SERVICE DATE – JULY 25, 2013

SURFACE TRANSPORTATION BOARD

DECISION

Docket No. FD 35506

WESTERN COAL TRAFFIC LEAGUE—PETITION FOR DECLARATORY ORDER

Digest:[1] Because Berkshire Hathaway, Inc., failed to seek and obtain agency authorization for its purchase of BNSF Railway Company, as was required by federal law, BNSF may not revalue its railroad assets to reflect a markup during 2010, 2011, and 2012, the years when Berkshire had unauthorized control of BNSF. Commencing with its asset valuation as of January 1, 2013, BNSF is directed to transition to the full asset markup over a four-year period.

Decided: July 24, 2013

INTRODUCTION

On February 12, 2010, Berkshire Hathaway, Inc. (Berkshire) acquired BNSF Railway Company (BNSF) in its entirety through a purchase of BNSF stock. Berkshire did not believe that Board approval was necessary and, therefore, did not seek our authorization. Because Berkshire paid more than the book value of BNSF (sometimes referred to as a "premium" over book value), our accounting regulations and Generally Accepted Accounting Principles (GAAP) required BNSF to revalue its rail assets for purposes of financial reporting to reflect the current fair market values of those assets. This revaluation resulted in a net increase (or "markup") in the value of BNSF's rail assets. Shipper interests, led by the named petitioner, the Western Coal Traffic League (WCTL), believe that the markup would allow BNSF to raise its rates and make it more difficult for shippers to obtain rate relief from the Board. Therefore, they have asked the Board to require the use of "predecessor costs," such that the post-acquisition values of BNSF's rail assets would not be included on BNSF's financial statements and reports to the Board.

A complicating factor in this matter is the discovery during the course of this proceeding that Berkshire's portfolio of assets included two small common carrier railroads, WCTU Railway LLC[2] and CBEC Railway, Inc., at the time Berkshire acquired BNSF in early 2010.[3]

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[1] The digest constitutes no part of the decision of the Board but has been prepared for the convenience of the reader. It may not be cited to or relied upon as precedent. Policy Statement on Plain Language Digests in Decisions, EP 696 (STB served Sept. 2, 2010).

[2] On March 18, 2013, the current owner of WCTU Railway LLC notified the Board that WCTU Railway LLC had changed its name effective March 15, 2013, to Rogue Valley Terminal

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Berkshire was therefore required to seek Board approval for its acquisition of BNSF prior to obtaining control, which Berkshire failed to do. Although Berkshire proposed to bring itself into compliance by divesting itself of those other two small carriers, which it did in November and December of 2012, the Board sought public comment on what impact, if any, Berkshire's non-compliance should have on this proceeding. The parties' positions vary widely. Some argue that the Board should require Berkshire to file an application seeking regulatory approval of the acquisition, while others argue that Berkshire's non-compliance provides an additional reason for disallowing the asset revaluation. BNSF contends that no further action is necessary.

Following a review of the record in this proceeding, the Board has decided not to alter its accounting rules for acquisitions. The Board will, however, take certain actions, described below, in recognition of the unique circumstances surrounding this particular transaction.

First, to address Berkshire's failure to seek and obtain required Board approval for its acquisition of BNSF, we are directing BNSF to resubmit its STB Form R-1 submissions for 2010, 2011, and 2012 without the markup within 60 days of the effective date of this decision. Second, we are directing BNSF to transition in the full markup equally over a four-year period, beginning in the R-1 reporting year for 2013. This action stems from our concern that a full markup of all of BNSF's rail assets in one reporting year, without any countervailing merger synergies, would suddenly exclude a subset of the traffic of captive shippers from the agency's jurisdiction because we cannot investigate the reasonableness of transportation rates if those rates produce a revenue-to-variable cost ratio below 180%. Normally, the impact on this jurisdictional threshold from raising the book value of the rail assets to reflect the market price is offset, to some degree, by merger synergies that would translate into efficiencies and lower variable costs. Because the markup here is not offset by any countervailing synergies, even small changes to the variable costs can have an impact on the subset of the traffic of captive shippers near the jurisdictional threshold. Those shippers should have the opportunity to adapt, to the extent possible, to the impacts of the markup in BNSF's asset valuations.[4]

At the end of this four-year transition period, the markup will be fully recognized in BNSF's financial statement filed with the Board, in accordance with GAAP. As explained in detail in this decision, the Interstate Commerce Act requires the Board to conform its accounting

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Railroad Corporation. For simplicity, however, this decision will continue to refer to that entity as WCTU Railway LLC.

[3] As noted later in this decision, not only was Berkshire required to obtain approval for its acquisition of BNSF in 2010, it also should have obtained Board approval for its 2008 purchase of a 60% interest in a company that controlled WCTU Railway LLC, because at that time it already controlled CBEC Railway, Inc.

[4] We have chosen to mitigate the impact of BNSF's asset write-ups by combining the three-year delay and four-year transition period to capture a full seven-year business cycle. See Major Issues in Rail Rate Cases, EP 657 (Sub-No. 1), slip op. at 62 (STB served Oct. 30, 2006) (noting that since 1960, the average length of a business cycle was approximately seven years).

rules to GAAP "[t]o the maximum extent practicable." 49 U.S.C. §§ 11142, 11161. Since 1990, the Interstate Commerce Commission (ICC)—our predecessor agency—and the Board have repeatedly ruled that rail carriers must follow GAAP and use acquisition costs (purchase accounting) to account for rail carrier acquisitions unless it can be shown that GAAP produces depressed or overvalued market values due to government action, regulatory policy, or other market distorting reasons.

FACTUAL BACKGROUND

We began this declaratory order proceeding under 5 U.S.C. § 554(e) and 49 U.S.C. § 721 to consider the request of WCTL that we disallow, for certain regulatory purposes, the revaluation of the assets of BNSF recorded in BNSF's R-1 financial statements in calendar year 2010 and subsequent years, due to the acquisition of BNSF by Berkshire.

On February 12, 2010, Berkshire acquired 100% of the outstanding shares of BNSF's parent company that Berkshire did not already own in a transaction valued at $34.5 billion in cash and Berkshire stock (the Purchase Price).[5] The Purchase Price reflected a premium of approximately $22 billion over the net book value of pre-acquisition BNSF, which was approximately $13 billion.[6]

Our regulations and GAAP require rail carriers to follow specific accounting principles when reporting acquisitions in their annual R-1 filings. 49 C.F.R. § 1201, Instruction 2-15(c). GAAP requires all business combinations to be accounted for by a single method: the purchase method (sometimes referred to as "acquisition accounting").[7] Where, as here, the consideration paid exceeds the net book value of the acquired company, the purchaser must allocate the premium first to any differences between the book value and the fair market value of the assets acquired and then to goodwill. Accordingly, when BNSF filed its STB Form R-1 annual report for 2010, it increased the net book value of its tangible assets to reflect the fair market value of those assets.[8] Some assets were written down, while others were written up or not revalued, but

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[5] See Burlington Northern Santa Fe, LLC, Form 10-Q, at 8 (May 4, 2012), available at http://www.sec.gov/edgar.shtml; Burlington Northern Santa Fe Corporation, Schedule 13D (Amendment No. 4 to Schedule 13D), at 6 (Feb. 16, 2010), available at http://www.sec.gov/edgar.shtml. The transaction also included the assumption of $10 billion of BNSF debt.

[6] As part of the transaction, the corporate entity that owned BNSF's rail assets and business was merged into a new corporate entity that was renamed BNSF Railway LLC.

[7] See Accounting Standards Codification (ASC) 805—Business Combinations. ASCs are issued by the Financial Accounting Standards Board, an independent private sector organization that establishes uniform standards of financial accounting.

[8] Valuation reporting for calculating the return on net investment (ROI) is based on a calendar year calculation, using an average of a beginning-of-year and an end-of-year investment base as reported in a carrier's annual R-1 filing. For this reason, approximately 50% of the revaluation was included in the investment base used to compute BNSF's ROI for 2010, as the

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the net effect was an increase of $8.1 billion in the value of BNSF's tangible assets. The primary adjustment to the value of BNSF's tangible assets was a write-up of the value of "road" costs (i.e., the value of the land used as right-of-way). The remainder of the premium, approximately $14 billion, was allocated to goodwill.[9]

In its petition, WCTL asked the Board to declare that it will exclude the acquisition-related revaluation of BNSF's tangible assets ($8.1 billion) when determining BNSF's system-wide costs under the Uniform Railroad Costing System (URCS). WCTL argued that the Board should not follow acquisition cost accounting for purposes of BNSF's URCS calculations based on the facts of this case. BNSF opposed the petition, claiming that WCTL had not shown why the Berkshire acquisition should be treated differently from prior mergers and acquisitions.

By decision served on September 28, 2011, the Board instituted this proceeding and set a procedural schedule for the submission of written evidence and comments.[10] Subsequent filings by the parties raised the additional issue of whether the acquisition premium should be excluded from BNSF's asset base for purposes of the agency's revenue adequacy determination for BNSF, and related cost of capital issues. The Board decided to address these issues in the course of this proceeding. After receiving several rounds of written evidence and argument, the Board held a public hearing on March 22, 2012, to explore the arguments raised by WCTL, BNSF, and other parties to the proceeding.[11] In addition, on October 9, 2012, the Board served a notice of request for public comments after the discovery that Berkshire's acquisition of BNSF was not in compliance with the Interstate Commerce Act.

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transaction did not close until February 2010. The full premium was included in the investment base used to compute BNSF's ROI for 2011. See R.R. Revenue Adequacy—2011 Determination, EP 552 (Sub-No. 16) (STB served Oct. 16, 2012).

[9] Goodwill is not included as part of the asset base for purposes of determining revenue adequacy under the agency's current methodology.

