BEFORE THE UNITED STATES
SURFACE TRANSPORTATION BOARD

236966

ENTERED
Office of Proceedings
November 4, 2014
Part of
Public Record

STB Ex Parte No. 722

RAILROAD REVENUE ADEQUACY

REPLY COMMENTS OF CSX TRANSPORTATION, INC.

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Dated: November 4, 2014

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CSX Transportation, Inc. ("CSXT") respectfully submits these Reply Comments concerning railroad revenue adequacy. *See Railroad Revenue Adequacy*, STB Ex Parte No. 722 (served April 2, 2014).[1] Proposals presented in opening comments advocating greater regulatory intervention and sweeping rail carrier revenue reductions—based on the faulty premise that carriers are "revenue adequate"—highlight the need for a more robust and accurate measure of revenue adequacy, starting with proper valuation of rail assets using replacement costs. As CSXT explained on opening, before the Board considers any other "revenue adequacy" issue or any further application of its annual revenue adequacy findings, it is essential that the agency first correct a fundamental flaw in its annual revenue adequacy calculations by developing a methodology that uses replacement costs to value rail carrier assets. Until the Board addresses this threshold flaw and grounds its annual revenue adequacy determinations on an economically sound footing, it should not consider them for any additional purpose.

Because a more meaningful and rational revenue adequacy determination is an essential prerequisite to consideration of any further regulatory use of such a determination, the Board should institute a proceeding aimed at developing a new and more meaningful methodology for determining whether a carrier has earned adequate revenues in a year or other period of time. Any proposed new methodology must correct flaws in the Board's current approach, including the erroneous use of backward-looking historical book values of rail assets as the foundation for revenue adequacy calculations. Section I of these Reply Comments affirms that the Board must first develop an appropriate and accurate methodology for measuring whether a carrier has

[1] CSXT also joins in the Opening and Reply Comments of the Association of American Railroads.

earned adequate revenues, before it can begin to address questions of possible regulatory implications of a finding that a carrier has earned adequate revenues over the long term.

Moreover, even if the Board's revenue adequacy methodology and determinations were sufficiently corrected, they could form no basis for the broad and undifferentiated rate reduction proposals advocated by some opening comments. As discussed in Section II below, shipper proposals for rate freezes and rail revenue caps are little more than schemes to effect quick-and-easy revenue transfers from carriers to shippers, through increased regulatory intervention and avoidance of established rate reasonableness tests. The proposals for regulatory rate reductions advanced in this proceeding are woefully incomplete, unsupported by facts, evidence, or legal analysis, and contrary to basic principles of railroad economics and regulation. Accordingly, even if a carrier were found to have attained long term revenue adequacy under a more robust methodology, the shippers' arbitrary rate reduction proposals would be inappropriate and impermissible.

I. THE BOARD'S ANNUAL REVENUE ADEQUACY DETERMINATIONS ARE FUNDAMENTALLY FLAWED BECAUSE THEY ARE NOT PREMISED ON ASSET REPLACEMENT COSTS.

Before the Board considers use of its annual "revenue adequacy" findings for any further regulatory purpose, it should first revise the method and standards it uses to measure whether carriers are earning adequate revenues.[2] Most important, the Board must change its method for valuing assets, in order to account for their current replacement value rather than their

[2] CSXT's comments are focused on the need to change the Board's methodology for determining whether a carrier has earned adequate revenues in a particular year. It is well established, however, that "revenue adequacy" is a long term concept that cannot be based on a carrier's financial performance in a single year or even a few years. Thus, while use of replacement costs of carrier assets to make annual revenue adequacy determinations is a *necessary* threshold condition for a meaningful assessment of long term revenue adequacy, it is by no means a *sufficient* condition to allow meaningful determinations of (long term) revenue adequacy.

depreciated historical book value. Congress has directed the Board to "maintain and revise as necessary standards and procedures" for determining the level of revenue rail carriers need to earn (including a "reasonable and economic profit or return") and to "make an adequate and continuing effort to assist those carriers in attaining revenue levels" sufficient to "support prudent capital outlays" and repayment of reasonable debt and to "attract and retain capital in amounts adequate to provide a sound transportation system in the United States." 49 U.S.C. § 10704(a)(2). Based on those standards and procedures, the Board is to make an annual determination of "which rail carriers are earning adequate revenues." *Id.* § 10704(a)(3).

