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September 5, 2014

VIA HAND DELIVERY

Ms. Cynthia Brown
Chief, Section of Administration
Office of Proceedings
Surface Transportation Board
395 E Street, S.W.
Washington, DC 20423-0111

Re: Ex Parte No. 722, *Railroad Revenue Adequacy*

Dear Ms. Brown:

Enclosed for filing in the referenced proceeding, please find an original and ten (10) copies of the Joint Opening Comments of The Western Coal Traffic League, Consumers Energy Company and South Mississippi Electric Power Association. An extra copy also is enclosed for time-stamping and return to our messenger, as confirmation of filing.

Thank you for your attention to this matter.

Sincerely,

Kelvin J. Dowd

Enclosures

BEFORE THE
SURFACE TRANSPORTATION BOARD

RAILROAD REVENUE ADEQUACY	)	Ex Parte No. 722

JOINT OPENING COMMENTS OF THE WESTERN COAL TRAFFIC LEAGUE CONSUMERS ENERGY COMPANY and SOUTH MISSISSIPPI ELECTRIC POWER ASSOCIATION

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Dated: September 5, 2014

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SURFACE TRANSPORTATION BOARD

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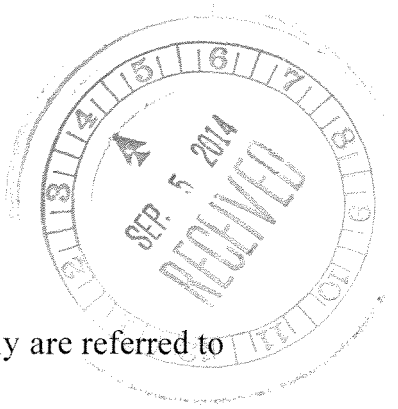
JOINT OPENING COMMENTS OF
THE WESTERN COAL TRAFFIC LEAGUE
CONSUMERS ENERGY COMPANY
and
SOUTH MISSISSIPPI ELECTRIC POWER ASSOCIATION

The Western Coal Traffic League ("WCTL"), Consumers Energy Company ("Consumers") and South Mississippi Electric Power Association ("SMEPA")[1] hereby submit these Joint Opening Comments in response to the Notice served by the Board on April 1, 2014 in the captioned proceeding (*"Notice"*), and in accordance with the Board's subsequent Decision served June 16, 2014.



[1] In these Joint Comments, WCTL, Consumers and SMEPA collectively are referred to as "Allied Shippers."

SUMMARY

In its April 1 *Notice*, the Board invited public comment on (1) whether the agency should make changes to the methodology that it currently uses to determine whether a railroad subject to its jurisdiction is earning "adequate revenues" as defined in 49 U.S.C. §10704 (a)(2); and (2) how the Board should implement the Revenue Adequacy Constraint under the *Coal Rate Guidelines*[2] in a case brought by a captive shipper to challenge rates or rate increases imposed by a rail carrier that is earning adequate revenues. *Notice* at 4. As more fully explained *infra*, Allied Shippers submit the following for the Board's favorable consideration:

1. By any reasonable, recognized and objective measure of financial health, U.S. Class I railroads today are earning adequate revenues as defined in the applicable statute, and indications are that they will continue to do so for the foreseeable future.

2. The Board should change its current, narrow test for revenue adequacy by adding other metrics of financial health to the return-on-investment standard. *No* changes should be adopted that would make any Class I railroad appear to be farther away from revenue adequacy than the current test indicates.

3. Existing precedent and the *Coal Rate Guidelines* preclude a market dominant, revenue adequate carrier from imposing any additional differential pricing on a captive shipper.

4. The Revenue Adequacy Constraint under the *Coal Rate Guidelines* should be applied to prohibit a revenue adequate railroad from imposing any rate increases on the traffic of a captive shipper beyond actual cost inflation, as measured by the Rail Cost Adjustment Factor, adjusted for improvements in railroad productivity ("RCAFA").

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[2] *Coal Rate Guidelines, Nationwide*, 1 I.C.C. 2d 520 (1985), *aff'd. sub nom., Consolidated Rail Corp. v. United States*, 812 F. 2d 1444 (3d Cir. 1987).

Allied Shippers' Opening Comments are supported by the accompanying Verified Statement of recognized transportation economist Dr. Harvey Levine.

WCTL, Consumers and SMEPA reserve their rights, individually or collectively, to submit additional comments during the Reply phase of this proceeding, and to participate in any oral hearing that may be scheduled by the Board.

IDENTITY AND INTEREST

WCTL is a voluntary association formed in 1976, whose regular membership consists of utility shippers of coal mined west of the Mississippi River. WCTL members[3] currently ship and receive in excess of 140 million tons of coal by rail each year. Many WCTL members are dependent on a single railroad for the transportation and/or delivery of their essential coal fuels, and look to the Board and its regulatory regime to constrain monopoly pricing practices by their serving railroads.

WCTL has been a leading participant in every proceeding before the agency and its predecessor, the Interstate Commerce Commission ("ICC"), concerning railroad revenue adequacy and its role in the rail regulatory process since before the enactment of the *Staggers Rail Act of 1980*, including Ex Parte No. 338, *Standards and Procedures for the Establishment of Adequate Railroad Revenue Levels;* Ex Parte No. 393, *Standards for Railroad Revenue Adequacy*; Ex Parte No. 664, *Methodology to be Employed In Determining the Railroad Industry Cost of Capital*; and Ex Parte No. 664 (Sub- No. 1), *Use of a Multi-Stage Discounted Cash Flow Methodology in Determining*

[3] The members of WCTL are listed in Attachment 1 hereto.

the Railroad Industry Cost of Capital. WCTL also has participated in the annual revenue adequacy and cost of capital proceedings, starting with Ex Parte No. 353, *Adequacy of Railroad Revenue (1978 Determination)*, and was a key party to the proceedings leading to adoption of the *Coal Rate Guidelines*.

Consumers is an electric and gas utility company serving all 68 counties of Michigan's Lower Peninsula. Consumers' electric utility operations serve a mix of approximately 1.6 million residential, commercial and industrial customers, with the largest being the automotive industry. Principal cities served include Battle Creek, Flint, Grand Rapids, Jackson, Kalamazoo, Midland, Muskegon and Saginaw. Over 78% of Consumers' base load system capacity is comprised of coal-fired generation assets, the largest of which is the J.H. Campbell Station near West Olive, MI. Rail shipments of Powder River Basin coal destined for Campbell can originate on either BNSF Railway or Union Pacific Railroad, but then must be interchanged for delivery to CSXT, which is the sole destination transportation available to the plant. Campbell's captivity to CSXT makes the matters under consideration in this proceeding of significant importance to Consumers.

SMEPA is an electric generation and transmission cooperative headquartered in Hattiesburg, Mississippi. SMEPA generates, sells and transmits bulk supplies of wholesale electricity to its eleven Member-owner electric power associations through more than 1,700 miles of high-voltage transmission lines. SMEPA's Member systems own and maintain approximately 56,200 miles of distribution line and provide service to more than 406,000 homes and businesses in fifty-six of Mississippi's eighty-

two counties, which comprise nearly two-thirds of the state's land mass. Because SMEPA and its Members are consumer-owned, not-for-profit businesses, SMEPA's rates reflect only the cost of supplying wholesale electric energy to these rural electric systems. SMEPA's primary electric generating resource is the Morrow Station, a 400 megawatt, coal-fired facility located in Purvis (Lamar County), Mississippi. For coal transportation purposes, Morrow is captive to the Norfolk Southern Railway, a carrier which even under the Board's current methodology has been revenue adequate for almost all of the past decade. The Board's regulatory mandate serves as the only meaningful, potential constraint on NS' coal transportation pricing, which makes this proceeding particularly important to SMEPA.

BACKGROUND

The history of the revenue adequacy concept in the context of the Board's and its predecessor's approach to the regulation of railroad rates on captive traffic is long and complex, and need not be recounted in detail here. In order to put their Comments on the issues raised by the Board's *Notice* in perspective, however, Allied Shippers offer a brief background summary.

A. Early Evolution of the Board's Revenue Adequacy Model

The concept of revenue adequacy entered the field of federal railroad regulation through the *Railroad Revitalization and Regulatory Reform Act of 1976*, Pub. L. No. 94-210, 90 Stat. 41 (1976). Under Section 205 of the so-called *4-R Act*, the ICC was directed to:

> develop and promulgate (and thereafter revise and maintain) reasonable standards and procedures for the establishment of revenue levels adequate under honest, economical and efficient management to cover total operating expenses, including depreciation and obsolescence, plus a fair, reasonable and economic profit or return (or both) on capital employed in the business.

According to the statute, those revenues levels should:

> (a) provide a flow of net income plus depreciation adequate to support prudent capital outlays, assume the repayment of a reasonable level of debt, permit the raising of needed equity capital, and cover the effects of inflation and (b) insure retention and attraction of capital in amounts adequate to provide a sound transportation system in the United States.

Section 205 further directed the ICC to "make an adequate and continuing effort to assist such carriers in attaining such revenue levels," in exercising its responsibilities as the regulator of railroad rates, rules and practices.