[10] In a separate decision on the same date, the Board granted WCTL's motion for protective order filed on May 4, 2011.

[11] On December 20, 2011, the Arkansas Electric Cooperative Corporation (AECC) filed a motion for leave to file rebuttal evidence along with the rebuttal evidence. BNSF filed in opposition to AECC's motion. We are denying AECC leave to file rebuttal evidence. AECC did not file a timely election to become a party, did not participate in the discovery phase of the proceeding, and did not file initial and reply testimony and argument. Yet, in its proffered rebuttal evidence, it attempts to make a new affirmative case that BNSF's asset valuation should be excluded because BNSF's methodology is inappropriate. This is a matter that clearly should have been raised in the opening evidence, and AECC has not justified its failure to raise the issue earlier. The remainder of AECC's rebuttal is cumulative of matters covered by other parties. Insofar as AECC attempts to introduce its rebuttal as an exhibit in response to our request for comments on October 9, 2012, we reject that exhibit as non-responsive.

This proceeding generated great interest from the railroad industry, shippers, government officials, and the public. We received letters and comments from several members of Congress, the United States Department of Agriculture, the United States Department of Transportation, numerous state agricultural commissions and associations, and the National Association of Regulatory Utility Commissioners.[12] A broad array of shipper and railroad interests also filed comments.

Shippers, their trade associations, and agricultural and utility interests are concerned that allowing BNSF to value its assets based on the price paid by Berkshire would allow BNSF to raise its rates unfairly without any change in service. They also argue that the Federal Energy Regulatory Commission (FERC) and state public utility regulators do not permit utilities to pass through acquisition premiums to their customers' rates, and that the Board should follow this precedent.

BNSF and other railroad interests argue that the Board's accounting rules are well established, that the ICC, the Board, and the courts have previously rejected the shippers' arguments, and that the shippers have presented no new arguments. BNSF also argues that the increase in its asset value here is no greater in relation to its predecessor book value than the premiums in other railroad acquisitions. BNSF claims that shipper concerns about rate increases are overstated and argues that the accounting treatment of the asset values would have little or no impact on the transportation rates it charges.

REGULATORY FRAMEWORK

The issues raised by WCTL require an overview of certain accounting principles and several regulatory concepts, including the jurisdictional threshold, constrained market pricing, and revenue adequacy, and how these concepts fit into the Board's role in the regulation of railroad rates.

Purchase Accounting. The Interstate Commerce Act, as amended by the ICC Termination Act of 1995 (ICCTA), Pub. L. No. 104-88, 109 Stat. 803, authorizes the Board, in 49 U.S.C. § 11142, to prescribe a uniform accounting system for rail carriers subject to our jurisdiction and, in 49 U.S.C. § 11161, to maintain cost accounting rules for rail carriers. Each rail carrier must maintain a cost accounting system in compliance with the Board's rules. 49 U.S.C. § 11162. Sections 11142 and 11161 both require the Board to conform its accounting rules to GAAP "[t]o the maximum extent practicable."

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[12] Additionally, prior to the filing of WCTL's petition in this proceeding, the Board received two letters from members of Congress regarding the acquisition premium. On March 22, 2011, the Board received a joint letter from Senator Al Franken (D-Minn.), Senator Tom Harkin (D-Iowa), Senator Tim Johnson (D-S. Dak.), Senator David Vitter (R-La.), Senator Herb Kohl (D-Wisc.), Senator Mary Landrieu (D-La.), Senator Mark Pryor (D-Ark.), Senator Amy Klobuchar (D-Minn.), Senator Michael Enzi (R-Wyo.), and Senator Jon Tester (D-Mont.) (March 22, 2011 Letter). On April 11, 2011, the Board received a letter from Senator John Thune (R-S. Dak.).

Congress sought to address comprehensively rail carrier accounting issues in the Staggers Rail Act of 1980 (Staggers), Pub. L. 96-448, 94 Stat. 1895. In Staggers, Congress established the Railroad Accounting Principles Board (RAPB), an independent body of accounting experts from industry, government, and academia, charged with developing accounting principles to govern the determination of costs for regulatory proceedings before the ICC. See 49 U.S.C. §§ 11161, 11162, 11167 (1994). Staggers also authorized the ICC to prescribe expense and revenue accounting and reporting requirements consistent with GAAP in accordance with the cost accounting principles established by the RAPB. 49 U.S.C. § 11166(a) (1994).

The ICC formerly required rail carriers to account for mergers and acquisitions using the predecessor cost principle; that is, railroad assets were valued at the cost incurred by the entity that first devoted the property to common-carrier railroad service, usually original cost. However, for business acquisitions, GAAP valued the transaction at the price paid by the acquiring company, often referred to as acquisition cost or purchase cost.[13] In its 1987 Final Report, the RAPB concluded that GAAP represented the superior method for measuring economically accurate costs, and that GAAP should be used to value assets in railroad mergers and acquisitions unless the ICC determined that the use of GAAP produced depressed or overvalued market values due to government action, regulatory policy, or other market distorting reasons. RAPB Final Report, Vol. 2 at 45-46. The RAPB reasoned that acquisition costs better represented the economic conditions facing railroads than predecessor costs, because a large share of the industry's revenues are determined in competitive markets rather than through the regulatory process. Id. at 46. It also concluded that using GAAP accounting was consistent with the objective of enabling railroads to attract capital and represented the most practicable and verifiable accounting method, because railroads use the same records to support their financial accounting. Id. at 47-48. As discussed later in this decision, the RAPB's recommendations and conclusions were a substantial factor in the ICC's decision to require carriers to use purchase accounting.

Jurisdictional Threshold. The Board may consider the reasonableness of a challenged rail rate only if the carrier has market dominance over the traffic involved. 49 U.S.C. § 10707(b)(c).[14] By statute, a carrier is not considered to have market dominance unless the revenue produced by the rate is greater than 180% of its variable cost of providing the service (R/VC Ratio). 49 U.S.C. § 10707(d)(1)(A). The statutory R/VC Ratio is also the floor for any rate relief.

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[13] Under purchase accounting, the acquiring corporation records the fair-market value of the acquired assets less liabilities assumed as its cost. It records the excess (if any) of the cost of an acquired company over the sum of the fair values of tangible and identified intangible assets less liabilities as goodwill. When the RAPB issued its 1987 Final Report, GAAP treated mergers and acquisitions differently. While acquisitions were accounted for using purchase accounting, mergers used "pooling of interest" accounting. GAAP for mergers subsequently was changed to the purchase accounting method.

[14] Market dominance is "an absence of effective competition from other rail carriers or modes of transportation for the transportation to which a rate applies." 49 U.S.C. § 10707(a).

The Board uses URCS to determine a carrier's variable costs in rate reasonableness complaints and other regulatory proceedings. URCS is the Board's general purpose costing system used to estimate variable and total unit costs for railroads; it reflects the extent to which different types of costs incurred in the rail industry change in proportion to changes in output. See Adoption of the Unif. R.R. Costing Sys. as a Gen. Purpose Costing Sys. for All Regulatory Costing Purposes (Unif. R.R. Costing Sys.), 5 I.C.C. 2d 894, 898-99 (1989). URCS, however, is not a measure of short-run variable costs or the marginal cost of hauling rail traffic. It is a measure of intermediate variable costs on a system-average basis that includes costs (such as return on road property investment) that are fixed in the short term. E.I. DuPont De Nemours & Co. v. CSX Transp. Inc., NOR 42099, slip op. at 19 (STB served June 30, 2008). URCS treats 50% of road ownership costs as variable. All other things being equal, an increase in the value of the road investment on the railroad's books will reduce the R/VC ratios of the carrier's rates, because such costs are included as variable costs in determining the ratio.

The parties provided varying estimates of the average increase in URCS costs caused by inclusion of the increased asset values in URCS. WCTL estimates the average increase in variable cost was approximately 4%.[15] BNSF offers a similar estimate, claiming the average increase was 4.0% to 5.1%.[16] The Alliance for Rail Competition et al. (ARC)[17] estimates that the increase in URCS variable costs was 9.59%.[18]

Constrained Market Pricing. The Board's standards for judging the reasonableness of rail freight rates are set forth in Coal Rate Guidelines, Nationwide (Coal Rate Guidelines), 1 I.C.C. 2d 520 (1985), aff'd sub nom. Consol. Rail Corp. v. United States, 812 F.2d 1444 (3d Cir. 1987). Coal Rate Guidelines sets forth a set of pricing principles known as "constrained market pricing" (CMP),[19] which imposes three main constraints on the extent to which a railroad

[15] WCTL Opening, V.S. Crowley & Fapp, Ex. 3.

[16] Initially, BNSF stated that inclusion of the acquisition premium would result in a BNSF system-wide variable cost increase of 5.6%. BNSF Opening 20; BNSF Opening, V.S. Baranowski & Fisher at 4. BNSF later stated that the average increase in BNSF URCS costs attributable to the purchase accounting adjustment was in the range of 4% to 5.1%. BNSF Reply 14; BNSF Reply, V.S. Baranowski & Fisher at 2-3.

[17] Specifically, the Alliance for Rail Competition filed comments with: the Montana Wheat & Barley Committee; the Colorado Wheat Administrative Committee; the Idaho Barley Commission; the Idaho Wheat Commission; the Montana Farmers Union; the Nebraska Wheat Board; the Oklahoma Wheat Commission; the South Dakota Wheat Commission; the Texas Wheat Producer Board; the Washington Grain Commission; and the National Association of Wheat Growers.

[18] ARC Opening 2; ARC Opening, V.S. Fauth at 3.