The Board's existing annual "revenue adequacy" determination uses the depreciated original (historical) cost of rail assets as the value of the "investment" base on which it calculates the carrier's return. The use of historical depreciated costs to value a carrier's assets renders the Board's revenue adequacy determinations poor and inaccurate measures of whether a carrier is actually earning a level of return adequate to meet the goals and requirements of Section 10704(a)(2). Specifically, the Board's current methodology does not accurately gauge either: (i) whether a given carrier has earned adequate revenues; or (ii) whether the Board is discharging its responsibility to allow carriers to earn adequate revenues over the long term. *See* Section 10704(a)(2).

Although the Board and the ICC before it have consistently acknowledged the superiority of asset replacement values as the foundation for evaluating railroad revenue adequacy, for nearly 40 years the agency has declined to adopt a methodology using replacement values, based largely on historical difficulties that either no longer apply or now appear manageable. Because of changed conditions and the acknowledged superiority of the use of the replacement value of assets as the basis for a sound and accurate evaluation of the adequacy of revenues earned by rail carriers, it is incumbent on the Board to conduct a thorough and serious inquiry regarding the current feasibility of implementing such a methodology to better meet its responsibility to maintain standards and procedures for evaluating whether rail carriers are earning adequate revenues. *See* CSXT Opening Comments at 20-22; 49 U.S.C. § 10704(a)(2).

The Board's current annual revenue adequacy determinations are useful for the limited purpose of determining whether carriers are making progress toward earning adequate revenues, but not for evaluating whether a carrier has actually earned revenues adequate to satisfy statutory goals in a particular year—and certainly not for purposes of regulating carriers' rates. The current methodology is akin to a broken thermometer, which can show whether the temperature of a pot of water becomes warmer or cooler over time, but cannot be used to determine either the actual temperature of the water or how close it is to the boiling point. Similarly, comparing annual revenue adequacy determinations over a period of years provides some indication of whether a rail carrier's fiscal condition is improving, but not whether it is earning adequate revenues as defined by the Commerce Act. *A fortiori*, the Board's existing annual measure cannot be used to assess whether a carrier has attained *long term* "revenue adequacy," let alone form the predicate for significant policy changes or decisions.

Unless the Board implements a methodology founded in the use of replacement costs of rail assets, its revenue adequacy determinations will remain fundamentally flawed for any purpose beyond the annual finding the Board presently makes, and the very rough measure of carrier financial progress that limited finding provides. Relying on historical-cost-based revenue adequacy findings as the basis for any additional affirmative regulatory action would be arbitrary and capricious.

II. THE BOARD SHOULD REJECT ILL-CONCEIVED PROPOSALS TO IMPOSE RATE CEILINGS OR REDUCTIONS BASED ON ITS ANNUAL REVENUE ADEQUACY FINDINGS.

The Board should reject proposals to use existing revenue adequacy determinations to reduce rail carrier revenues. The Board's Stand-alone Cost ("SAC") test is a sound, rigorous, reliable, and judicially approved method for assessing the reasonableness of rail rates for transportation over which a rail carrier has market dominance. In contrast, findings regarding the adequacy of a carrier's revenues generated by all of its operations over its entire network—even calculated using a rigorous and accurate methodology—would provide no logical, principled basis for determining the reasonableness of specific individual rates. Thus, the Board should not consider using revenue adequacy findings to determine rate reasonableness. *See* CSXT Opening Comments at 27-29.

Moreover, there is no need for the Board to develop yet another rate reasonableness test or methodology. The Board's three existing rate reasonableness case methods (SAC, SSAC, and Three Benchmark) provide ample opportunity for shippers to challenge rates they believe are unreasonable. Roughly two-thirds of all rail traffic within the Board's jurisdiction is subject to the very simple Three Benchmark test, and *all* regulated traffic is now eligible for SSAC. *See generally, Rate Regulation Reforms*, STB Ex Parte 715. Shippers that believe that specific common carrier rates they are offered are unreasonable have multiple options to challenge those rates before the Board, each providing different trade-offs between complexity, accuracy, and costs. Particularly given that the Board recently opened the lower-cost SSAC method for all rate cases within its jurisdiction, there is no basis to find that the Board's rate reasonableness methodologies are not working properly or provide insufficient remedies for any rail shipper that contends that market forces do not adequately constrain its rail transportation rates.

Attempting to adjudicate the reasonableness of individual rates based on a general system-wide revenue adequacy finding would be particularly unwise. Even if the Board were to develop a new revenue adequacy methodology properly based on replacement costs, prescribing individual rail rates based on a system-wide revenue adequacy finding would generate cross-subsidies, resulting in regulatory selection of winners and losers, and distortions of markets and resource allocations. *See* CSXT Opening Comments at 28-32. In addition to contravening successful rail policy established over the last four decades, such regulatory action could roll back much of the progress and improvements made during that time and impede further investments and improvements necessary to meet transportation needs and challenges in the coming years. Below, CSXT discusses some of the ill-conceived proposals of shipper interests for rail rate caps and revenue reductions.