Following enactment of the *4-R Act*, the ICC conducted a public proceeding to develop standards and procedures for determining railroad revenue adequacy. Almost from the outset, the railroad industry advocated a standard that relied entirely on a carrier's rate of return on its asset investment base ("ROI") and the relationship between

that ROI and the railroad industry cost of capital ("COC"). In contrast, the shipper community – including WCTL – advocated a "multiple indicators" approach, under which the ICC would consider not only ROI, but other financial measures, such as funds flow analysis and various financial ratios. After due consideration, the ICC adopted the multiple indicators methodology supported by WCTL and other shipper groups:

> The railroads argue that a rate of return on net investment equal to the cost of capital should be the primary standard of revenue adequacy. They state that such a return is necessary to enable them to attract equity capital.
>
> The shippers, while acknowledging a legitimate role for return on net investment, urge that the Commission reaffirm its determination to consider other factors as well. They state that there are serious doubts about the usefulness of portions of the investment base; that resolving such doubts would be a massive undertaking; but that otherwise return on net investment cannot be the sole or even primary determinate of revenue adequacy. Moreover, they state that section 15a(4) suggests something more comprehensive and complex than simple reliance on a rate of return standard.
>
> We recognize that the act calls for a "fair, reasonable and economic profit or return" and that a rate of return on investment equal to the cost of capital is ordinarily a good measure of such a return. For this reason, we will make cost of capital findings in the revenue adequacy proceedings. However, as the shippers observe, there are doubts about the usefulness of the book investment that cannot be easily resolved, and the act also specifies other considerations in the determination of revenue adequacy. Therefore, a return on net investment equal to the cost of capital will be only one of the factors to be considered, as we previously found.

Standards and Procedures for the Establishment of Adequate Railroad Levels, ICC Ex Parte No. 338, 359 I.C.C. 270, 273 (1978). The agency also confirmed that a railroad's revenue adequacy status would be taken into account in individual rate complaint proceedings. *Id.*, 359 I.C.C. at 274.

In its first application of the multiple indicators model for revenue adequacy, the ICC found that as of 1977, 11 out of the then 31 Class I railroads earned adequate revenues as defined in the governing statute. *Adequacy of Railroad Revenue (1978 Determination)*, ICC Ex Parte No. 353, 362 I.C.C. 199, 257 (1979). Responding again to railroad arguments that ROI=COC should be the sole test for revenue adequacy, the ICC cited the governing statutory language:

> ...[s]ection 205 [of the *4-R Act*] specifies other criteria besides a fair rate of return, such as the support of needed capital spending. For proper observance of these criteria, consideration of factors other than a cost-of-capital return was found appropriate.

362 I.C.C. at 216.

> Section 205 [requires] observance of both a fair return test and a funds flow test as measures of revenue adequacy.

362 I.C.C. at 222.

During the Congressional deliberations that eventually led to enactment of the *Staggers Rail Act of 1980*, the railroads and their legislative allies sought to rewrite the statutory definition of revenue adequacy then codified in 49 U.S.C. § 10704 (a)(2), to mandate exclusive use of the ROI=COC test. These efforts were unsuccessful, and the version of Section 205 of the *Staggers Act* that ultimately became law made no

substantive changes to the existing statutory standard. *See Cong. Rec.* S-14003 (Daily ed., September 30, 1980) (statement of Sen. Long); *Cong. Rec.* E-4857 (Daily ed., October 15, 1980) (statement by Rep. Eckhardt). However, the ICC had become more receptive to the railroads' petitions, and in 1981 the agency reversed course and jettisoned its multiple indicators model in favor of sole reliance on the ROI=COC test as a determinant of railroad revenue adequacy. *Standards for Railroad Revenue Adequacy*, ICC Ex Parte No. 393, 364 I.C.C. 803 (1981).

B. Revenue Adequacy Under ROI=COC

The immediate effect of the ICC's switch to the ROI=COC single indicator methodology in *Ex Parte No. 393* was a dramatic increase in the level of revenues that a carrier was shown to need to earn in order to be deemed revenue adequate, with the predictable result that as of the early 1980s, not one of the Class I railroads that previously had been found to be revenue adequate achieved that designation under the new definition. There followed a long era during which a wide and illogical disparity grew between the ICC's (and later the Board's) revenue adequacy findings and "real world" manifestations of the major railroads' financial health. For example, at the same times that the agency's standard deemed them incapable of attracting sufficient capital to "provide a sound transportation system in the United States,"[4] Class I railroads were able to accomplish the following:

[4] 49 U.S.C. § 10704 (a)(2)(B).

- In 1983, the predecessor of BNSF acquired El Paso Natural Gas Company for $600 million.

- In the same year, CSX Transportation's parent purchased Texas Gas Resources Corporation for $1.8 billion.

- Through the early 1990s, Class I railroads reported record earnings, which the President of the Association of American Railroads publicly touted as representing a "Second Golden Age of Railroading."

- In 1994, BNSF's predecessor earned a return on equity of nearly 17%, and the following year acquired the Atchison, Topeka & Santa Fe Railway for $4.1 billion.

- In 1995, Union Pacific Railroad earned a 16.7% return on equity, and purchased Southern Pacific Transportation Company the following year for approximately $4 billion.

- In 1999, CSX and Norfolk Southern Corporation completed their acquisition and division of Conrail for over $10 billion, after posting equity returns of 12.4% and 12.6%, respectively, the previous year.

See V.S. Levine at 4-5. Not only were these disparities noted by shippers, but they were commented on publicly by at least one member of the Board. *See Railroad Revenue Adequacy – 1995 Determination* (STB Ex Parte No. 552), 1 S.T.B. 167, 169-171 (Commissioner Owen, concurring).

More recently, over the ten (10) year period ending in 2010 the four (4) largest U.S. railroads (UP, BNSF, NS and CSXT) nearly doubled their collective profit margin to 13%, which placed the industry fifth out of 53 major sectors. Between 2001 and 2008, the railroad industry ranked in the top ten (10) on *Fortune* magazine's

profitability list seven (7) out of eight (8) years.[5] An index of large railroad company stocks appreciated by almost 120% between 2003 and 2009, the same time period that saw the broad Standard & Poor's stock index fall by 0.3%.

In 2008, the Board reformed its approach to calculating the railroad industry's cost of capital for revenue adequacy purposes, to be more consistent with the methodology generally employed by the financial community.[6] Only one year later, however, essentially at the behest of the railroad industry, the Board revised its methodology again[7] in a manner that tends to produce higher capital cost calculations and, thus, make it less likely that a given railroad would be found to be earning "adequate" revenues. Despite these regulatory shifts, the investment community's perception of the railroads' financial health remained robust and forward-looking (as did the perception of the railroads themselves), driven by myriad indicators of strength of performance, including increased dividends, lower operating ratios, higher returns on equity and stronger stock prices.[8] Perhaps the most emphatic affirmation of that sound

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[5] *The Current Financial State of the Class I Freight Rail Industry*, Report of Office of Oversight and Investigations, U.S. Senate Committee on Commerce, Science and Transportation, September 15, 2010, at 4-5 ("2010 Senate Report").

[6] *Methodology to be Employed in Determining the Railroad Industry's Cost of Capital*, STB Ex Parte No. 664 (STB served January 17, 2008).

[7] *Use of a Multi-Stage Discounted Cash Flow Model in Determining the Railroad Industry's Cost of Capital,* STB Ex Parte No. 664 (Sub-No.1) (STB served January 28, 2009).

[8] *Update on the Financial State of the Class I Freight Rail Industry*, Report of the Office of Oversight and Investigations, U.S. Senate Committee on Commerce, Science and Transportation, November 21, 2013, at 2-7 ("2013 Senate Report").

financial position was the 2010 acquisition of BNSF by Berkshire Hathaway, the fourth largest company in the United States, for a price that reflected a 31% premium over market value at a time when that market value significantly exceeded the book value of BNSF itself.[9]

C. The Railroads' Current Status Under the Board's Revenue Adequacy Standard

In a parallel proceeding initiated in response to a petition by WCTL, the Board again is considering reform of its approach to calculating the railroad industry cost of capital.[10] WCTL has been advocating that the Board consider railroad revenue adequacy in a manner more consistent with the realities of the railroads' actual financial condition since *Ex Parte No. 393*, and will continue to make the clear case for meaningful reform in *Ex Parte No. 664* (*Sub-No.2*). However, even looking at the four (4) major Class I railroads through the prism of the flawed (in Allied Shippers' view) approaches to revenue adequacy that the agency has employed over most of the past 30 years, it is undeniable that the long-term goal envisioned by the statutory standard in 49 U.S.C. § 10704 (a)(2) has been achieved:

NS: The ROI reported for NS has exceeded the industry COC in seven (7) out of the ten (10) years from 2003 through 2012, and was within 0.3% of the COC in two (2) of the remaining three (3) years.

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[9] V.S. Levine at 5.

[10] *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*, STB Ex Parte No. 664 (Sub-No.2) (STB served June 16, 2014).

UP: The reported ROI for UP exceeded the Board's COC calculation in each of the three (3) years from 2010 through 2012. In four (4) of the remaining years, the UP's ROI was within 2.0% of the Board-determined COC.

CSXT: CSXT's reported ROI was within 0.3% of the industry COC in each of the three (3) most recent years for which results have been published by the Board, and within 1.8% in a fourth year.