[19] There are four basic objectives of CMP. A captive shipper should not be required to pay more than is necessary for the carrier involved to earn adequate revenues. Nor should it pay more than is necessary for efficient service. A captive shipper should not bear the cost of any facilities or services from which it derives no benefit. And responsibility for payment for

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may charge differentially higher rates on captive traffic: revenue adequacy, management efficiency, and stand-alone cost (SAC). Id. at 534. A fourth constraint—phasing—can be used to limit the introduction of otherwise-permissible rate increases when necessary for the greater public good. Id. at 546-47.

The revenue adequacy and management efficiency constraints employ a "top-down" approach, examining the incumbent carrier's existing operations, and, as discussed below, the revenues, expenses, asset values, and liabilities associated with rail operations reported in the carrier's financial statements. If the carrier is revenue adequate (earning sufficient funds to cover its costs and provide a fair return on its investment), or would be revenue adequate after eliminating unnecessary costs from specifically identified inefficiencies in its operations, the complaining shipper may be entitled to rate relief. See, e.g., CF Indus., Inc. v. Koch Pipeline Co., NOR 41685 (STB served May 9, 2000), aff'd sub nom. CF Indus., Inc. v. STB, 255 F.3d 816 (D.C. Cir. 2001). In contrast, the SAC constraint uses a "bottom-up" approach, calculating the revenue requirements that a hypothetical new, optimally efficient carrier would need to provide rail service to the complaining shipper. Thus, the SAC constraint does not rely on book asset values.

The revenue adequacy constraint rests on the concept of revenue adequacy embodied in the Interstate Commerce Act. Since enactment of the Railroad Revitalization and Regulatory Reform Act of 1976 (4R Act), Pub. L. No. 94-210, 90 Stat. 127 (1976), Congress has required the ICC and the Board to maintain, and revise as necessary, standards and procedures for establishing railroad revenue adequacy and to determine annually which of the Class I rail carriers are earning adequate revenues. 49 U.S.C. §§ 10704(a)(2)-(3).[20]

To make the annual revenue adequacy determination, the Board compares a carrier's ROI with the rail industry's after-tax cost of capital for that year.[21] The Board calculates the carrier's ROI by dividing net railway operating income (an after-tax, before-interest figure) by an investment base that consists of the firm's net investment in railroad property, plus working

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facilities or services that are shared by other shippers should be apportioned according to the demand elasticities of the various shippers. Coal Rate Guidelines, 1 I.C.C. 2d at 523-24.

[20] Adequate revenues are defined by 49 U.S.C. § 10704(a)(2) as those "that are adequate, under honest, economical, and efficient management, to cover total operating expenses, including depreciation and obsolescence, plus a reasonable and economic profit or return (or both) on capital employed in the business." Such revenues should "provide a flow of net income plus depreciation adequate to support prudent capital outlays, assure the repayment of a reasonable level of debt, permit the raising of needed equity capital, and cover the effects of inflation," 49 U.S.C. § 10704(a)(2)(A), and "attract and retain capital in amounts adequate to provide a sound transportation system in the United States," 49 U.S.C. § 10704(a)(2)(B).

[21] The Board determines the industry's cost of capital annually in a separate proceeding. See, e.g., R.R. Cost of Capital—2011, EP 558 (Sub-No. 15) (STB served Sept. 13, 2012) (finding industry cost of capital to be 11.57%).

capital, less accumulated deferred income tax credits. If its ROI is equal to or exceeds the cost of capital, the railroad is considered to have been revenue adequate for that year; if its ROI is less than the cost of capital, the railroad is considered to be revenue inadequate for that year. Assuming everything else remains constant, an increase in the investment base will reduce the carrier's ROI.

The Board has not addressed how the revenue adequacy constraint would work in practice in rail rate cases. See, e.g., S. Miss. Elec. Power Ass'n v. Norfolk S. Ry., NOR 42128 (STB served Aug. 31, 2011) (proceeding in which revenue adequacy constraint raised in complaint was subsequently settled). Revenue inadequacy, however, is not a defense to a complaint demonstrating that the carrier's challenged rates exceed the SAC constraint. BNSF Ry. v. STB, 453 F.3d 473, 480 (D.C. Cir. 2006) (citing Coal Rate Guidelines, 1 I.C.C. 2d at 536 ("a rate may be unreasonable even if the carrier is far short of revenue adequacy")). Consequently, shippers have used the SAC constraint to obtain refunds and rate relief from revenue inadequate railroads.

DISCUSSION AND CONCLUSIONS

The central issue in this case is whether we should continue to follow GAAP purchase accounting, which requires BNSF to mark up its rail assets to reflect acquisition costs. The agency has required this kind of markup since 1990, reasoning that acquisition costs are inherently a better measure of value than old book costs. WCTL and its supporters urge the Board to depart from that precedent, while BNSF and its supporters urge the Board to continue to follow GAAP here.

We present our analysis of this issue in four parts. **Section I** describes our long-standing precedent that requires rail carriers to revalue their rail assets in acquisition transactions. **Section II** addresses the arguments offered to depart from that precedent. **Section III** discusses our decision to order BNSF to remove the markup of its rail assets from its R-1 reports for the reporting years 2010, 2011, and 2012, due to Berkshire's non-compliance with 49 U.S.C. § 11323. Finally, **Section IV** discusses the measured steps we are ordering to help mitigate the impact of the asset markup, beginning with reporting year 2013.

I. Agency Precedent Concerning Regulatory Accounting for Acquisitions

In 1990, the ICC ruled that it would follow GAAP and use acquisition costs (purchase accounting) instead of predecessor costs to value rail carrier acquisitions "unless it can be shown that government regulatory policy has produced an artificially depressed price." R.R. Revenue Adequacy—1988 Determination (Revenue Adequacy—1988), 6 I.C.C. 2d 933, 939 (1990). The ICC required railroads to use purchase accounting because it "comports with [GAAP], it is supported by the RAPB's principle on asset valuation and related expense, and it is consistent with the underlying objectives of our revenue adequacy analysis." Id. The ICC reaffirmed that its paramount objective was to set revenue levels that "permit the present and prospective investors to earn the market rate of return on their investment in railroad assets." Id. at 940. It explained that to understate the value of a railroad's assets is to understate that railroad's revenue requirements. Conversely, to overstate the value of a railroad's investment is to overstate its revenue requirements. Revenue Adequacy—1988 also rejected the argument that predecessor costs fairly depict the age and physical condition of the road property and equipment. The ICC stated that: "At the time of sale, market price (acquisition cost) becomes a better measure of value. It inherently takes into account the age of the assets purchased, the levels of maintenance performed, obsolescence, and the presence of any excess assets." Id. at 941.

Revenue Adequacy—1988 required certain rail carriers that had made acquisitions of other carriers at prices that were less than the pre-existing book values of the acquired companies to mark down the value of those acquisitions over the objections of the carriers and the Association of American Railroads (AAR), but the agency made clear that its policy was not one-sided. The ICC stated that if the agency were to use old book values in cases where railroads are sold for a premium over book value, "[s]uch an approach would potentially shortchange those recent investors who have paid a premium above the old book value with a return below the cost of capital for their investment." Id. at 940.

On judicial review, the United States Court of Appeals for the District of Columbia Circuit affirmed the agency's decision. The court found that the agency's decision was rational and lawful, that the ICC had reasonably concluded that acquisition value provided more current and probative evidence of value than did predecessor costs. Ass'n of Am. R.Rs. v. ICC, 978 F.2d 737, 740-42 (D.C. Cir. 1992). The court noted that Congress, in Staggers, required the ICC to "prescribe expense and revenue accounting and reporting requirements consistent with generally accepted accounting principles" and to "promulgate such rules pursuant to accounting principles established by the Railroad Accounting Principles Board." Id. at 741-42 (quoting 49 U.S.C. § 11166, now codified at 49 U.S.C. §§ 11142, 11161). "In the rule before us," said the court, "the ICC did exactly that, relying on the expert views expressed by the RAPB consistent with generally accepted accounting principles as support for its valuation methodology." Ass'n of Am. R.Rs. v. ICC, 978 F.2d at 742.

The Board reaffirmed the use of purchase accounting for regulatory purposes—this time in the context of an acquisition at a price substantially above net book value. CSX Corp.—Control—Conrail, Inc. (Conrail), 3 S.T.B. 196 (1998). Characterizing several shipper groups' positions as "result-oriented," the Board denied their request to disallow the premium above predecessor book value that CSX Corporation (CSX) and Norfolk Southern Corporation (NS) paid to acquire the assets of Conrail, Inc. Id. at 262-63. The Board explained that its Uniform System of Accounts, adopted in conformity with GAAP, required that the former Conrail assets be valued based on their recent acquisition cost, and not upon Conrail's book value. Id. The Board noted that its decision in Revenue Adequacy—1988 to use acquisition cost, rather than book value supported by shipper interests, was judicially affirmed. Conrail, 3 S.T.B. at 262; see also Ass'n of Am. R.Rs. v. ICC, 978 F.2d at 740-42.

The Board acknowledged in that decision that following GAAP could increase URCS system-wide costs and the 180% jurisdictional threshold for an average movement by as much as 4.9% for CSX and 7.26% for NS, but concluded that such increases in the jurisdictional threshold did not justify departing from GAAP:

> The statute specifically limits our rate regulation to situations where the rate exceeds 180% of the variable cost of service, and the statute also directs that we conduct our costing in accordance with GAAP to the maximum extent practicable. See 49 U.S.C. § 10707(d)(1)(A) and 49 U.S.C. § 11161 (accounting). The relief that protestants are requesting would seem to contravene these specific statutory directives.