A. The Board Should Reject Proposals For Rate Caps as Unwarranted, Arbitrary, and Inconsistent with Demand-Based Differential Pricing.

Rate ceilings that shipper commenters propose to impose on "revenue adequate" carriers are inconsistent with railroad economics and fundamental principles of modern rail regulation and policy. Even if the Board were to determine that a carrier had earned adequate revenues over the long term under an appropriate test, imposing the rate caps and reductions proposed by the Alliance for Rail Competition ("ARC"), Western Coal Traffic League ("WCTL"), and Olin Corporation ("Olin") would be arbitrary, capricious, and contrary to law.

1. ARC proposes generally that the Board "apply the revenue adequacy constraint to limit future increases of rates on captive traffic by revenue adequate railroads," but offers no intelligible approach for determining or applying such limits. *See* ARC Opening Comments at 19-29. ARC underscores its outcome-driven motivation to obtain revenue transfers from carriers to its members when it states that "implementation of the revenue adequacy constraint should not be delayed while the STB consider[s] whether, and if so how, to revise its procedures for determining railroad revenue adequacy." *See id.* at 16. In other words, regardless of whether the Board's revenue adequacy determinations are accurate, it should proceed as if they are and get on with applying a new rail rate cap and reduction program!

Moreover, despite referring to the "revenue adequacy constraint" as a limit on rail carrier rates, ARC fails to explain how it would propose to apply that constraint to rail rates. Instead, it focuses on criticizing the Board's existing rate case methodologies, rejecting two of them (SAC and SSAC) as not "viable," and proposing that the already crude and inaccurate Three Benchmark methodology be further diluted by eliminating one of the existing benchmarks. *See id.* at 13-15, 19-27 (proposing elimination of the R/VC_{COMP} benchmark). Significantly, ARC does not explain how it proposes to apply the resulting "Two Benchmark" test, or how such an approach would determine which rates should be capped and at what levels. *See id.* at 24-25 (relying on comment in *Simplified Guidelines* concerning hypothetical extraordinary circumstances that might justify resort to a Two Benchmark test). Instead of proffering a coherent proposal for analysis, ARC merely offered the understatement that "the Board did not explain exactly how to apply a Two-Benchmark analysis [and] [s]ome simplifying assumptions maybe be needed . . . ." *Id.* at 26. If the R/VC_{COMP} benchmark were eliminated as ARC suggests, all rate reasonableness analyses would collapse into simple (and arbitrary) comparisons of the R/VC ratio generated by a rate against the carrier's Revenue Shortfall Allocation Method ("RSAM") ratio.[3] Moreover, if the predicate for application of a Two Benchmark approach is a

[3] While ARC "presume[s] that SAC and SSAC . . . will remain [rate case options] despite a railroad becoming revenue adequate," (ARC Opening Comments at 13) it is unlikely that any shipper would bring a SAC or SSAC case when it could obtain rate freezes or reductions through a quick-and-dirty comparison of the R/VC ratios generated by its rates against a carrier's RSAM ratio.

carrier's attaining revenue adequacy, any logical basis for a "Revenue *Shortfall* Allocation Method" ratio would evaporate. In short, ARC's proposals are woefully incomplete and deficient and do not merit further consideration.

2. Olin skips discussion of the Board's revenue adequacy analysis entirely and simply proposes that, without any further proceedings, the Board impose an across-the-board R/VC ceiling on rail rates. *See* Olin Opening Comments at 7-10. Significantly, Olin fails to explain how the Board should determine the level at which to impose such an industry-wide R/VC ceiling. While it is easy to understand the appeal of such heavy-handed regulatory intervention to a party in Olin's position, its simplistic proposal is irreconcilable with basic principles of railroad economics, governing rail law and policy, or even due process.

For example, Olin blithely asserts that because a "revenue-to-variable cost ratio is already imposed by Congress as a jurisdictional floor on the Board's ability to intervene in rate cases, [an] R/VC ceiling would act as a counterweight to this floor by providing a rate ceiling." *Id.* at 8. Olin misses the point implicit in its own argument: *Congress* created a jurisdictional floor and only *Congress* could mandate a specific across-the-board rate ceiling. The Board lacks the power to amend the statute establishing its duties and authority, and thus may not change the law to provide Olin's desired "counterweight" to a congressional mandate. Further, the very same statute expressly *prohibits* the use of an R/VC ratio to create a presumption that a rail rate exceeds a maximum reasonable level. *See* 49 U.S.C. § 10707(d)(2)(B) (prohibiting a presumption that a rate generating an R/VC ratio in excess of 180%—the jurisdictional threshold—exceeds a reasonable maximum level); *see also id* § 10707(c) ("a finding of market dominance does not establish a presumption that the … rate exceeds a reasonable maximum.").