BNSF: The reported ROI for BNSF exceeded the Board-determined COC in 2006, and also in 2011 and 2012 after the distorting effects of the Berkshire Hathaway acquisition premium were accounted for.[11]

The foregoing summary is based on the Board's published revenue adequacy findings for each of the years 2003 through 2012. Earlier this week, the Board confirmed that for 2013, the ROIs for NS, UP and BNSF (along with the U.S. divisions of Canadian National Railway and CP Rail) all exceeded the Board-determined COC for 2013 of 11.32%, while CSXT's 10.0% reported ROI was within 1.5% of that level.[12]

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[11] Recognition of the Berkshire Hathaway acquisition premium under the Board's current accounting rules has the perverse effect of increasing the "value" of the BNSF investment base and, thus, lowering its ROI, despite the obvious fact that the existence of the premium itself confirms the railroad's ability to attract ample capital investment. *See Western Coal Traffic League – Petition for Declaratory Order*, STB Finance Docket No. 35506 (STB served July 25, 2013).

[12] *See Railroad Adequacy*, STB Ex Parte No. 552 (Sub-No. 18) (STB served September 2, 2014) at 1 and Appendix A.

D. Revenue Adequacy Under the Coal Rate Guidelines

In the *Coal Rate Guidelines*, the ICC adopted Constrained Market Pricing ("CMP") as a "practical and economically sound method of applying competitive pricing principles to a regulatory [*i.e.*, a rail market dominant] framework." 1 I.C.C. 2d at 523. The agency went on to state that the first objective of CMP was that "[a] captive shipper should not be required to pay more than is necessary for the carrier(s) involved to earn adequate revenues." *Id.* The ICC further elaborated on the key role of revenue adequacy in the inter-related scheme of rail rate constraints that comprise CMP:

> Our revenue adequacy standard represents a reasonable level of profitability for a healthy carrier. It fairly rewards the rail company's investors and assures shippers that the carrier will be able to meet their service needs for the long term. Carriers do not need greater revenues than this standard permits, and we believe that, in a regulated stetting, they are not entitled to any higher revenues.

Id., 1 I.C.C. 2d at 535.

Specifically with regard to differential pricing – the railroads' practice of charging disproportionately higher rates on captive traffic in an effort to cover costs that purportedly cannot be covered by rates constrained by genuine market competition – the ICC prescribed that the achievement of revenue adequacy (which reflects the full recovery of all system costs) would terminate a railroad's ability to continue to impose differentially higher rates on captive shippers:

> [T]he logical *first constraint* on a carrier's pricing is that its rates not be designed to earn greater revenues than needed to achieve and maintain this "revenue adequacy" level. In other words, captive shippers should not be required to continue to pay differentially higher rates than other shippers when some or all of that differential is no longer necessary to ensure a financially sound carrier capable of meeting its current and future service needs.

Id., 1 I.C.C. 2d at 535-36 (emphasis supplied).

At the time of the *Guidelines*' adoption, none of the major U.S. railroads were considered revenue adequate under the ROI=COC standard promulgated in *Ex Parte No. 393*. As a consequence, and as the ICC pointed out at the time, a principal concern expressed by the captive shipper community was directed not at preventing rate increases *over* the revenue adequacy level, but with the agency potentially giving the railroads carte blanche to raise rates *up to* that level. *See* 1 I.C.C. 2d at 536. The ICC responded by clarifying that as a result of the other CMP constraints, "a rate may be unreasonable even if the carrier is far short of revenue adequacy." *Id.* As the Board acknowledged in its *Notice* in this proceeding, one of those constraints – the Stand Alone Cost ("SAC") test – subsequently became the predominant standard employed in large rate reasonableness proceedings brought by captive rail customers. *Notice* at 4.

COMMENTS

Allied Shippers' Comments in response to the *Notice* are presented in two (2) parts, which correspond to the inquiries posed by the Board. Part I addresses recommended steps that the Board should – and should not – take to modify its revenue adequacy methodology, beyond the reforms being advocated by WCTL in *Ex Parte No. 664 (Sub-No. 2)*. In Part II, Allied Shippers propose specific regulatory measures that the Board should adopt to implement the Revenue Adequacy Constraint amid the other components of CMP.

At the outset, it is important to note that the impact of any reforms adopted by the Board are limited to the class of railroad customers who lack effective competitive transportation alternatives to the single carrier that serves them, and whose rates already exceed the Board's jurisdictional threshold of 180% of the unadjusted, system average variable cost of providing the subject service.[13] Thus, while the issues under consideration are of paramount importance to Allied Shippers and others in similar circumstances, the Board should cast a skeptical eye on assertions by any interested party – particularly the railroads and/or their associations – that meaningful, substantive implementation of the Revenue Adequacy Constraint against the framework of a realistic assessment of railroad financial health somehow might threaten the stability or future sustainability of the U.S. rail system. As Dr. Levine explains clearly in his testimony, the day has come when regulatory decisions by the Board with respect to captive shippers'

[13] 49 U.S.C. § 10707 (d)(1)(A).

rates must be as concerned about the carriers' earnings in excess of a reasonable revenue adequacy threshold as they have been in the past about revenue shortfalls. V.S. Levine at 5. The Board should not be distracted by rhetoric – however packaged – that is contradicted by simple reality.

I. MODIFICATIONS TO THE BOARD'S REVENUE ADEQUACY METHODOLOGY

As the testimony offered by Dr. Levine clearly establishes, the U.S. Class I railroads' financial condition has been sound for many years, and faces enviable prospects for continued stability in future years. By all objective financial measures generally used to assess the viability of business enterprises, including rates of return on invested capital, return on shareholder's equity, free cash flows and operating ratios, the major U.S. rail carriers compare very favorably to the other major industrial sector participants, and have demonstrated a strong capacity to attract the capital necessary to sustain and expand their systems, a key element of the statutory definition of railroad revenue adequacy. *See* V.S. Levine, at 6-11, and Table 1. The market-to-book value ratios of the four (4) principal Class I railroads likewise confirm their established capital attractiveness. *Id.* at 4-6.

Dr. Levine's testimony is squarely consistent with the results of investigations conducted on behalf of the United States Senate's Committee on Commerce, Science and Transportation. As the Committee's staff reported in 2010:

> While the freight railroads have been investing record amounts of their profits into much-needed capital projects, they have also doubled dividend payments to their shareholders and spent billions more dollars repurchasing their publicly-traded shares to boost the short-term value of their stocks. These large expenditures undermine the railroads' argument that they still lack the income to invest in their long-term capital needs. In addition to their own capital investments, the railroads have recently received hundreds of millions of dollars from state governments and the federal government to support their network improvement activities.
>
> The companies' strong financial performance has attracted billions of new investment dollars, including the unprecedented $34 billion dollar purchase of the BNSF railroad by Berkshire Hathaway, the operating company of the investor Warren Buffett. Buffett predicts that BNSF and the other large Class I railroads will show "steady and certain growth" over the coming decades.

2010 Senate Report at 1.

> In fact, the railroads' growth in earnings and profitability has outpaced almost all of the other large industries it competes with for capital in the equity markets. Over the last decade, the large railroad companies have reported higher revenues and stable or only slowly-growing expenses, even during the recent economic recession. This relationship between operating expenses and revenues is known as the "operating ratio" and is an important indicator of financial performance in many transportation sectors, including the rail and trucking industries.

Id. at 5-6[14]. The Committee Staff's conclusions were updated and confirmed just last year:

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[14] The Committee Staff quoted the testimony of CSX Chairman Michael J. Ward on March 5, 2008, before the Subcommittee on Railroads, Pipelines, and Hazardous Materials of the U.S. House Committee on Transportation and Infrastructure: "Operating ratio which is inverse margin or the ratio of operating expenses to operating revenues

Specifically, this Committee staff report finds:

- In every public reporting period since the last quarter of 2009, at least one of the three largest publicly traded Class I freight railroads set an all-time company quarterly record for operating ratio, operating income, or earnings per stockholder share (EPS);

- In the past four years, these companies broke records for operating ratios in 29 of the 48 quarters, with Union Pacific having a streak of 8 consecutive quarters in the most recent reporting periods. A decrease in operating ratio means a company is keeping more income after operating expenses are removed from revenue;

- In 30 of the past 48 quarters, the companies set new records for operating income – or the amount of income left over after subtracting a company's operating expenses from its gross profit. It is a measure of the profitability of a company's basic business activities;

- The railroads have also achieved record results in earnings per share (EPS) for stockholders, with Union Pacific breaking its EPS record in 15 of the last 16 quarters, and Norfolk Southern setting records for 6 straight quarters in 2011 and 2012.

2013 Senate Report at i-ii. *See also*, *id.* at 3-7.

In its *Notice*, the Board invited interested parties to address the agency's current methodology for determining revenue adequacy "and whether it appropriately measures the financial condition of the railroad industry." *Notice* at 4. Allied Shippers submit that based on the clear and incontrovertible record of the major U.S. carriers'

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expressed as a percentage, is a widely used performance measurement in the railroad industry."

strong financial condition, the Board's first order of business in this proceeding should be to reject *any* proposed changes to its revenue adequacy model that would have the effect of making a railroad appear to be farther from revenue adequate status than the current methodology shows. Whether a modification is suggested with respect to a component of the current test (*e.g.*, calculation of COC, measurement of a railroad's investment base, etc.) or a new or additional criterion, if the effect is to make the railroads look less healthy financially it can be assumed that the proponent is result-oriented away from revenue adequacy, and the change should not be adopted.