Conrail, 3 S.T.B. at 264.[22]

The Board likewise rejected the argument that the agency should not permit CSX and NS to use the acquisition price of the Conrail assets in determining whether the carriers were revenue adequate because the increase in asset values would move both carriers further away from achieving revenue adequacy. The Board explained that the requirement to use purchase accounting is evenhanded, as it applies whether an acquisition-related asset revaluation moves the acquiring carrier closer to or further away from revenue adequacy:

> In any event, the statute dictates that our regulation overall should give railroads the opportunity to earn the current cost of capital on their investments in rail property. 49 U.S.C. 10101(3), 10701(d)(2), 10704(a)(2). If we were to adopt a policy of using the predecessor book value of property obtained through a merger or consolidation for various regulatory purposes, then this could deter efficiency enhancing transactions such as this one. Stated another way, carriers cannot attract and retain capital unless they are given the opportunity to be compensated for the real value of the property, not just the book value.

Conrail, 3 S.T.B. at 265.

On judicial review, the United States Court of Appeals for the Second Circuit affirmed the Board's decision. The court explained that, in valuing rail assets, the STB is statutorily required to conform its accounting rules to GAAP to the maximum extent practicable. Erie-Niagara Rail Steering Comm. v. STB, 247 F.3d 437, 442 (2d Cir. 2001) (citing 49 U.S.C. §§ 11142, 11161, 11164). The court explained further that the STB determined that the railroad industry is not a heavily regulated industry and that, because only a relatively small fraction of traffic is subject to the Board's rate jurisdiction, "paying too much for property in hopes of extracting increased rents would be a self-defeating strategy in the rail industry." Id. at 443. The court found this conclusion reasonable. Id.

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[22] The Board believed that the projected increases in the jurisdictional threshold from the asset markup were likely to be offset by merger synergies, but concluded that, even under the worst case scenario, the projected increases in the jurisdictional threshold were not so large as to call into question the use of purchase accounting. Conrail, 3 S.T.B. at 264.

II. Departure from Agency Precedent

In this case, no party has demonstrated that the price paid by Berkshire was artificially inflated due to government regulatory policy. In other words, there is no evidence that the acquisition cost paid by Berkshire does not reflect the best measure of the true value of these rail assets. Therefore, our precedent requires BNSF to mark up the rail assets in accordance with GAAP to reflect the more recent evidence of the true value of those assets revealed by this market event.[23]

As such, the key question in this case is should we depart from our precedent and prohibit BNSF from marking up its rail assets in accordance with GAAP? As discussed above, the Board's rules on the regulatory accounting valuation of railroad assets in purchase transactions have been settled for many years. Consistent with GAAP, the Board has required the use of purchase accounting since 1990 both where the railroad assets were acquired for more than predecessor book value and for less. Because the statute directs the agency to follow GAAP "to the maximum extent practicable," we retain discretion to determine what is practicable and when deviations from GAAP are necessary.

The arguments as to why the Board should depart from its precedent in this case fall into five major categories. First, some parties urge the Board to follow the example of agencies of more heavily regulated industries. Second, some parties repeat arguments made previously (by the railroad industry) and rejected (by the Board and the federal courts) that the use of purchase accounting suffers a fatal circularity problem. Third, many claim that this transaction is different, because there will be no merger synergies to offset the impact of the markup. Fourth, some commenters object to a perceived conflict between our accounting rules that follow purchase accounting and our recent decision to reject a petition to move to replacement cost accounting. Finally, WCTL and others claims that it is unfair to permit BNSF to mark up its rail assets. We will address these arguments in turn below,[24] but will first address the concerns raised by several members of Congress regarding the impact on captive shippers of the revaluation of BNSF's assets required under purchase accounting.

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[23] Consumers United for Rail Equity (CURE) argues that the Board should not permit BNSF to write up the value of its assets because BNSF itself did not make the asset purchases; the premium reflects the price paid by Berkshire to acquire 100% of BNSF's stock. CURE Opening 6; CURE Reply 8-9. CURE's position is contrary to GAAP, which requires that "the parent company's purchase cost [must be] pushed-down onto the subsidiary's financial statements." Rio Grande Indus., Inc.—Control—S. Pac. Transp. Co., 4 I.C.C. 2d 834, 980 (1988).

[24] The record in this case is substantial and we are addressing in this decision only the most substantial and well-developed arguments raised by parties for why we should depart from our precedent. Parties seeking a departure from agency precedent bear the burden of proof. We have carefully reviewed the entire record and conclude that any other arguments raised by a party in this proceeding were not sufficiently developed to justify a departure from GAAP and our precedent.

A. Congressional Concerns

Several members of Congress filed testimony or appeared before the agency to express deep concerns about how our decision could impact captive rail shippers in their states. They expressed concern that permitting BNSF to revalue its asset base would result in artificially higher rates for captive shippers. In a joint letter, Senators Franken, Vitter, Harkin, Kohl, Johnson, Landrieu, Pryor, Enzi, Klobuchar, and Tester cautioned that "Berkshire Hathaway could pay an inflated price for BNSF, and then pass that cost on to its captive customers in the form of higher rates."[25] Senators Conrad and Hoeven expressed similar concerns that "Berkshire Hathaway paid a premium when it purchased BNSF and there is concern this could indirectly influence rates for a number of shippers."[26] Congresswoman Lummis related that "[m]any shippers have stated that they are already experiencing the effects of higher rates due to the inclusion of the acquisition premium."[27] Congressman King noted that his constituents believe that "the inclusion of BNSF's acquisition premium in its regulatory rate base may result in higher costs for captive consumers, with those higher costs impacting a large segment of rural America, electric producers that rely on coal, and others who rely on BNSF Railway for service."[28] In his testimony at our hearing, Senator Franken advised us that most shippers facing this situation do not want to say anything publically because of fear of retaliation, and expressed concern that changing the asset base would "send the message to shippers that the Board does not care about them, and isn't worried that they may face higher rates."[29]

While the accounting treatment of the acquisition will not impact the majority of rail rates because they are constrained by market forces, we understand the concerns shared by members of Congress about how this decision could impact some captive rail shippers. Although the primary regulatory tools we use to set maximum lawful rates—the SAC test, and a simplified version of the SAC test[30]—do not rely on the historic book value of the railroad's assets, there will be some impact on our rate complaint determinations. For example, permitting the markup

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[25] March 22, 2011 Letter. In a joint letter dated March 4, 2013, Senators Franken, Vitter, Pryor, Klobuchar, Baldwin, Johnson, and Landrieu reiterated these concerns, and commented further that BNSF should not be allowed to markup its assets during the period that the transaction was not approved by the Board as well as all subsequent years that BNSF is owned by Berkshire. (March 4, 2013 Letter).

[26] Letter from Senator Kent Conrad (D-N. Dak.) and Senator John Hoeven (R-N. Dak.) to the Surface Transportation Board (Apr. 25, 2012).

[27] Letter from Representative Cynthia Lummis (R-Wyo.) to the Surface Transportation Board (Mar. 12, 2012).

[28] Letter from Representative Steve King (R-Iowa) to the Surface Transportation Board (Mar. 20, 2012).

[29] Hearing Tr. 16 (Mar. 22, 2012).

[30] We recently issued a decision adopting changes to our rate reasonableness procedures, including eliminating the relief limit in Simplified-SAC cases. Rate Regulation Reforms, EP 715 (STB served July 18, 2013).

is estimated to increase URCS variable costs by as much as 5.1%, according to BNSF, and by 9.8%, according to the Board's own analysis.[31] This will raise the 180% jurisdictional threshold, placing an additional amount of BNSF's rates outside our authority to review. Further, the markup of the book value of the asset base will increase the revenue level needed for BNSF to be considered revenue adequate. And, those captive shippers whose rates are currently prescribed by the Board—Western Fuels Association, Inc., and Basin Electric Power Cooperative, Inc. (collectively, WFA) and Arizona Electric Power Cooperative, Inc. (AEPCO)—could be impacted without further Board action, which we address below.

Therefore, in light of the unique circumstances of this acquisition, we are requiring a transition to a full recognition of the asset write-up and taking the case-specific action discussed below. We do not believe, however, that the effects on our rate regulation procedures from the markup justify a full departure from purchase accounting, which is required by GAAP. As noted, purchase accounting is evenhanded and has the opposite effects when rail carriers acquire railroad assets at less than book value.

With respect to one of the cases involving a current BNSF rate prescription, Senators Conrad, Hoeven, and Thune note that revaluation of BNSF's railroad assets could increase the rates BNSF may charge WFA. In Western Fuels Ass'n v. BNSF Railway, NOR 42088, slip op. at 8 (STB served Feb. 18, 2009), the Board prescribed the maximum lawful rate, expressed as a revenue-to-variable cost percentage, that BNSF could charge for each year of a 20-year period ending in 2024. For example, for the year 2009, BNSF could not charge rates for the movements

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[31] Because they lacked access to the Phase II portion of URCS, the parties provided informed estimates, based on varying assumptions, on how the asset write-up would affect the assignment of variable costs. Of the estimates provided by the parties, ARC's estimate on the impact on URCS was the highest at 9.59%, ARC Opening 2, ARC Opening, V.S. Fauth at 3, though its methodology was flawed in that it failed to recognize that URCS includes a return on 50% of a rail carrier's road investment, not 100%. BNSF estimated that the average increase in its URCS costs attributable to the purchase accounting adjustment was in the range of 4% to 5.1%. BNSF Reply 14; BNSF Reply, V.S. Baranowski & Fisher at 2-3. WCTL's estimate was approximately 4%. WCTL Opening, V.S. Crowley & Fapp, Ex. 3.

