bryan A. Garner, *Reading Law: The Interpretation of Legal Texts* 183 (2012).").

factors' two references to adequate revenues reinforce the point that revenue adequacy is a goal to strive for, not a constraint on rates. RTP(3) contains the one direct, express reference to revenue adequacy in the RTPs, directing the Board to "promote a safe and efficient rail transportation system by allowing rail carriers to earn adequate revenues."[42] But RTP(3) does not provide the slightest suggestion that financial viability means that rail rates should be capped.

RTP(6) refers indirectly to revenue adequacy by stating that it is the Board's policy "to maintain reasonable rates where there is an absence of effective competition and where rail rates provide revenues which exceed the amount necessary to maintain the rail system and to attract capital."[43] AAR addressed questions regarding RTP(6) from the December 2019 hearing in its comments filed in February 2020, set forth in full below.

> On its face, RTP(6) expresses nothing more than Congress's desire that the agency enforce the provisions of the statute that govern rate reasonableness challenges, already discussed above. In other words, RTP(6) does not grant the Board authority above and beyond what the statute authorizes elsewhere. And the text of RTP(6) accords with this. The plain reading of RTP(6) is that rates must be "reasonable" when, in the context of market power, rates "provide revenues which exceed the amount necessary to maintain the rail system and to attract capital." RTP(6) does not say that rates must be "capped" when they exceed the amount necessary to maintain the rail system and to attract capital (to say nothing about a reasonable and economic profit or return), only that the rates must be "reasonable."
>
> Importantly, a "reasonable rate[]" is not defined in RTP(6). Rate reasonableness principles are set out elsewhere in the statute, particularly in section 10701. But nowhere in section 10701 or elsewhere in the statute is a "reasonable" rate defined by reference to the level of firm-wide earnings or revenue adequacy. In fact, as discussed above,

[42] 49 U.S.C. § 10101(3).

[43] 49 U.S.C. § 10101(6).

> section 10701(d)(2), which identifies general rate reasonableness principles, does so with an express instruction that STB recognize the mandatory, affirmative goal of revenue adequacy, not utilize that concept to somehow constrain railroad revenues.
>
> In assessing the reasonableness of a particular rate, the STB does consider the revenues generated by the challenged rate to determine whether the rate reflects an abuse of market power. But there is no connection between overall revenue levels earned by a rail carrier and the particular economic circumstances of the movement at issue in a rate reasonableness case. This analysis is consistent with RTP(6) and the rest of the statute, which must be read as a whole. While railroads must charge reasonable rates, as envisioned by RTP(6), RTP(6) does not state or suggest that the reasonableness of a particular rate can be determined based on the level of a railroad's overall earnings.[44]

For these reasons, AAR has urged the Board to abandon the revenue adequacy constraint that is set out in *Coal Rate Guidelines*. Nothing in the statute supports any rate regulation standards or methodologies that allow the Board to constrain rates on individual movements based on the overall level of revenues earned by the railroad.[45] Moreover, and importantly, even if it were supported by the statute, the revenue adequacy constraint created in *Guidelines* in the 1980s cannot be squared with modern economics.[46]

CONCLUSION

As established above, the Board's current methodology for annually estimating revenue adequacy suffers three serious infirmities. First, it overstates railroad return on investment by not using replacement costs to calculate the return on investment. Second, the existing approach fails to reflect a reasonable economic profit as required by statute, while

[44] AAR Comments, EP 722 *et al.* at 17-18 (filed Feb. 13, 2020) (internal citations omitted).

[45] *See also* AAR Comments, EP 722 *et al*. at 9–10 (filed Nov. 26, 2019).

[46] *See id.*; Kalt & Reishus V.S. ¶ 55 & note 28.

simultaneously overstating a railroad's actual "economic" profits or returns. Third, the existing approach distorts the annual findings with its antiquated treatment of deferred taxes, as was clearly illustrated in 2019 when corporate tax rates changed and required a massive, manual adjustment to avoid an absurd result. As such, the Board should modernize its calculation to correct these measurement errors.

To be clear, however, fixing these measurement errors is not grounds to use the annual determination to regulate individual rail rates because of statutory constraints and sound economics counsels against using firmwide returns to evaluate the reasonableness of individual rates. Instead, the Board should continue to utilize an improved and modernized annual revenue adequacy methodology for its intended purpose—as a snapshot of railroad financial performance each year.

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