Allied Shippers submit that there are two (2) affirmative steps that the Board can and should take instead. First, consistent with the plain language definition of revenue adequacy set out in 49 U.S.C. § 10704 (a)(2)(A), the Board should restore the use of funds flow analysis as a check on the results of the ROI=COC test. As the ICC explained in *Ex Parte No. 353*:

> A funds flow test is more appropriate for an industry whose overall earnings are not limited under a rate of return standard. For such an industry, the chief prerequisite of the inducement of new investment is that such new investment itself be allowed to earn a return at least equal to the cost-of-capital rate. Where this condition is met, actual investment decisions will be based on profitable investment opportunities, not on the return being earned on the book value of existing assets.
>
> Such an industry is the railroad industry. Regulation of overall earnings is not necessary for this industry, because so much of its operation is in competitive markets. In fact railroads are not subjected to direct regulation of overall earnings, and the returns being earned on their existing investments

> do not represent a limitation on the returns possible from judicious new investments. Indeed, large investments are now being made in the railroad industry, despite relatively low returns on the book value of existing assets. A funds flow test is useful in these circumstances, because it permits a determination of the earnings needed for a specific objective, such as providing a profitable return on a given amount of new investment.

362 I.C.C. at 223. As the evidence summarized by Dr. Levine demonstrates, sole reliance on the ROI=COC standard has led the Board to make determinations that consistently and significantly understate the financial stability and capital attractiveness of the studied railroads. A funds flow metric is one of the indicators recommended by Dr. Levine (V.S. Levine, Table No. 1), and was used by the ICC during a time where its revenue adequacy determinations compared more realistically to investor criteria and the railroads' own internal measures. Consistent with its role in *Ex Parte No. 353*, if a funds flow-based rate of return is adequate to cover a carrier's needed capital spending, that railroad should be considered revenue adequate under the governing standard regardless of whether its ROI regularly exceeds the industry average COC. *See* 362 I.C.C. at 204.

Second, the Board again should heed the recommendations made by then-ICC Commissioners Clapp and Gilliam in *Ex Parte No. 393*,[15] and incorporate operating ratios, return on shareholders' equity, market-to-book ratios and other financial indicators into the revenue adequacy determination. As shown *supra* and by Dr. Levine, the ROI=COC test does not reflect a number of key markers of railroad capital attractiveness

[15] *See* 364 I.C.C. at 824 (Commissioner Clapp, concurring in part and dissenting in part), and 825 (Commissioner Gilliam, concurring.)

and overall financial health, such that carriers with very robust financial profiles from a capital investor perspective can and are shown to be only barely at – or even below – the threshold for "revenue adequacy" as determined by the Board. *See, e.g.*, V.S. Levine at 10-13.

One way to re-integrate a multiple indicators feature into the revenue adequacy determination would be to identify the financial ratios to be used (such as the six (6) generally recognized indicators shown in Dr. Levine, which include a funds flow analysis); develop a composite index of those ratios; and benchmark the individual railroads' composite indices to these of established business entities with demonstrated abilities to attract capital. If this exercise shows a railroad's financial position to be strong when the narrow ROI=COC test suggests that the carrier nevertheless is revenue *in*adequate, the carrier's revenue adequacy status would be redetermined based on the composite index.[16]

The Board's *Notice* seeks general comments on its revenue adequacy methodology and the implementation of the Revenue Adequacy Constraint under CMP, so Allied Shippers are not herein proposing specific procedures or data sources for the composite indices and benchmarking step described above. Allied Shippers (and other interested parties) should have an opportunity to weigh in on those details in any rulemaking or other proceeding that follows this phase of this Docket. The principal point to be emphasized here is that just as the clear record of the railroads' financial

[16] 364 I.C.C. at 825 (Commissioner Gilliam, concurring) ("…I would also use other financial ratios to make sure that our [ROI=COC] results are not distorted.")

performance over the past 20 years establishes that there is no justification for adopting changes that effectively might move the revenue adequacy goal posts further downfield, the too frequent disparities over the same time period between the results of the ROI=COC test and the financial community's ringing endorsements of the major railroads' capital attractiveness point to a prudent return to a multiple indicators approach to revenue adequacy.

II. IMPLEMENTATION OF THE REVENUE ADEQUACY CONSTRAINT UNDER CMP

The second basic question posed by the Board's *Notice* concerns the changes that the Board should consider to its standards for judging the reasonableness of rail freight rates in order to give effect to the Revenue Adequacy Constraint under CMP. *Notice* at 4. Implicit in this question also are issues concerning how the revenue adequacy status of a given railroad should be measured "over time,"[17] and the proper interaction of the Revenue Adequacy Constraint in relation to other components of CMP.

A. Measuring Revenue Adequacy Over Time

In *Coal Rate Guidelines*, the ICC emphasized that when applied as a rate constraint, revenue adequacy is a concept that looks to a railroad's ability "*over time*, to average [sic] return on investment equal to its cost of capital." 1 I.C.C. 2d at 536 (emphasis in original). The agency specifically declined to prescribe a time period over which revenue adequacy should be measured for purposes of CMP in every case, instead leaving the determination open to variation "depending upon the carrier's traffic base and

[17] *Coal Rate Guidelines*, 1 I.C.C. 2d at 536.

reasonableness methodology in cases where use of the SAC test is too costly or impractical. *See Simplified Standards for Rail Rate Cases*, STB Ex Parte No. 646 (Sub-No.1) (STB served September 5, 2007) at 20 ("[I]n a rate case, we will not rely on the figures from a single year, but will use a 4-year average when possible."). *See also, Rate Guidelines – Non-Coal Proceedings,* 1 S.T.B. 1004, 1032-33 (1996) (Annual fluctuation in revenue "[is] not surprising given the cyclical nature of railroad traffic, and the effect can be minimized by applying a multi-year average (we use a 4-year averaging period), so as to smooth out annual variations and minimize the impact of any year that may have been aberrational for that carrier.")[20]. It also is consistent with the twin observations in *Coal Rate Guidelines* that the revenue adequacy determination should account for the fact that business cycles can include individual years of excess and shortfall, and that railroads should not be forced to "continually readjust" rates in order to keep revenues exactly at the break-even point. 1 I.C.C. 2d at 536.

Allied Shippers emphasize that the foregoing presumption should be considered an alternative method to demonstrate summarily that a defendant railroad is subject to the Revenue Adequacy Constraint. Complainants in individual rate cases would retain the option to offer evidence that a carrier which did not meet the presumption's criterion nevertheless should be considered revenue adequate based on the principles and factors identified by the ICC in *Coal Rate Guidelines*, 1 I.C.C. 2d at 534-537.

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[20] The virtue of this approach in the specific context of revenue adequacy was endorsed by then-ICC Commissioner Clapp in *Ex Parte No. 393*, 364 I.C.C. at 824.

B. Revenue Adequate Railroads Should Be Prohibited From Increasing Rates on Captive Traffic Beyond Actual Cost Inflation

1. Rate Increases By Revenue Adequate Carriers

The first principle that should be promulgated by the Board to implement the Revenue Adequacy Constraint under the *Coal Rate Guidelines* is a rule that any rate increase which a revenue adequate railroad attempts to impose upon a captive shipper's traffic in excess of actual cost inflation as measured by the RCAFA, will be conclusively presumed unreasonable and unlawful under 49 U.S.C. § 10701(d).

As summarized *supra*, in promulgating the *Coal Rate Guidelines* the Board's predecessor put revenue adequacy first among the regulatory constraints on a market dominant railroad's pricing power. In so doing, the ICC emphasized the direct link between revenue *in*adequacy and the rationale for permitting differential pricing on captive traffic:

> Our revenue adequacy standard represents a reasonable level of profitability for a healthy carrier. It fairly rewards the rail company's investors and assures shippers that the carrier will be able to meet their service needs for the long term. Carriers do not need greater revenues than this standard permits, and we believe that, in a regulated setting, they are not entitled to any higher revenues. Therefore, the logical first constraint on a carrier's pricing is that its rates not be designed to earn greater revenues than needed to achieve and maintain this "revenue adequacy" level. In other words, captive shippers should not be required to continue to pay differentially higher rates than other shippers when some or all of that differential is no longer necessary to ensure a financially sound carrier capable of meeting its current and future service needs.

Coal Rate Guidelines, 1 I.C.C. 2d at 535-536 (footnote omitted). In *Major Issues*,[21] the Board reaffirmed that a revenue adequate railroad does not have a sound regulatory basis for continued differential pricing, and explained that its then newly-adopted Maximum Markup Methodology was designed to promote the objective of allowing a railroad to "engage in enough differential pricing to earn adequate demand-based revenues, but no more." *Major Issues* at 21.

When the Board expanded the application of the key principles of CMP beyond cases suitable for adjudication under the *Coal Rate Guidelines*, it continued to decree that revenue adequacy would constrain a carrier's ability to impose further differential pricing on its captive customers. Thus, for example, in *E.I. Dupont De Nemours and Company v. CSX Transportation, Inc.*, STB Docket No. 42101 (STB served June 20, 2008), the Board held that in applying its *Simplified Standards* for "small" cases, any surplus revenue earned by a defendant carrier over the revenue adequacy level would be deducted from aggregate revenue on traffic moving at rates in excess of 180% of variable costs when calculating the Revenue Shortfall Allocation Methodology benchmark. *Id.* at 6. *See also, U.S. Magnesium, LLC v. Union Pacific Railroad Co.*, STB Docket 42114 (STB served January 28, 2010) at 10.