The Board elected to develop its own estimate of the impact on URCS by re-running Phase II of URCS with the acquisition premium removed. We began with the undisputed evidence submitted by BNSF on the investment and depreciation accounts impacted by the markup. We then adjusted the 2010 BNSF R-1 reports used to develop URCS to remove the markup and re-ran our URCS software programs. This produced 2010 URCS results without the markup that we could compare directly to the 2010 URCS results with the markup. Our analysis indicates that including the markup would increase BNSF's URCS costs by approximately 9.8%. Parties of record may obtain the workpapers supporting the Board's calculation from the Board's Office of Economics (OE) by providing OE with a signed copy of the protective order adopted by decision served September 8, 2011, in this proceeding.

at issue that exceeded 241% of the variable costs of providing transportation.[32] The R/VC ratios for the 20-year period were calculated using projections of variable costs that did not include any change in road investment (50% of the return on which is included as an intermediate-term "variable cost"). The Board chose to prescribe future rates as a function of variable costs so that the rate prescription would have the flexibility to adjust to expected changes in operating costs, such as raising or lowering fuel costs. If operating costs rise, the maximum lawful rate should rise as well. However, there is no basis to increase the maximum lawful rate because of the recognition on BNSF's books of the 2010 fair market value of BNSF's road investment. The prescribed rate for 2009 of 241%, for example, already was sufficient to provide BNSF a reasonable return on the replacement cost of the facilities needed to serve WFA, including the replacement cost of road investment. If we do not adjust the rate prescription, BNSF would be able to charge higher rates to WFA based on a revaluation of fixed costs that we already recognized in our rate prescription. Accordingly, we are concurrently issuing a decision in Western Fuels Ass'n v. BNSF Railway, Docket No. NOR 42088, in which we direct the parties in that case to meet and propose a suitable mechanism to adjust the current rate prescription to hold WFA harmless from the markup of BNSF's rail assets.

Although the same rationale typically would apply to AEPCO, the other shipper with a current BNSF rate prescription, AEPCO's prescription is set at the jurisdictional floor of 180%. See Ariz. Elec. Power Coop. v. BNSF Ry., NOR 42113, slip op. at 37 (STB served Nov. 22, 2011). As such, we are also concurrently issuing a decision in that proceeding directing the parties to confer and comment on options for reinstituting the rate prescription. Ariz. Elec. Power Coop., Inc. v. BNSF Ry., NOR 42113 (STB served July 25, 2013).

B. Relevance of Policies of Utility Regulators That Disallow Acquisition Premiums

WCTL and its supporters analogize the Board's regulation of the railroad industry to the regulation of natural gas pipelines and electric transmission by FERC and to state regulation of public utilities. They argue that FERC and state regulators do not allow regulated utilities to increase their rates to include acquisition premiums and claim that the Board is violating this cardinal principal of public utility regulation.[33]

WCTL's analogy to principles of public utility regulation is inapposite. Under the public utility model relied on by WCTL, the regulator establishes maximum rates for the utility's regulated services designed to recover the utility's cost of service including a return on the utility's investment. See, e.g., N. Ind. Pub. Serv. Co. v. FERC, 782 F.2d 730, 733-36 (7th Cir. 1986) (describing the four-step process—cost of service, cost classification, cost allocation and

[32] The maximum lawful rate, which varies from year to year, was established in the February 18, 2009 decision, and modified slightly by a decision served on June 5, 2009. See W. Fuels Ass'n v. BNSF Ry., NOR 42088 (STB served June 5, 2009).

[33] WCTL Opening 24; Id. at 28 ("Public utility regulators consistently deny requests for inclusion of acquisition premiums in regulated utility rate bases"); Id. at 29 (inclusion of the premium requires captive BNSF customers to pay higher rates for the same service, pay twice for the same assets, and offers no offsetting benefits).

rate design—for developing rates for natural gas sales and transportation service by FERC). The utility's profit level depends primarily on the rate of return allowed by the regulator on the utility's net investment in the business.[34] The utility cannot increase its rates without obtaining regulatory approval.[35] To obtain a rate increase, the utility must show either that its current rates are too low for it to earn its authorized rate of return, or that the rate of return authorized by the regulator is itself too low and should be set at a higher level. If the utility is earning more than its authorized rate of return, the regulator can, on its own motion, seek to reduce the utility's rates. See, e.g., Bear Creek Storage Co., 137 FERC ¶ 61,134 (2011) (instituting investigation into interstate natural gas storage company's rates on agency's own motion based on overall rate of return of 22.4%). In contrast to purchase accounting, original cost accounting is a bedrock principle of the public utility ratemaking model; otherwise, all a utility "would have to do to raise rates and obtain greater income would be to buy utility properties from another at a price higher than original cost and in this very simple way increase the cost of service to consumers." N. Border Pipeline Co. v. FERC, 129 F.3d 1315, 1318 (D.C. Cir. 1997) (quoting Arkla Energy Res., 61 FERC ¶ 61,004 (1992)).

Congress deliberately chose to move away from a public utility model of regulation for the railroad industry. Before 1976, consistent with the public utility model of regulation, the ICC "was charged with examining *every* railroad shipping rate to ensure that it was 'just and reasonable.'" Ass'n of Am. R.Rs. v. STB, 237 F.3d 676, 677 (D.C. Cir. 2001) (emphasis added). The 4R Act largely deregulated railroad rates so that thenceforth the ICC was authorized to examine a rail carrier's service rate only if it first affirmatively found that the carrier had "market dominance over such service." Id. Further, in Staggers, "Congress set forth a national policy of allow[ing], to the maximum extent possible, competition and the demand for services to establish reasonable rates for transportation by rail and minimiz[ing] the need for Federal regulatory control" of the railroad industry. Kawasaki Kisen Kaisha Ltd. v. Regal-Beloit Corp., 561 U.S. __, __, 130 S. Ct. 2433, 2462 (2010) (internal quotations omitted).

In ICCTA, Congress continued the national policy allowing competition and the demand for service to set rates to the maximum extent possible and minimizing the need for Federal regulatory control of the railroad industry. See 49 U.S.C. § 10101(1), (2). In contrast to the regulated utility model, railroads do not file their tariff rates with the Board, and the Board has

[34] "Calculation of rate base is a critical step in establishing maximum rates, since the product of rate base multiplied by allowed rate of return is the total sum of money the agency allows to investors in the firm." United Distrib. Cos. v. FERC, 88 F.3d 1105, 1179 (D.C. Cir. 1996) (quoting Richard J. Pierce, Jr. & Ernest Gellhorn, Regulated Industries 102 (3d Ed. 1994)).

[35] See 1-3 Energy Law and Transactions § 3.02. Changes by a natural gas company in any rate, charge, classification, or service must be preceded by thirty days' notice to FERC and the public in the form of a filing of new schedules. Upon complaint or *sua sponte*, FERC may conduct a hearing on the filing, at which the natural gas company bears the burden of proving that the proposed rate is just and reasonable. FERC is authorized under the Natural Gas Act to suspend the filing for up to five months. Any rate increase that becomes effective after expiration of the suspension period without an order by FERC and conclusion of the hearing is subject to refund.

limited power to suspend railroad rates (by issuing injunctions to prevent irreparable harm) and no authority to initiate rate reasonableness investigations on its own initiative. See 49 U.S.C. § 10704(b). Railroads decide what to charge their customers without prior Board approval. The Board does not establish maximum rates for classes of railroad rates. Indeed, the Board has no rate jurisdiction over railroad tariff rates unless the railroad is market dominant with respect to the shipment, and the rate is greater than 180% of variable costs. 49 U.S.C. §§ 10701(c), (d)(1), 10707. Further, the Board has no rate jurisdiction over private contracts between railroads and shippers. 49 U.S.C. § 10709.

Importantly, in contrast to the public utility model, the Board's ability to protect captive customers from unreasonable rates does not rest on whether the railroad is earning a sufficient profit on its book assets.[36] While the revenue adequacy constraint may become more important in the future, the primary constraint on railroad pricing employed by the Board to protect captive shippers from unreasonable rates is the SAC test, under which the Board examines the costs required to develop a hypothetical railroad designed to efficiently serve the shipper's traffic. See Coal Rate Guidelines, 1 I.C.C. 2d at 541-42. "[S]ystem-wide revenue inadequacy is not a basis upon which a carrier may defend an unreasonable rate over a segment of its system" based on the SAC test. BNSF Ry. v. STB, 453 F.3d 473, 480 (D.C. Cir. 2006). The Board has also established an alternative simplified method of determining rate reasonableness in smaller cases, the Three-Benchmark methodology, which compares relative rates (R/VC ratios) paid by similarly situated shippers, and is not based on allocating a utility-type cost of service to shipper rates. Simplified Standards for Rail Rate Cases (Simplified Standards), EP 646 (Sub-No. 1) (STB served Sept. 5, 2007).

The Board is also subject to statutory commands that negate regulating railroads under public utility-type cost of service ratemaking with a return allowance computed on an original cost rate base. As the court noted in Erie-Niagara, our governing statute commands that the uniform accounting system and cost accounting rules that we establish for rail must follow generally accepted accounting principles "[t]o the maximum extent practicable." 247 F.3d at 442 (citing 49 U.S.C. §§ 11142, 11161). Purchase accounting is the generally accepted accounting principle for acquisitions. Further, 49 U.S.C. § 10704(a)(2) requires the Board to establish standards and procedures for establishing revenue levels for rail that are adequate to provide "a reasonable and economic profit or return (or both) on *capital employed in the business.*" (Emphasis added.) The Board has interpreted this phrase to mean the market return on the amount that the investors paid for their investment in the railroad assets, rather than the original book cost of the assets. Otherwise, the revenue needs of investors would be overstated where they purchased railroad assets at less than original book value and understated where they purchased railroad assets at more than original book value or the predecessor's costs. Conrail, 3 S.T.B. at 265; Revenue Adequacy—1988, 6 I.C.C. 2d at 940.

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[36] As the Board stated in Conrail: "Neither the Board nor the ICC has ever decided a maximum rate case based upon whether the defendant carrier or carriers was or was not revenue adequate. The fact that a carrier is revenue inadequate has never been used as a reason to deny or limit the scope of maximum rate relief." 3 S.T.B. at 265.