Thus, Olin's proposal is not only beyond the Board's authority, it would require the agency to violate express statutory commands.

3. Other shipper interests propose that carriers found to have earned adequate revenues be prohibited from increasing rail rates in real terms. Both "Concerned Shippers" and WCTL propose that the Board prohibit revenue adequate carriers from increasing rates within the Board's jurisdiction by more than the amount of increase in the carrier's operating costs. *See* Concerned Shippers Opening Comments at 13 ("[A] rail carrier that is subject to the [revenue adequacy] constraint . . . should not be able to <u>increase</u> existing rail rates on market dominant traffic in excess of increases in its cost of operations."); WCTL Opening Comments at 26 (advocating new "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 . . . will be conclusively presumed unreasonable and unlawful"). Concerned Shippers offer no meaningful support or rationale for their conclusory claim or the sweeping rate cap they propose. And the rationale proffered by WCTL does not withstand scrutiny.

WCTL erroneously relies on the Board's reasoning in the separate and distinct context of a Stand-Alone Cost case to support its proposed across-the-board rate cap for all carriers found to have earned adequate revenues. *See* WCTL Opening Comments at 26-27. In relying on the Board's Maximum Mark-up Methodology ("MMM") developed for SAC cases to justify the imposition of overall rate caps under the rubric of the "revenue adequacy constraint," WCTL ignores critical differences between the two analyses. SAC is a "bottom-up" analysis that determines the revenue requirement for a least-cost, most efficient stand-alone railroad ("SARR") serving only the traffic selected by the complainant, while the revenue adequacy constraint is intended to employ a "top-down" analysis to all traffic across a rail carrier's entire network. Moreover, revenue adequacy determinations are unrelated to SAC analysis. Thus, a rate reduction methodology applied to rates found to exceed a maximum reasonable level based on an independent (SAC) analysis has no bearing on whether particular rates (or rate increases) are reasonable under a conceptually distinct top-down, system-wide analysis.

WCTL's reliance on SAC principles and analyses also highlights a fundamental flaw in the existing revenue adequacy methodology—its use of depreciated historical costs to value a rail carrier's assets. SAC analyses use forward-looking replacement costs to calculate the capital investment requirements of the SARR. The foundation of the Board's annual revenue adequacy determinations, in contrast, is the historical cost of a carrier's capital investments. Thus, the Board's SAC analysis and its existing annual revenue adequacy determinations are two fundamentally different and irreconcilable inquiries. SAC-based methods and analyses—such as the MMM rate reduction mechanism—are not transferrable to the revenue adequacy context.

B. The Board Should Reject AECC's Vague and Arbitrary Revenue Reduction Proposal.

Arkansas Electric Cooperative Corporation ("AECC") offers a vague and indefinite proposal to freeze and "roll back" rail carrier revenues in order to "reduc[e] or eliminat[e] supracompetitive earnings while retaining earnings sufficient to preserve revenue adequacy." *See* AECC Opening Comments at 22. AECC's proposal is so ill-defined that it is difficult to evaluate without more explanation and description. To the extent that the broad outline of its proposal can be discerned, AECC seems to be proposing that the Board somehow determine an amount of rail carriers' "total contribution that accrues above the 180 percent R/VC jurisdictional threshold" that should be reduced in order to "eliminate the supracompetitive portion of rail earnings." *Id.* AECC would then have the Board order carriers to refund that amount to shippers able to "document their cumulative rate payments above the jurisdictional threshold." *See id.* AECC's vague proposal is fatally flawed in a number of respects.

First, AECC's proposal is so nebulous and inadequately described that it is not susceptible to meaningful evaluation and must be rejected on that basis alone. For example, AECC provides no meaningful definition of "supracompetitive" earnings or how it proposes that the Board would determine the level of earnings deemed to be supra-competitive.[4] Nor does it state whether the determination of "supracompetitive earnings" would be made for individual carriers or simply as a gross estimate for the entire industry.[5] Without a decipherable definition of "supracompetitive earnings," it is impossible to evaluate a proposal to reduce or eliminate them. Nor does AECC discuss how it would propose to exclude or otherwise address revenues generated by traffic moving under transportation contracts. *See* 49 U.S.C. § 10709.