In its *Notice* in this proceeding, the Board observed that it "has not yet had the opportunity to address how the revenue adequacy constraint would work in practice in large rail rate cases." *Notice* at 4. However, there is clear, applicable legal precedent

[21] *Major Issues in Rail Rate Cases*, STB Ex Parte No. 657 (Sub-No.1) (STB served Oct. 30, 2006) at 7.

establishing at least one element of that constraint that should be adopted here: a prohibition on further increases in captive rail rates.

In *CF Industries, Inc. v. Koch Pipeline Company, L.P.*, STB Docket No. 41685 (STB served May 9, 2000), the Board applied the Revenue Adequacy Constraint of CMP to judge the reasonableness of certain proposed increases in rates for the transportation of anhydrous ammonia[22] by pipeline, which rates – like rail rates on captive traffic – fall within the scope of the Board's regulatory jurisdiction. In that case, after affirming the complainants' right to seek relief based on the defendant's revenue adequacy, the Board ruled that "if we find that Koch's revenues are adequate without the challenged rate increases, then those rate increases are unreasonable." *Id.* at 21. The Board specifically referenced the portion of the *Guidelines* discussing the essential connection between revenue *in*adequacy and a carrier's right to differentially price its service. *Id.* at 25. After evaluating the evidence, the Board found the defendant to be revenue adequate, and fashioned a remedy:

[22] Anhydrous ammonia is a hazardous chemical compound which also commonly is transported by rail.

> Applying the CMP revenue adequacy constraint, we find that Koch's rate increases to those points are unreasonable because Koch's revenues are adequate under its pre-rate increase structure. As a result, we will award reparations for past pipeline movements to those points, and prescribe maximum reasonable rates at the pre-increase…level for future movements.

Id. at 27.

In response to a petition for judicial review brought by the carrier, the U.S. Court of Appeals for the District of Columbia Circuit specifically approved of the Board's construction and application of the Revenue Adequacy Constraint and its adopted remedy, finding the Board's rulings to be "a reasonable reading of the agency's rate guidelines and…not subject to reversal by this court." *CF Industries, Inc. v. Surface Transportation Board*, 255 F. 3d 816, 828 (D.C. Cir. 2001). The court affirmed the Board's *CF Industries* decision in all reviewed respects.

That *CF Industries* addressed rates established by a pipeline company has no impact on the applicability of the court-approved remedy in that case to revenue adequate, market dominant railroads whose rates are subject to scrutiny under CMP. That remedy is squarely consistent with the *Coal Rate Guidelines'* admonition that rail carriers "do not need greater revenues than [the revenue adequacy] standard permits, and we believe that, in a regulated setting, they are not entitled to any higher revenues." 1 I.C.C. 2d at 535. The rate analysis conducted by the Board in *CF Industries* took place under the very same CMP guidelines that apply to rail rate adjudications, as the Court of Appeals acknowledged. *CF Industries v. Surface Transportation Board*, 255 F. 3d at 819. Additionally, as the Board itself pointed out, CMP (including the Revenue

Adequacy Constraint) was being imported *into* the field of pipeline regulation *from* the railroad regulatory regime in which it was developed. *CF Industries* at 6-7. Plainly, the Board's prior construction of the revenue adequacy component of its rail rate guidelines properly can be adopted for use in rail rate proceedings. Indeed, the Board indicated as much in its 2002 decision in *PPL Montana,*[23] a rail rate adjudication wherein *CF Industries* was cited with approval as precedent for rate relief available under the Revenue Adequacy Constraint. *See* 6 S.T.B. at 291, n. 10.

2. Implementation

Implementation of the rate increase constraint should be straightforward and efficient. Upon complaint by a shipper against a rate increase imposed by a railroad, the Board should inquire whether (1) the identified issue traffic is subject to market dominance under 49 U.S.C. § 10707; and (2) the defendant railroad was revenue adequate (on the basis described *supra*) prior to the challenged increase. If the shipper succeeds in demonstrating both, then subject only to the limited exceptions described *infra*, the challenged rate increase would be judged unreasonable and unlawful. If it already had been put in effect pending the determination, the carrier would be directed to restore rates to the pre-increase level and pay reparations in the principal amount of the additional revenues already collected.[24]

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[23] *PPL Montana, LLC v. The Burlington Northern and Santa Fe Railway Company*, 6 S.T.B. 286 (2002).

[24] *See* 2010 Senate Report at 2, n. 6 *quoting* the Conference Report on the *Staggers Rail Act of 1980* ("when the industry is earning revenues which are adequate, it is appropriate for the Commission to have the authority to review rate increases more carefully.").

the relative stability of the economy at the time." *Id.*, n. 37. The agency also cautioned that a railroad should not be required to "continually readjust its rates in an effort to keep its revenues at the precise point of revenue adequacy each year." 1 I.C.C. 2d at 536.

Allied Shippers agree that whether a particular railroad is revenue adequate for purposes of CMP should be determined in the first instance on a case-by-case basis, with the complaining shipper having the responsibility to present and defend evidence of its position. To aid in this determination, however, and avoid unnecessary delay and complexity in making what should be a threshold finding, the Board should adopt a conclusive evidentiary presumption as part of the Revenue Adequacy Constraint.

Specifically, a railroad should be deemed revenue adequate for purposes of CMP if the simple average of its return on investment for the most recent four (4) complete calendar years is equal to or exceeds the simple average of the lower of the railroad industry cost of capital, or the funds flow analysis threshold, over the same period. The ROI, COC and funds flow values would be taken from the Board's annual revenue adequacy and cost of capital determinations.[18] Use of a four-year time period is consistent with the approach that the Board already takes in calculating the railroads' annual RSAM and R/VC>180 ratios[19] for purposes of applying the Three Benchmark rate

[18] Currently, the ROI and COC determinations are made in the Board's Dockets *Ex Parte No. 552* and *Ex Parte No. 558* series, respectively. As Allied Shippers demonstrate, *supra*, the Board should add a funds flow return calculation to its revenue adequacy methodology.

[19] *See, e.g., Simplified Standards for Rail Rate Cases*, STB Ex Parte No. 689 (Sub-No. 5) (STB served April 21, 2014).

The revenue adequacy-based rate increase constraint should be available to any shipper whose traffic would be subject to the Board's jurisdiction after the increase at issue was imposed. This includes both shippers whose traffic moved under tariff or other common carrier pricing platform prior to the increase, and shippers whose traffic moved under a contract which was set to expire at or before the imposition of the increase. The availability of the regulatory remedy for the latter group – which is essential if the Revenue Adequacy Constraint is to have any meaningful impact on the captive shipper community – is fully consistent with the Board's lack of jurisdiction over contracts and contract rates. *See* 49 U.S.C. § 10709 (c). The Board routinely relies on contracts as source documents for rate and rate adjustment data relevant to the determination of maximum reasonable rates under the *Guidelines*, including the current and forecasted revenues attributable to members of a designated traffic group under the SAC Constraint. *See, e.g. AEP Texas North Co. v. BNSF Railway Co.*, STB Docket No. 41191 (Sub-No. 1) (STB served September 10, 2007) at 37; *Texas Municipal Power Agency v. The Burlington Northern and Santa Fe Railway Company*, 6 S.T.B. 573, 601 (2003). If a rate increase is proposed for application to a movement upon expiration of a contract, payment of the rate as increased would be subject to the Board's jurisdiction, and the last rate(s) paid under the contract would represent the charges in effect immediately prior to the increase. Under *CF Industries*, that would be the level of charges that may not be exceeded under the Revenue Adequacy Constraint.

The prohibition against further rate increases on captive traffic handled by a revenue adequate railroad could be made subject to two (2), strictly limited exceptions. First, in order to ensure that revenue adequacy as a rate constraint is not "misused to freeze a carrier's rates artificially," revenue adequate railroads might be permitted to adjust their rates on captive traffic by changes in the RCAFA to account for the effects of actual cost inflation, consistent with the approach taken by the Board in executing the Maximum Markup Methodology (MMM) under the SAC constraint.[25] Second, in accordance with the exception noted by the Board in the *Coal Rate Guidelines*,[26] in the rare instance where a revenue adequate carrier can prove by clear and convincing evidence (1) a need for higher revenues; (2) specific harm that would result if it could not collect them; and (3) an inability to raise them from any source other than captive traffic, the Board could entertain a request by the carrier for approval of rates to recover a fair and equitable share of the needed revenues (and nothing more) from the complaining shipper. However, the evidentiary bar for relief under this exception must be set particularly high, lest it swallow the rule through general railroad allegations of future system capital requirements, arguments for deference to railroad management decisions, or claimed inabilities to identify specific revenue "needs" with particular facilities. The Board should make clear the expectation that this would be a rarely-used exception, to be

[25] *See Western Fuels Association, Inc., Et. al. v. BNSF Railway Company*, STB Docket No. 42088 (STB served February 18, 2009) at 30.

[26] 1 I.C.C. 2d at 536, n. 36.

invoked only in response to detailed and particularized evidence demonstrating each of the three (3) separate criteria.