In sum, the policies of FERC and state utility regulators concerning the regulatory treatment of acquisition premiums are not a road map for the Board's regulation of railroads because of fundamental differences in how Congress has directed the Board to regulate the rates charged in this industry.

C. Circularity and Spiraling Rates

WCTL asserts that the Board should exclude the BNSF acquisition premium, because allowing regulated companies to record the market value of their assets on their books is inherently circular.[37] According to WCTL, the circularity problem arises because the market value of an enterprise is a function of its current and anticipated future earnings, but the present and future earnings of a regulated utility depend upon the rates that the regulator allows. Investors may continue to bid up the market price of the regulated company if the regulator allows the utility to increase its rates to recover the higher earnings required as a result of the increased market value. See FPC v. Hope Natural Gas Co., 320 U.S. 591, 601 (1944); N. Border Pipeline Co., 129 F.3d at 1318. The AAR raised this same concern in the late 1980s, when the ICC was marking down the value of the rail assets, but in the reverse. The AAR was concerned that investors would mark down the price of a regulated company, fearing the regulator would force the railroad to lower its rates to reflect the lower market value of the assets, and the repetition of this cycle would cause the market values of the railroad to tumble uncontrollably.

WCTL acknowledges that the Board has previously held that circularity is not a concern in the existing regulatory structure for railroads, because most rail rates are not subject to regulation. However, WCTL claims that the Board's prior assertions regarding circularity were merely dicta, and that the Board has previously justified its approval of the pass-through of merger premiums by stating that the premium cost would be offset by merger synergies.[38] WCTL also suggests that there does not need to be total circularity for rates to be affected by the acquisition premium.[39]

In three cases, the ICC and the Board have rejected the claim that the agency's rate regulation policies are tainted by circularity. These determinations have been upheld by the courts. As noted earlier, in Revenue Adequacy—1988, 6 I.C.C. 2d at 938-39, the ICC determined that circularity was not a problem in railroad regulation, because a large share of revenues was determined by competitive markets and not by regulation. The ICC, therefore, rejected the railroad industry's argument that the use of acquisition costs would result in a circular downward rate spiral in which rates would be based on lower acquisition costs which, in turn, would produce lower rates. For much the same reason, the Board in Conrail characterized as "not credible" the argument that NS and CSX "would pay a multi-billion dollar 'premium' based upon the expectation of extracting increased monopoly rents (because of adjustments in

[37] WCTL Opening 28-31.

[38] Id. at 31.

[39] Id. at 30, V.S. Wilson at 19-20; see also CURE Opening 4; National Corn Growers Association Opening 13.

the regulatory rate base) from the very small number of shippers that are truly captive." 3 S.T.B. at 262. The Board found that, "paying too much for a property in hopes of extracting increased rents would be a self-defeating strategy in the rail industry," because only a relatively small fraction of railroad traffic is subject to regulatory rate review, id., a conclusion the Second Circuit fully endorsed in Erie-Niagara, 247 F.3d at 442-43.

Contrary to WCTL's assertions, the agency's findings rejecting the circularity argument are not dicta. Our precedent on this issue is clear and has been judicially affirmed. As the Second Circuit explained in Erie-Niagara, which affirmed Conrail:

> We agree with the STB's view that Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591, . . . is inapplicable here. Hope held that the Federal Power Commission properly rejected the use of market value in setting rates in the heavily regulated natural gas industry, because the use of such a value created a circularity problem. See id. at 601 . . . . That is, market value would be inherently inaccurate as an independent valuation of the company because an essential component of the company's value, future earnings, was dependent on the level of the very same regulated rates.
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> Here, by contrast, the STB determined that the railroad industry is not a heavily regulated industry and that "given that very few rail shippers are captive shippers whose rates ever require regulatory intervention, paying too much for property in hopes of extracting increased rents would be a self-defeating strategy in the rail industry." This conclusion is reasonable and entitled to deference. See Association of Am. Railroads v. ICC, 978 F.2d at 741-42 (holding Hope inapplicable on similar ground).

247 F.3d at 442-43.

In 2009, the Board again rejected this "fatal circularity" argument. In Use of a Multi-Stage Discounted Cash Flow Model in Determining the Railroad Industry's Cost of Capital (Multi-Stage DCF), EP 664 (Sub-No. 1) (STB served Jan. 28, 2009), the Board rejected WCTL's claim that the circularity problem made it improper for the Board to use analysts' projections of earnings growth in the discounted cash flow (DCF) method of determining the railroad industry's cost of capital. The Board stated that the vast majority of rail traffic is not subject to rate review before the agency. That is because most rates fall below the statutory threshold for rates established by the statute, and most of the remainder is either under contract (and thus, has been agreed to by the shipper) or involves the transportation of commodities that the Board has found to be subject to effective competition and thus exempt from rate regulation. Id. at 9. The Board observed that only a fraction (roughly 10% to 20%) of railroad traffic is subject to potential STB rate review. Id. It concluded, therefore, that the growth estimates provided by railroad industry analysts are driven more by market forces than regulatory concerns. Id. The Board acknowledged that there is some relationship between the Board's cost-of-equity determination and the returns that railroads may be permitted to earn on regulated traffic, and concluded that the effect is a small component of overall growth in the rail industry and would not create the kind of fatal circularity that should preclude the use of a multi-stage DCF model. Id. at 10.

The Board's reasoning in Multi-Stage DCF addresses WCTL's arguments regarding circularity, partial or total. Given the percentage (roughly 10% to 20%) of traffic that is potentially subject to rate review, WCTL and its supporters have failed to show that any portion of the Purchase Price paid by Berkshire was associated with the perceived ability to charge higher rates from regulated traffic or that it would have been rational for Berkshire to pay more for BNSF's assets in the belief that it could recoup the higher price through such rate increases.[40]

D. The Role of Merger Synergies in Cases Involving Acquisition Premiums

A number of commenters argued that this case is different because of the absence of any merger synergies, and thus deserves different treatment. For example, WCTL interprets the Board's decisions as allowing "the pass-through of merger premiums," because the mergers were projected to produce offsetting merger synergies that would offset the acquisition premiums.[41] WCTL characterizes the Board as applying its own version of the "public benefits" exception to the general rule of utility ratemaking against recovery of acquisition premiums.[42] WCTL and other parties misunderstand our precedent and policies on this issue.

The Board requires railroads to write up or write down assets acquired in an acquisition because purchase accounting is the generally accepted accounting principle for acquisitions, and our statute requires that our accounting rules follow GAAP to the maximum extent practicable. 49 U.S.C. §§ 11142, 11161.[43] Acquisition accounting provides the most accurate, up-to-date values of the railroad's assets arising out of arm's-length financial transactions. When there is an acquisition, the Board uses the updated financial values of the acquired assets in its annual determinations of rail carrier revenue adequacy, because the Board has interpreted 49 U.S.C. § 10704(a)(2) as requiring it to determine the market return on the amount that the investors paid for their investment in the railroad assets, rather than the original book cost of the assets. Conrail, 3 S.T.B. at 265. Otherwise, the revenue needs of investors would be overstated where they purchased railroad assets at less than original book value and understated where the assets

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[40] The argument that Berkshire paid a premium over book value for BNSF because Board regulatory policies would allow it to recover the premium through increased rates is particularly unconvincing because nearly two-thirds of the premium (approximately $14 billion out of $22 billion) was allocated to goodwill, which is excluded from URCS and the calculation of revenue adequacy.

[41] WCTL Opening 31.

[42] Id.

[43] As noted by the Board in Conrail, removal of the acquisition premium appeared to contravene the specific statutory directives of 49 U.S.C. §§ 10707(d)(1)(A) and 11161 "that we conduct our costing in accordance with GAAP to the maximum extent practicable." 3 S.T.B. at 264.

were more than original book value or the predecessor's costs. Id.; Revenue Adequacy—1988, 6 I.C.C. 2d at 940.

The presence or absence of merger synergies did not play a dispositive role in the agency's rationale for following GAAP and thereby placing the more precise valuation on the accounting ledgers. To be sure, the Board noted in Conrail that projected merger synergies appeared to offset or reduce the impact of the acquisition premium on the Board's jurisdiction over the rates charged by NS and CSX. 3 S.T.B. at 264. But, as the Second Circuit pointed out in affirming Conrail, the Board "performed an extensive analysis, using worst-case scenarios, and determined that even if no efficiencies were captured by this transaction, the thresholds for rate regulation would only rise 7.26% for NS and 4.9% for CSX." Erie-Niagara, 247 F.3d at 443. The Court agreed with the Board that these impacts were not so great as to warrant reconsideration of the Board's accounting rules even if the Board had the statutory authority to do so. We have considered the potential impacts on our jurisdiction of Berkshire's acquisition of BNSF and find that the projected increase in BNSF variable costs under URCS is an insufficient basis upon which to change our accounting rules. However, we recognize that a full markup of all of BNSF's rail assets in one reporting year, without any countervailing merger synergies, would suddenly exclude a subset of the traffic of captive shippers from the agency's jurisdiction. Therefore, we are providing a four-year transition period until the full recognition of the asset write-up.

E. Consistency of Board Policy on Purchase Accounting and Replacement Costs

Some shippers argue that purchase accounting is a form of replacement cost accounting and its use is inconsistent with the agency's repeated rejection of replacement cost accounting to value railroad assets.[44] While the mechanism used by BNSF to determine the fair market values of its assets resembles a replacement cost approach, we disagree that its use here is inconsistent with our rejection of using replacement cost accounting on an annual basis. Purchase accounting is required by GAAP; replacement cost accounting is not. Purchase accounting requires a *one-time* adjustment to asset values and is triggered by a *company-specific market event* that signals that the book values of that company's assets are under- or overstated relative to their real values. In contrast, replacement cost accounting would need to be applied across the entire industry and would be imposed by a change in accounting philosophy rather than a market event. In addition, replacement cost accounting has a number of practical implementation problems that purchase accounting does not.