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[4]AECC describes "supracompetitive earnings" as "earnings above the revenue adequacy level." AECC Opening Comments at 2, 5. But this broad "definition" is both circular and entirely dependent on what level of earnings for a given carrier constitutes "the revenue adequacy level." AECC offers no definition of "revenue adequacy level" or how it should be calculated or determined, other than a quotation of the general language of the statute. *See id.* at 12 (quoting 49 U.S.C. § 10704(a)(2)). AECC further fails to explain how "supracompetitive" earnings are related to or distinguished from earnings generating "a reasonable and economic profit or return" expressly included in the definition of carrier revenue levels the Board is directed to promote. *See id*. AECC goes on to claim that the existing annual revenue adequacy determinations are "overly conservative" and that the Board's cost of equity capital is overstated and defective. *Id.* at 13-14. But AECC fails to explain how it contends the Board *should* determine revenue adequacy. Instead, it merely criticizes the current approach and elsewhere separately advocates a different methodology for calculating the cost of capital. *See id.* at 13-15, Appendix A. It is thus impossible to determine from AECC's comments what rail revenue level(s) it would deem to constitute "competitive earnings" and or what earnings level would be deemed "supra-competitive," let alone why.

[5] AECC does assert, without support or explanation, that "supracompetitive earnings made up approximately 13.5 percent of total Class I industry net earnings in 2013." AECC Opening Comments at 17 n.16. This could be read to suggest that AECC believes that revenue adequacy and "supracompetitive earnings" should be calculated on an industry-wide rather than carrier-specific basis.

AECC further fails to explain how it would propose to calculate "total contribution" above the jurisdictional threshold (which fixed, joint and common costs would be attributed to what traffic, and how?). And even if AECC had explained how it would calculate carriers "total contribution that accrues above the R/VC jurisdictional threshold," it fails to describe how such "excess" contribution would be allocated to individual shippers. Indeed, AECC concedes that it has no idea of how such a process might work or what proof would be required of shippers seeking a refund, suggesting that "hopefully," the Board would develop a "simple administrative process" to address such knotty and complex issues. AECC Opening Comments at 22.

Second, AECC's general proposal is based on the implicit assumption that revenues earned by rail carriers are unreasonable to the extent that they exceed 180 percent of variable costs. The AECC approach effectively would presume that any rate generating an R/VC ratio above the jurisdictional threshold also necessarily exceeds a maximum reasonable level, and thus compels a *de facto* rate prescription and reparations. But such a presumption is expressly prohibited by the governing statute. *See, e.g.*, 49 U.S.C. §§ 10707(c), 10707(d)(2)(B) (barring presumption that a rate generating R/VC > 180 exceeds a reasonable maximum level).[6] Use of such a meat-axe approach to reduce carrier rates also would be contrary to the Board's statutory mandate to determine rate reasonableness individually on a rate-by-rate basis. *See id.* §

[6] The fact that a railroad's total revenue for certain traffic exceeds 180 percent of its variable costs, by itself, provides no indication as to whether any specific individual rate is reasonable. Nor would the undifferentiated, gross revenue "roll back" advocated by AECC account for the attributable common and fixed costs of a specific movement or the continuing necessity of demand-based differential pricing. Instead, AECC's approach apparently would require a carrier to return to shippers all revenue generated by rates generating an R/VC ratio greater than 180 percent—including individual rates producing a R/VC ratio only slightly greater than 180 percent—regardless of the relevant characteristics of individual movements or other factors bearing on the reasonableness of specific rates. Such indiscriminate, wholesale revenue transfer from carriers to shippers would be arbitrary and capricious.

10701(d)(1) (if Board determines a carrier has market dominance "over the transportation to which a particular rate applies," the rate "for such transportation must be reasonable").

Third, AECC's proposal to "roll back" and cap railroad's total revenues would cause substantial harm to railroads, shippers, and the public. Such revenue caps would reduce rail carriers' ability to make investments necessary to maintain and improve service, increase productivity, innovate, and make rail operations more efficient. As AECC concedes, "a bright-line rate limit based on R/VC ratios could produce unintended harmful consequences, not the least of which would be the further undermining of incentives for productivity improvement." AECC Opening Comments at 21-22. What AECC fails to acknowledge is that an indiscriminate, bright-line R/VC limit on *total* rail *revenues* would be even more pernicious because it would apply to the aggregate of all rail rates within the Board's jurisdiction.

CONCLUSION

The proposals for reductions of carrier rates and revenues that have been advanced in this proceeding are unsupported, ill-conceived, and inconsistent with modern railroad economics, regulatory policy, and law. Those proposals are demonstrably arbitrary, unworkable, and unlawful, and could not form a reasonable or rational basis for further rail rate regulation.

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Dated: November 4, 2014