In addition to adoption of a rule on rate increases, Allied Shippers submit that the Board should consider re-examining other elements of CMP as currently administered, including components of the SAC Constraint, to determine whether other modifications to enhance the protection of captive shippers from unreasonable rates would be appropriate in cases where the defendant railroad is revenue adequate. Consideration of these potential, additional reforms, however, need not and should not delay adoption of the regulatory measures detailed herein.

C. Maximum Rates on Captive Traffic Should Be Set At the Lowest Level Determined Under CMP

In adopting changes to the *Coal Rate Guidelines* specifically to implement the Revenue Adequacy Constraint, the Board should clarify that in any proceeding wherein a captive shipper challenges the reasonableness of a market dominant carrier's rates (or rate increases) using more than one component of CMP, the maximum lawful rates for the issue traffic should be set at the lowest levels indicated by the alternative constraints, subject to the 180% revenue/variable cost jurisdictional floor.

In the *Guidelines* decision, the ICC explained that the individual CMP constraints are intended to function in an integrated fashion, consistent with their common purpose:

> Although we have described the constraints in CMP separately, they are necessarily interrelated [fn]. They represent different means of approaching the same basic issue, i.e., the extent of unattributable costs to be covered though differential pricing and the portion that can be charged to the shipper involved.

Id., 1 I.C.C. 2d at 547 (footnote omitted). Necessarily, then, it follows that a complainant can advance its rate challenge under one constraint or several, in the same proceeding:

> Thus, the various constraints contained in CMP may be used individually or in combination to analyze whether the rate at issue is unreasonably high, i.e., set at a level greater than necessary to collect the portion of unattributable costs that can properly be charged to that shipper. If we determine that a rate has been set at an unreasonably high level, we will take whatever action is appropriate, based upon the nature and extent of the violation shown, to afford relief to the complaining shipper and to promote proper pricing by the carrier.

Id., 1 I.C.C. 2d at 548. *See also, Consolidated Rail Corp.*, 812 F.2d at 1451.

Following initial promulgation of the *Guidelines*, the ICC applied them in a number of cases that were pending or had returned to the agency after court remands. One such case was *Arkansas Power & Light Company v. Burlington Northern Railroad Company, et al.,* 3 I.C.C. 2d 757 (1987). In that decision, the parties submitted evidence, and the ICC analyzed the reasonableness of the challenged rates, under all three of the substantive CMP constraints, with each one considered separately and serially. *See* 3 I.C.C. 2d at 765-777. Significantly, not only did the agency apply all three constraints in a single docket, it squarely held that a rate that was not found to be unreasonable under one constraint still could be held unlawful under another:

> While complainants have failed to demonstrate a violation of the management efficiency constraint, they have shown that the rates exceeded the stand-alone cost for some time periods, as discussed *infra*.

3 I.C.C. 2d at 770. The ICC performed the same kind of interrelated analysis under all three constraints in *Bituminous Coal – Hiawatha, UT to Moapa, NV,* 6 I.C.C. 2d 1, 6-17 (1989). While complainants in maximum coal rate proceedings initiated in more recent years have elected to proceed solely under the SAC Constraint,[27] the foregoing authorities still stand as valid precedent.

Agency precedent also confirms that where more than one CMP constraint is involved, if any of them shows a rate (or rate increase) to be unreasonable, the maximum lawful level should be set in accordance with that constraint. For example, in *Arkansas Power & Light Co., supra*, the evidence did not support a finding of unreasonableness under the Revenue Adequacy or Management Efficiency Constraints. However, the challenged rates were found to exceed SAC, and relief was ordered on that basis. *See* 3 I.C.C. 2d at 782-783. Conversely, in *CF Industries*, the complainants demonstrated that the rate increases at issue were unreasonable under the Revenue Adequacy Constraint, while the pipeline defended them on the grounds that the challenged rates did not exceed SAC. The Board awarded relief based upon the revenue adequacy finding, and the Court of Appeals affirmed the decision:

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[27] *See Notice* at 4.

> In this case, CF and Farmland elected to rely on the revenue adequacy constraint. Holding that revenue adequacy and SAC provide 'alternative methodologies for examining the reasonableness of a carrier's rates,' and that 'complainants may use any methodology that is consistent with CMP,' Final Order at 7, the Board employed the revenue adequacy approach and found Koch's 1996 rate increases unnecessary to ensure adequate revenues, *id.* at 27. In so doing, the STB rejected the relevance of Koch's SAC evidence, which purportedly would have justified the company's rate increases. *Id.* at 22.
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> * * *
>
> In sum, the Board's determination that Koch could not charge rates higher than those permitted by the revenue adequacy constraint, and therefore that Koch's SAC evidence was not relevant even if it would have yielded a different result, was a reasonable reading of the agency's rate guidelines and is not subject to reversal by this court.

CF Industries, Inc. v. Surface Transportation Board, 255 F. 3d. at 827-828.

CONCLUSION

The Board should revisit its methodology for determining railroad revenue adequacy, implement the Revenue Adequacy Constraint under CMP and the *Coal Rate Guidelines*, and consider further, appropriate reforms to CMP in cases involving revenue adequate railroads, in accordance with Allied Shippers' recommendations as set forth in these Opening Comments.

Respectfully submitted,

The Western Coal Traffic League
Consumers Energy Company and
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Association

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Dated: September 5, 2014

Attachment 1

MEMBERS OF THE WESTERN COAL TRAFFIC LEAGUE

Ameren Missouri

Arizona Electric Power Cooperative, Inc.

CLECO Corporation

Austin Energy (City of Austin, Texas)

CPS Energy

Entergy Services, Inc.

Kansas City Power & Light Company

Lower Colorado River Authority

MidAmerican Energy Company

Minnesota Power

Nebraska Public Power District

Omaha Public Power District

Texas Municipal Power Agency

Western Fuels Association, Inc.

Wisconsin Public Service Corporation

VERIFIED STATEMENT

OF

DR. HARVEY A. LEVINE

My name is Harvey A. Levine. I am an independent transportation economics consultant and the sole proprietor of Levine Consulting Services, located in Potomac, Maryland. Specializing in economics and finance, with a concentration on the railroad industry, I have consulted to clients in both the public and private sectors, in the United States (U.S.) and Canada, and to freight carriers, trade associations representing both railroads and railroad shippers, law firms, and other consulting entities. I received a Bachelor's degree in Business Administration with a major in transportation economics, from the University of Pittsburgh; a Master of Business Administration degree with an emphasis in economics, from Duquesne University; and a Ph.D in Business Administration with a major in transportation economics from the American University, where I was the Fletcher Fellow in Transportation.

In 1965, I began my professional career in the transportation industry as a Market Research Analyst, and subsequently became the Assistant Director of Pricing Research for the New York Central Railroad. In 1997 I retired from the Association of American Railroads (AAR), where for 18 years I was an officer and Vice President of the Economics & Finance Department. In the intervening years, I was employed by Planning Research Corporation, where I was the Assistant Director of Transportation; the U.S. Department of Transportation (DOT), where I was a Senior Economist; the Interstate

Commerce Commission (ICC), where I was the Director of Economics; and, R. L. Banks & Associates, where I was a senior consultant. Throughout my career, the interrelated subjects of the rail industry cost-of-capital (COC) and revenue adequacy (RA) have been major focuses of my interest, study, and practical application. I have testified before the California Equalization Board, Canada Transportation Act Review Panel, ICC, Federal and State courts, Presidential Emergency Board, Railroad Commission of Texas, Surface Transportation Board (STB), U.S. Congress, U.S. Price Commission, and the Washington Metropolitan Transit Authority. A copy of my resume is attached to this statement.

The purpose of this Verified Statement is to provide my views regarding the methodology that currently is used by the STB to determine railroad RA. In so doing, I am mindful of the regulatory environment in which this determination is made, and the practical limitations of the STB's RA methodology. More precisely, the following three considerations guide my comments in this proceeding:

1. The concept of RA refers to a business entity being able to attract the minimum capital required to sustain a viable for-profit enterprise, but the determination of RA is not required to be based on a single standard. While a return on investment (ROI) equal to the COC currently is the sole determinant of RA used by the STB, it does not follow that it is the only appropriate measure of capital attractiveness. At a minimum, it would be illuminating to supplement the current standard with other financial indicators, to better understand what information affects the investment decisions of equity providers, and to better align the STB's determinations

with the profile of railroad financial health that is reflected by those indicators.

2. The goal of RA is based on the concept that in that the long run, sustainable business entities operating in a competitive marketplace will earn returns equal to the risk-adjusted opportunity COC. The STB's current methodology takes an accounting approach to the calculation of a railroad's investment, which avoids undue speculation and is reasonably verifiable. My comments here are directed toward maximizing the effectiveness of the Board's approach.

3. Since capital attractiveness, and thus RA, is a relative concept (at its core are assessments of alternative risk-adjusted investment opportunities), it is appropriate to benchmark both the RA model and the resulting calculations with market standards, comparable investment opportunities, and recognized financial indicators relied upon by the investment community and the railroads themselves. Certainly, the supplemental use of financial ratios allows for such benchmarking, but so too does an awareness of the capital attractiveness of other companies in railroad peer groups, which provides surrogates for the availability of capital to the railroads.