This agency has declined to adopt replacement cost accounting, most recently in Association of American Railroads—Petition Regarding Methodology for Determining Railroad Revenue Adequacy (AAR Revenue Adequacy Petition), EP 679 (STB served Oct. 24, 2008). The Board explained in AAR Revenue Adequacy Petition that "[t]he biggest obstacle to the use of a replacement-cost approach has always been the challenge of identifying and valuing those rail assets that the railroad will not replace in its current configuration" on an annual basis. Id. at 5-6. This kind of annual inquiry entails a highly case-specific analysis of the lines in question

[44] E.g., CURE Opening 6.

and an analysis of the projected traffic flows into the future and the profitability of the traffic that would use those facilities. Rather than conducting a particularized analysis of the existing rail network, the railroads in AAR Revenue Adequacy Petition assumed that all of their infrastructure would be replaced. Id. at 6. Using this assumption, which the Board rightly characterized as implausible, id., AAR's witness estimated that the replacement cost of BNSF's assets was approximately $79.9 billion. AAR Revenue Adequacy Petition, EP 679, AAR Petition, V.S. Baranowki, Ex. 2, at 1.

By contrast, under purchase accounting, BNSF was required by GAAP to allocate the premium paid over the book value of the company first to any differences between the book value and the fair market value of the assets acquired and then to goodwill. To perform this particularized analysis, Berkshire and BNSF engaged outside valuation experts (the accounting firm of Ernst & Young) that conducted a full review of BNSF's physical and intangible assets to determine their "fair value" in accordance with accounting standards.[45] In the valuation process, BNSF did not simply write up all of its existing assets to replacement cost. Instead, BNSF optimized its network so that only the productive capacity of the railroad was considered in establishing the new book value for property, plant, and equipment. Some of BNSF's assets were written up while others were written down. Among other things, the theoretically optimized rail network assigned no value to more than 6,600 route miles or about 30% of the network. BNSF wrote up the book value of land and grading—much of which dates back to the nineteenth century.[46]

In this case, BNSF placed a fair market value on its assets of approximately $21 billion ($13 billion pre-acquisition book value plus $8 billion tangible asset write-up), relying on Ernst & Young's valuation report,[47] compared to the replacement value of $79.9 billion claimed by AAR in AAR Revenue Adequacy Petition. BNSF and Berkshire's outside public accountants, Deloitte & Touche, audited the valuation results. Based on this process, BNSF's tangible assets were written up by approximately $8 billion above their prior book value; the remainder of the acquisition premium—approximately $14 billion—was allocated to goodwill, which is excluded from URCS variable costs and the determination of revenue adequacy.[48]

The purchase accounting adjustments at issue in this case were recorded on BNSF's books and included in both Berkshire's and BNSF's annual 10-K filings with the Securities and Exchange Commission. These financial statements are certified as accurate by Berkshire's and BNSF's managements and as fairly reflecting BNSF's financial position and prepared in accordance with GAAP by BNSF's and Berkshire's independent certified public accountants. BNSF's STB Form R-1 for 2010 likewise was submitted by BNSF's management under oath as accurate and prepared in accordance with the Uniform System of Accounts.

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[45] BNSF Opening, V.S. Hund at 4-5.

[46] Id. at 5.

[47] Id. at 7; BNSF Reply, V.S. Weil at 2.

[48] BNSF Opening 5-6.

Under these circumstances, there is no inconsistency between our requirements on purchase accounting and our rejection of replacement cost accounting for regulatory purposes. The agency has consistently stated its preference for using the best valuation of a carrier's assets in performing its regulatory functions. But the Board has determined that *continuous* updating of railroad assets to replacement cost is too burdensome to be practicable. In contrast, Berkshire's acquisition of BNSF has revealed through a market transaction that the old book value of BNSF's assets understates the true value. This market event provides an opportunity to replace the outdated book value of the assets with an updated estimate of the true valuation of those assets, bounded at all times by the total market price. In other words, it is practicable to perform this kind of inquiry occasionally, when there is a market event that reveals a significant discrepancy between the book value and fair market value of the assets, but not on an annual basis.

We also reject suggestions made at oral argument that we do not have sufficient information to determine whether the asset write-up was reasonable. The write-up is reflected on BNSF's certified financial statements and no credible evidence has been presented that calls the valuations into question. The Board's accountants independently reviewed BNSF's valuation report prepared by Ernst & Young pursuant to the Board's authority to examine rail carrier documents and records, see 49 U.S.C. § 11162(b), and the record does not contain any expert testimony or documentary evidence that the valuations of asset values on BNSF's R-1 do not reflect the fair market values of the assets acquired by Berkshire.[49]

In a related argument, shippers argue we should depart from our precedent and not follow GAAP because otherwise our revenue adequacy and URCS model will double count inflation. This double count occurs, they maintain, because we have applied a nominal cost of capital (which includes inflation) to the historical value of the assets to determine revenue adequacy and variable costs. Given our directive to follow GAAP to the maximum extent practicable, we find that this double count argument does not justify a departure from precedent and GAAP. It is true that we would have a serious double count if each year we permitted a carrier to mark up the value of its assets for inflation, and then also provided a return on investment for that year that included the effects of inflation. But we are not permitting the continuous updating of assets here. Rather, this is a one-time increase to reflect the best evidence of the fair market value of these assets at a particular point in time, followed by normal depreciation of those assets and the use of nominal cost of capital to reflect the ongoing effects of inflation after the date of the evaluation.

Alternatively, shippers claim that we should use the "real" cost of capital in determining

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[49] Shipper representatives testified at the hearing that BNSF refused to produce documents regarding the valuation in response to shipper discovery requests. See Hearing Tr. 75-76, 380. But the shippers could have filed a motion to compel discovery from BNSF regarding the valuation of BNSF's assets if they wanted to dispute the amount of the premium or the approach used by BNSF. They did not do so. And as explained earlier, although AECC attempted to belatedly file testimony concerning the details of BNSF's valuation methodology, we are rejecting its filing as untimely. See supra n.11.

whether BNSF is revenue adequate rather than the "nominal" cost of capital, because BNSF's railroad assets have been marked up to replacement cost. We decline to adopt this suggestion. It is appropriate to use the real cost of capital in a replacement cost accounting system, because the asset values on the company's books are revalued annually. Purchase accounting, however, involves a one-time adjustment to asset values. Therefore, in determining whether the new owners are earning an adequate return on their investment in the business, it is appropriate to use the nominal cost of capital, which includes the effects of inflation.

F. Fairness

WCTL and its supporters argue that it is unfair for BNSF's rates to increase simply because Berkshire paid a premium to acquire BNSF. However, BNSF's rates do not automatically increase either as a result of Berkshire's acquisition or the revaluation of BNSF's assets. And two of our tests for determining the reasonableness of those rates (SAC and Simplified-SAC) are largely independent of the historical book valuation of BNSF's assets. Moreover, we are not permitting the markup "simply" because Berkshire paid a premium to acquire BNSF. Rather, subject to the transition we are imposing in light of the unique circumstances here, we are requiring BNSF to follow GAAP because the marketplace has revealed that the old book value of those assets understates the true value—a key principle of GAAP for corporate acquisitions. Finally, and most importantly, our requirement that carriers use purchase accounting rather than predecessor cost accounting is evenhanded. The ICC adopted purchase accounting in Revenue Adequacy—1988 over the objections of the railroad industry when railroads were being acquired below book value. It would be unfair to the carriers and their investors to adopt a policy where we write down the assets when the railroads are acquired at below book value, but refuse to write up the assets when the opposite occurs.

The agency "should not switch methodologies simply because they happen to affect revenue adequacy determinations. One method should be adopted and used, regardless of the results." Revenue Adequacy—1988, 6 I.C.C. 2d at 939 (describing one party's argument). Instead, our decision whether to accept the sales price of rail assets as a substitute for old book value is "driven by what is the most accurate and reasonable valuation in each particular case." Id. at 941. In this case, we find that the updated valuations provide more accurate and reasonable valuations of BNSF's rail assets than the old book values.

III. Berkshire Non-Compliance

Having concluded that BNSF is required to mark up its assets in conformity with GAAP in this case, we must also decide *when* BNSF should begin to mark up the assets given Berkshire's failure to seek and obtain Board approval for its acquisition of BNSF in 2010.[50]

[50] An entity that is not a rail carrier must obtain prior Board approval to acquire a railroad line through an asset purchase. 49 U.S.C. § 10901(a)(4). But the acquisition by a non-railroad of a controlling stock interest in a company that owns a railroad line does not trigger § 10901(a)(4). Prior Board approval of the acquisition of a controlling interest in the stock of a

(continued . . .)

During the course of this proceeding, the Board discovered that Berkshire may have owned a rail carrier prior to the acquisition of BNSF, and brought that information to BNSF's attention. In a letter filed in response to the Board on September 13, 2012, BNSF, on behalf of itself and Berkshire, advised the Board that, upon further investigation, Berkshire had found that subsidiaries did, in fact, own two Class III rail carriers—CBEC Railway, Inc., and WCTU Railway LLC—at the time Berkshire acquired control of BNSF, such that the BNSF acquisition was subject to Board approval. BNSF and Berkshire pointed out that, consequently, Berkshire's acquisition in 2008 of a 60% interest in a company that controlled WCTU Railway LLC likewise was subject to 49 U.S.C. § 11323(a)(5). The letter stated further that Berkshire incorrectly believed that it did not own or control any rail carriers subject to Board jurisdiction when it acquired BNSF, and informed the Board that Berkshire would come into compliance promptly by divesting itself of those two carriers.