I. ADDITIONAL INDICATORS OF CAPITAL ATTRACTIVENESS

In 2001, I testified before the U.S. Congress regarding the disparity between what the STB then viewed as revenue inadequate railroads and the seemingly contrary verdict rendered by other financial evidence. I stated that:

> Incredibly, the alleged state of railroad revenue inadequacy prevailed during the early and mid 1990s, even when railroads enjoyed record earnings and the president of the industry's major trade association – the Association of American Railroads (AAR) -- touted the "Second Golden Age of Railroading" . . . In 1994, the BN earned an impressive 16.9% rate of return on equity . . . Furthermore, the BN had the financial capacity to outbid the UP and acquire the Atchison Topeka and Santa Fe Railroad (ATSF) in 1995 for $4.1 billion. Similarly, in 1995 the UP earned a 16.7% ROE and completed its purchase of the Southern Pacific Railroad (SP) in the following year for about $4.0 billion. In 1997, the CSX and NS railroads realized ROEs of 12.4% and 12.6% respectively, and consummated their joint purchase of Conrail for over $10 billion in 1999. And yet, with the exception of NS in 1997, these railroads were declared by the STB to be revenue inadequate during those years. At the same time, the four railroads expended billions of dollars in employee buyouts, distributed expected dividends to their shareholders, and paid sizeable bonuses to their executives.[1]

At the time, I was fully aware that the major U.S. railroads had gone through a long period of financial challenges. However, it also was clear that they were trending toward financial prosperity. I could see the day coming when regulatory decisions based in part on a railroad's RA status would be as much concerned about earnings in excess of the RA threshold as they had been in the past about shortfalls. I believe that the objective evidence establishes that such a day has come. Since my testimony in 2001, the financial conditions of our nation's railroads have steadily improved to the

[1] Statement of Dr. Harvey A. Levine before the Subcommittee on Surface Transportation and Merchant Marine, of the Committee on Commerce, Science and Transportation, United States Senate, May 9, 2001.

point where in 2010, the country's fourth largest company, Berkshire Hathaway, completed a purchase of BNSF for a price that included a 31% premium over market value,[2] at a time when the market value of the railroad was significantly more than its book value.[3] Furthermore, as recently stated in an analysis of the Berkshire Hathaway purchase of BNSF, *it is impossible to know exactly what BNSF would be worth today as a public stand-alone company, but it is very likely that the company would be worth far in excess of Berkshire's purchase price or BNSF's current carrying value*[4]. It is equally impossible to seriously argue that a company that demonstrated the ability to attract such an investment was not RA under any rational standard. In a somewhat similar vein, UP has a current market value of over $91 billion, compared with a book value of $21 billion,[5] CSX has a market value of $30 billion compared with a book value of $11 billion,[6] and NS has a market value of $32 billion compared with a book value also of $11 billion.[7] Clearly, capital providers are optimistic about the railroad industry, and such optimism is accompanied by investment. The market-to-book value ratio of a company may be the most important evidence of the company's capital attractiveness.

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[2] Scott Patterson and Douglas A. Blackmon, "Buffet Bets Big on Railroad," Wall Street Journal, November 4, 2009.
[3] BNSF Railway Company, 2009 Annual Report to Surface Transportation Board, Schedule 200.
[4] Benjamin Graham, The Rational Walk, "Revisiting Berkshire Hathaway's Acquisition of BNSF," November 5, 2013, pp. 5/9-5/10, www.rationalwalk.com.
[5] Market value based on just over 445 million shares of common stock outstanding and a market per-share price of $200. Union Pacific Corporation, Form 10-K, Annual Report to Securities and Exchange Commission for Fiscal Year ended December 31, 2013, pp. 20, 22.
[6] Market value based on 999.6 million shares of common stock outstanding and a market per-share price of $30. CSX 2013 Annual Report, pp. 17, 55, and Charles Schwab, "Research, NSC" www.schwab.com.
[7] Market value based on 308.9 ,million shares of common stock outstanding and a market per-share price of $105. Norfolk Southern 2013 Annual Report, "Financial Highlights," and Charles Schwab, "Research, CSX," www.schwab.com.

II. VALUE OF FINANCIAL MEASURES TO HELP EVALUATE AND/OR DETERMINE REVENUE ADEQUACY

Financial measures – most often in the form of ratios – long have been used to determine not only the financial viability of business enterprises, but also their investment value and credit worthiness. Most noteworthy, financial ratios can be used to measure the results of a company's financial performance against those of other organizations[8] – that is, alternative investment opportunities. One finance advisory firm lists 19 such ratios.[9] In essence, the use of financial ratios to evaluate business performance is ubiquitous, including among the railroads themselves.

In determining non-salary compensation for their executives, the railroads employ financial measures in order to align the majority of executive pay with the interests of the shareholders who provide capital for the enterprise. UP states that: *By providing equity incentives we link a substantial portion of executive compensation to both short-term and long-term financial performance that benefits our shareholders and aligns the interests of management with those of our shareholders.*[10] CSX likewise requires *that a significant portion of overall compensation be performance based equity to align the long-term interests of executives with those of CSX's shareholders.*[11] Finally, NS states that it grants *. . . long-term, incentive awards . . . based on shareholder returns. The value of performance shares is also tied to achievement of disclosed goals for total stockholder*

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[8] DV Blog and Newsletter, Demonstrating Value, "Financial Ratio Analysis," www.demonstratingvalue.org.
[9] Investopedia, "Ratio Analysis Using Financial Ratios," www.investopedia.com.
[10] Union Pacific Corporation, 2014 Proxy Statement, p. 33.
[11] CSX, 2014 Proxy Statement, p. 35.

return, return on average invested capital and operating ratio.[12] The portions of railroad executive compensation that are made dependent on financial ratios include annual cash bonuses, performance stock units, retention stock units, and stock options, which historically have far exceeded actual salary in value. Among the other financial indicators, UP, CSX and NS executive compensation rely on the rate of return on invested capital, the rate of return on shareholders' equity, free cash flow, and operating ratios. Nowhere is RA as determined by the STB identified as a key financial measure. In fact, for many years (prior to 2013), CSX used the operating ratio alone as a measure of its financial performance. Both UP and CSX also benchmark their performance against "peer groups" of 18 and 19 companies, respectively, in a manner consistent with the concept of opportunity cost as a measure of relative value and/or capital attractiveness.

The value of considering multiple financial indicators is fairly obvious. After all, the more relevant the information available to investors, the better positioned they are to make sound decisions for committing (or not) capital funding. A case in point is a company that does not earn a profit (has no ROI), and yet has no trouble attracting more than enough needed capital. While in this example, prospects obviously trump historic earnings, capital attractiveness may be stimulated by a favorable capital structure, asset turnover rate, debt-capital ratio, operating ratio, cash flow, and other characteristics that are not illuminated at all in the ROI=COC standard. Supplemental information gained from multiple indicators also can deepen the investor's insight into established companies. Consider the case of BNSF and its relationship to its parent company. As stated in a recent review of the acquisition of BNSF by Berkshire Hathaway:

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[12] Norfolk Southern Railroad, 2014 Proxy Statement, p. 22.

> It is also clear that Berkshire has not been directing additional capital to BNSF so far. In fact, the opposite is true. Berkshire has been receiving significant cash from BNSF in the form of dividend payments. In fact, the dividends paid to Berkshire are close to total BNSF capital expenditures in magnitude. BNSF has been able to both fund its capex program and pay significant dividends to Berkshire by taking on additional debt over the years. Debt as a percentage of total capital has risen from 24 percent shortly after the acquisition to 33 percent as of September 30, 2013.[13]

This shows a side of BNSF's financial prowess that the ROI=COC standard does not measure, but that nonetheless has an important bearing on RA. The ability to fully fund the capex program *and* pay substantial dividends while maintaining an easily manageable level of debt (a 67/33 equity/debit ratio is enviable for most U.S. companies) is a clear manifestation of long-term enterprise sustainability.

III. RECONCILING REVENUE ADEQUACY WITH FINANCIAL RATIOS

In order to illustrate the concerns with the accuracy of the current RA model that emerge from an analysis of relevant financial ratios (other than the market-to-book value discussed above), I constructed Table No. 1, showing the values of five financial ratios for the major railroads, excluding the BNSF, in 2013.[14] Also presented are the values of a weighted-average "composite railroad."

The first measure, debt-capital ratio, is a leverage ratio that provides an indication of long-term solvency. While it is economical for a company to use borrowed money to make even more money, too much debt can increase investor risk to an unacceptable level. In general, it is widely accepted in the financial community that up

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[13] Benjamin Graham, op. cit., p. 4/10.

[14] Now that BNSF no longer is a public company, data necessary to compute the ratios no longer is available.

to a 40/60 debt-capital ratio is not excessive, assuming normal earnings sufficient to service the debt. Railroad debt percentages shown in Table No. 1 are not at all excessive. The relatively low ratio for UP (31.1%) is consistent with it being RA under the STB's model, and there is no basis to suggest that the CSX (46.2%) and NS (45.6%) ratios are indicative of inadequate revenues or an inability to raise sufficient capital.

The second measure, operating ratio, is an indicator of operating efficiency and identifies the amount of revenue available for servicing debt, paying dividends, investing in the company, etc., once operating expenses are paid. The operating ratio is so important to railroads that it is a common metric used to determine executive compensation. In recent years, railroad operating ratios have declined from levels often in the 80's, to the 2013 composite railroad average of 68.6% as shown in Table No. 1. While UP has the lowest operating ratio, the comparable figures are relatively low for all three of the largest public railroads, especially when compared to peer companies. For example, Fed Ex (one of the 18 companies in the UP "Peer Group") had an operating ratio of 94% in 2013[15] and the company is not considered to be experiencing capital shortfalls. While the relatively low operating ratios of railroads can be explained partly by their capital intensiveness (e.g., labor expenses are a relative minor cost relative to revenue), it also is a noteworthy fact that depreciation (an accounting write-off of investment capital) is treated as an operating expense, which would put upward pressure on the ratio. A railroad with a very low operating ratio should be considered financially healthy and sustainable by any objective measure, regardless of whether its ROI regularly exceeds the STB-determined COC.

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[15] Federal Express, "North, South, East, West Forward," Fed Ex Annual Report 2013, p. 8.

A third financial ratio, return on shareholder equity (ROE), is the bottom line measure for shareholders, identifying the profits earned for each dollar invested in the firm's stock. In this sense, ROE is a valuable measure of equity-investor profit and capital attractiveness, and it is used by railroads as part of their executive compensation criteria. ROE treats a majority of cash flow (deferred taxes and depreciation) as operating expenses but it still is a comprehensive indicator of financial performance. The ROE results shown in Table No. 1 (16.9%-21.4%) are quite impressive. (By peer comparison, Fed Ex had a 9.0% ROE in 2013.)[16] On the basis of comparative ROEs, it is reasonable to conclude that all three railroads in 2013 were more than capable of attracting sufficient capital to sustain their systems.

The fourth measure, cash flow return on shareholder equity (CFROE) addresses the issue concerning ROE noted above by adding depreciation and deferred taxes to net income. As shown in Table No. 1, the CFROEs are significantly above the ROEs. The CFROEs of 27.3%-32.2% compare with 23.7% for Fed Ex,[17] and reflect the cash-flow benefits that capital-intensive companies realize from relatively large levels of depreciation and deferred taxes. On a comparative basis – that is, railroads versus peer groups – the data again indicates that the three railroads in Table No. 1 would be expected to fare quite admirably in regard to attracting capital. At a minimum, a comparative analysis of railroad CFROEs provides useful information about capital attractiveness as a supplement or relative to a ROI=COC determination. Moreover,

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[16] Ibid.
[17] Ibid., p. 13.

contradictory results should trigger an inquiry as to why a railroad with a high CFROE still would be considered revenue inadequate for regulatory purposes.

Finally, the fifth measure, the dividend payout rate, provides an indicator of how well a company's earnings support the payment of dividends. While dividends can be subject to decreases in mature and financially sound companies, they tend to remain stable, or increase in such cases. Railroad dividend payout rates for a single year, as shown in Table No. 1, do not reveal historic trends, but their level – between 2.0% and 2.7% -- indicates that equity investors in railroads can expect, at a minimum, to earn returns that are at levels similar to the risk-free returns from such financial instruments as Treasury bonds. Again, such a comparison highlights the railroads' capital attractiveness.

IV. A FINAL NOTE ON THE USE OF FINANCIAL RATIOS

While UP's reported ROI for 2013 exceeded the industry COC as determined by the STB, the railroad also implicitly showed itself to be RA based on five financial-performance measures, as compared with its Peer Group. As shown in Table No. 2, for the three-year periods between 2011-2013 and 2010-2012 respectively, the UP ranked first compared with the 19 companies in its Peer Group. In both the single years of 2013 and 2012, UP ranked third. In these instances, the STB findings and the UP data are consistent, but in other cases, there could be contrary results. Even if the RA determination was somewhat consistent with other financial ratios, there could be differences in degrees. Consider 2012 for example, where the ROIs of three railroads

were very close to the STB's RA threshold of 11.12%,[18] yet in no case was there any evidence of a capital shortfall on the part of any of them. In the following year (2013), NS was shown to be marginally RA as its 11.62% ROI just exceeded the 11.32% ROI standard, and yet it described its 2013 performance to shareholders as follows:

> 2013 was a big year for Norfolk Southern. We achieved record performance levels . . . We set new precedents for railway operating revenues and income from railway operations and achieved new landmarks for net income, earnings per share, and operating ratio. . . We also continued our tradition of a solid dividend policy, raising the dividend on the company's common stock by 5 percent, along with $627 million in share repurchases . . . 2013 marked a year of remarkable achievement by many measures.[19]

In 2013, the supposedly revenue inadequate CSX (9.9% ROI using the STB's formula) informed its shareholders that the company achieved record-high *revenue and earnings per share – all while taking forward-leaning action to create value for many years to come.*[20] The railroad went on to say:

> In the last decade CSX has increased operating income nearly 600 percent and earnings per share from contributing operations nearly 2,000 percent, while improving the operating ratio by more than 2,200 basis points. As a result, CSX shareholders have seen a total return on their investment of nearly 500 percent, easily outperforming the broader market. At the same time, shareholders have benefitted from more than $8 billion in share repurchases -- nearly a third of outstanding CSX shares -- and a dividend that increased 11 times in 8 years for a 30 percent compound annual growth rate.[21]

I am fully aware that for-profit companies tend to be optimistic when communicating with their shareholders, but the messages, financial ratios, and

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[18] NS (11.38%) CSX (10.81%), and GT (10.91%). STB, "Railroad Revenue Adequacy – 2012 Determination," Docket No. EP 552 (Sub-No. 17), September 30, 2013.
[19] Norfolk Southern, 2013 Annual Report, op. cit., pp. 3, 4.
[20] CSX, 2013 Annual Report, op. cit., p. 3.
[21] Ibid. p. 4.

comparative analyses of the major railroads indicate strong financial positions and no shortfall of capital. Financial ratios beyond the ROI, and comparative analysis beyond ROI=COC, clearly demonstrate that the ROI=COC standard currently employed by the STB carries no risk of overstating a railroad's financial health. To the contrary, the risk raised is that a railroad which is fully capable of covering all operating expenses and debt service and has no difficulty attracting sufficient capital to sustain itself nevertheless could be deemed to fall short of RA. I encourage the STB to give serious consideration to financial ratios and other indicators discussed in this Statement as it contemplates whether and how to modify its standard for determining RA in this proceeding.

Table No. 1

KEY FINANCIAL RATIOS, 2013: FREIGHT RAILROADS

	a/ UP	b/ CSX	c/ NS	d/ Composite Railroad
1/ Debt-Capital Ratio	31.1%	46.2%	45.6%	38.7%
2/ Operating Ratio	66.1%	71.1%	71.0%	68.6%*
3/ Return on Shareholder Equity	21.4%	17.7%	16.9%	19.3%
4/ Cash Flow Return on Shareholder Equity	32.2%	31.3%	27.3%	30.7%
5/ Dividend Payout Rate	2.0%	2.6%	2.7%	2.3%

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1 Long-term debt as percent of long-term debt plus shareholder's equity.
2 Operating expenses as percent of operating revenue.
3 Net income as percent of shareholder average equity.
4 Cash flow (mainly net income plus depreciation and deferred taxes) as percent of shareholder average equity.
5 Dividends paid (average of four quarters) as percent of average market value of company (average of daily stock prices).

a Union Pacific Corporation, Form 10-K, Annual Report to Securities and Exchange Commission, 2013, pp. 20, 22, 31-34, 67.
b CSX, 2013 Annual Report (to shareholders) pp. 20, 25-27, 55, 56.
c Norfolk Southern Railway, 2013 Annual Report (to shareholders) , pp.2, 25.
d Based on relative percentages of operating revenue: in 2013 UP (49%), CSX (26%) and NS (25%).

- While financial ratios that include measures of capital cannot be calculated for the BNSF in that it is a component of Berkshire Hathaway, the railroad reports its operating data to the STB, and in so doing, revealed an operating ratio of 70.3 in 2013. BNSF Railway Company, "Annual Report to the Surface Transportation Board for the Year Ended December 31, 2013," Schedule 210."

Table No. 2

COMPARISON OF UNION PACIFIC PERFORMANCE WITH PEER GROUP COMPANIES[22]

Three-Year Performance	1011-2013 Rank	2010-2012 Rank
Revenue Growth	4	4
Operating Income Growth	3	3
Earnings Per Share Growth	3	3
Return on Invested Capital	7	10
Total Shareholder Return	4	2
Overall Rank	1	1

One-Year Performance	2013 Rank	2012 Rank
Revenue Growth	2	7
Operating Income Growth	7	3
Earnings Per Share Growth	8	4
Return on Invested Capital	6	6
Total Shareholder Return	14	4
Overall Rank	**3**	**3**

Note: The 19 companies in the Peer Group are: 3M, Altria Group, Canadian National Railway, Canadian Pacific Railway, CSX, Deere & Company, Du Pont (E) De Nemours, Exelon, FedEx, General Dynamics, Halliburton, Honeywell International, Medtronic, Norfolk Southern, Raytheon, Southern Company, Time Warner Cable, and UPS.

[22] Union Pacific Corporation, Proxy Statement, "Notice of Annual Meeting of Shareholders," April 1, 2014, p. 35.

VERIFICATION

STATE OF MARYLAND)
)
)
COUNTY OF MONTGOMERY)

I, HARVEY A. LEVINE, verify under penalty of perjury that I have read the foregoing Verified Statement, that I know the contents thereof, and that the same are true and correct. Further, I certify that I am qualified and authorized to file this Verified Statement.

Harvey A. Levine

Harvey A. Levine