On October 9, 2012, the Board served a notice of request for public comments on what impact, if any, this non-compliance should have on this proceeding. Below we first summarize the public comments we have received and then describe the steps we will take to address the non-compliance issue.

A. Public Comments

We received many comments and replies in response to the October 9, 2012 notice of request for comments.[51] In these pleadings, shipper interests suggest that Board review of the BNSF acquisition may have resulted in conditions that protected shippers or in a more detailed examination of the amount of the premium.[52] In addition, shippers assert that Berkshire's acquisition of BNSF, while already owning two short line railroads, raises substantial competitive issues that the Board would have been able to address if Berkshire had filed an application pursuant to 49 U.S.C. § 11323.[53] Shippers also state that, based on BNSF's recent

(. . . continued)
rail carrier is only required where the purchaser already controls a rail carrier. 49 U.S.C. § 11323.

[51] Prior to our notice, we also received a letter dated September 27, 2012, from Senator John D. Rockefeller IV (D-W.Va.), the Chairman of the U.S. Senate Committee on Commerce, Science, and Transportation, raising issues about the regulatory impacts of BNSF's disclosure of its ownership of other rail carriers.

[52] ARC Comments 3 (Nov. 8, 2012).

[53] AECC Comments 2-3 (Nov. 8, 2012). AECC submitted comments in response to the Board's decision on October 9, 2012, which sought comments "on the effect, if any, of Berkshire's non-compliance with § 11323." AECC attached as an exhibit to its comments its rebuttal statement of December 20, 2011. As we explain earlier, we are rejecting AECC's rebuttal statement. Moreover, because the rebuttal does not address the effect of Berkshire's non-compliance with § 11323, we also reject AECC's attempt to introduce it into the record as an exhibit. We limit our review to the substance of AECC's comments that are responsive to the decision of October 9, 2012.

disclosures, Berkshire's BNSF acquisition is likely to result in the creation of artificial economic pressure for certain coal plants to shift their coal sourcing to BNSF.[54] In addition, shippers suggest that even if BNSF's recent disclosures were honest mistakes, the Board's procedural integrity may be damaged if other entities conclude that it is better to seek forgiveness instead of permission.[55] Some shippers also believe the Board should either expand this proceeding, or require Berkshire and BNSF to institute a new proceeding by filing an application seeking Board approval of the BNSF acquisition, to transfer the burden of proof to Berkshire and BNSF, and to consider all public interest issues associated with the transaction.[56] In addition, some shippers also suggest that a condition of Board approval of the BNSF acquisition should be that the Board will certify BNSF as revenue adequate as long as it is owned by Berkshire, as BNSF can no longer borrow funds from the capital markets on its own, but will now have the ability to obtain capital from Berkshire.[57]

In its comments, WCTL argues that Berkshire should not be permitted to retain the fruits of its unlawful actions, that the Board has broad equitable powers to prevent Berkshire from retaining these fruits,[58] and that Berkshire's lack of regulatory compliance is another reason supporting the exclusion of the premium from BNSF's net investment base.[59] WCTL further asserts that the Board should adjust BNSF's cost of capital for the years that Berkshire unlawfully controlled BNSF by using BNSF's 2009 regulatory cost of capital in developing BNSF's URCS variable investment costs, and in determining BNSF's revenue adequacy calculations.[60] Specifically, WCTL suggests that the Board use BNSF's 2009 regulatory cost of capital, which WCTL calculates at 10.01%, in its BNSF URCS and revenue adequacy calculations in all of the unlawful control years.[61]

In addition to the concerns previously expressed in this proceeding, shippers also suggest that the inclusion of the premium could adversely impact captive shippers by making the market dominance inquiry more difficult to satisfy. Pointing to the "refined approach" discussed in M&G Polymers USA, LLC v. CSX Transportation, Inc., Docket No. NOR 42123, some shippers observe that it will be harder for shippers to establish BNSF market dominance because the RSAM benchmark will rise if relief sought by shippers in this proceeding is denied.[62] Shippers also suggest that the inclusion of the premium would incentivize short-term investors and

[54] AECC Comments 3 (Nov. 8, 2012).

[55] ARC Comments 2-3 (Nov. 8, 2012).

[56] CURE Comments 3-4 (Nov. 8, 2012).

[57] Id. at 6.

[58] WCTL Comments 8 (Nov. 8, 2012).

[59] WCTL Reply Comments 2, 5, 7 (Nov. 28, 2012).

[60] WCTL Comments 13-14 (Nov. 8, 2012).

[61] Id. at 14-15.

[62] See ARC Comments 5 (Nov. 8, 2012).

corporate raiders to acquire Class I railroads for short-term gain, with major financing to come from rate increases on captive traffic.[63]

In its comments, BNSF argues that no further action by the Board is necessary. It observes that Berkshire had proposed a plan to remedy the issue by divesting both entities by the end of 2012, and was providing the Board with regular updates.[64] BNSF further argues that Berkshire's ownership of these two entities at the time of the BNSF acquisition has no impact on the accounting treatment of the premium,[65] and also had no effect on the valuation of BNSF's investment base.[66] In addition, BNSF states that neither Berkshire nor BNSF derived any benefits, anticompetitive or otherwise, from Berkshire's simultaneous control of BNSF and the two short line railroads, one of which, BNSF asserts, does not interchange with BNSF at all.[67] BNSF also argues that there is no basis for WCTL's assertion that the Board should calculate a separate BNSF 2009 cost of capital, as there were no "ill-gotten" gains or distortions that resulted from the Board's application of its normal rules after BNSF's acquisition by Berkshire, and further notes that the statutory violation resulting from Berkshire's failure to seek approval under § 11323 "is in the process of being remedied by Berkshire's divestiture" of both short line railroads.[68] BNSF also argues that the use of a 2009 cost of capital for BNSF is not justified based on the assertions of WCTL's witnesses Crowley and Fapp, who acknowledge that the industry cost of capital increased in 2010 and 2011.[69]

Finally, Senators Franken, Vitter, Pryor, Klobuchar, Baldwin, Johnson, and Landrieu express their concerns about Berkshire's failure to realize that its acquisition of BNSF was subject to Board approval under 49 U.S.C. § 11323. They urge the Board to exclude the asset markup during the period that Berkshire was not in compliance with the Interstate Commerce Act, as well as all subsequent years that BSNF is owned by Berkshire.[70]

B. <u>Board Action</u>

Under our precedent, an entity that unlawfully acquires control of a rail carrier without obtaining Board approval may remedy its non-compliance either through divestiture or through Board approval of the transaction. <u>See</u> <u>Ass'n of P & C Dock Longshoremen v. Pittsburgh &</u>

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[63] <u>Id.</u>

[64] BNSF Comments 1 (Nov. 8, 2012).

[65] <u>Id.</u> at 2.

[66] BNSF Reply Comments 6 (Nov. 28, 2012).

[67] <u>Id.</u>

[68] <u>Id.</u> Berkshire has since divested both carriers. By letters dated November 16, 2012, and December 18, 2012, BNSF stated that Berkshire had completed the divestitures of CBEC Railway, Inc., and WCTU Railway LLC, respectively.

[69] BNSF Reply Comments 10.

[70] <u>March 4, 2013 Letter</u>.

Conneaut Dock Co., 8 I.C.C. 2d 280, 295 (1992). Accordingly, Berkshire's decision to bring itself into compliance with the Interstate Commerce Act by divesting itself of the two small rail carriers it controlled when it acquired BNSF was appropriate.

We recognize, however, that divestiture does not change the fact that Berkshire's ownership and control of BNSF was unlawful for a period of nearly three years and that Berkshire was unlawfully in control of multiple carriers since 2008. A number of commenters argued that there must be some consequences for Berkshire's non-compliance beyond divestiture to emphasize the need for full compliance with the requirements of the Interstate Commerce Act and to deter similar non-compliance in the future. We agree that the period of noncompliance must be appropriately addressed.

We have been presented with no evidence that Berkshire knowingly violated the provisions of § 11323. Nonetheless, the statute was violated and the information to avoid such a violation was within Berkshire's control. Not only was Berkshire's acquisition of BNSF not in compliance with the Act, it owned and controlled two rail carriers subject to our jurisdiction without obtaining the necessary approval since 2008. Given that Berkshire did not come into compliance with the Act until December 2012, we have decided to prohibit BNSF from marking up its assets in its financial statements filed with the Board during the period that Berkshire's ownership of BNSF violated § 11323.

We take this action for two independent reasons. First, we find it impracticable to permit the markup of BNSF's railroad assets during this period of non-compliance. We believe that, from a practical standpoint, there must be symmetry between the markup and the approval process. Both should occur at roughly the same time. What we find impracticable from a regulatory perspective would be rules that permit the markup of rail assets due to an unauthorized acquisition. By authorizing the agency to use GAAP "to the maximum extent practicable," however, Congress gave us the discretion to decline to follow GAAP in certain circumstances, such as these.

Alternatively, even if it were arguably "practicable" to permit the markup during periods of non-compliance, we take this step under our broad discretion to fashion appropriate equitable remedies for violations of § 11323. We have the authority to take equitable actions "that are legitimate, reasonable and directly adjunct to the [agency's] explicit statutory power."[71] Here, we agree with commenters that preventing the markup during the period of non-compliance is a measured remedy designed to encourage full compliance with the requirements of the Interstate Commerce Act and to deter similar non-compliance in the future.

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[71] ICC v. Am. Trucking Ass'n, 467 U.S. 354, 365 (1984) (internal quotations and citations omitted); see also 49 U.S.C. § 721(a) ("[e]numeration of a power of the Board . . . does not exclude another power the Board may have in carrying out [the Act]"); Zola v. ICC, 889 F.2d 508, 516 (3d Cir. 1989). In fashioning appropriate remedies, we must give "'complete and efficacious effect to the prohibitions of the statute' with as little injury as possible to the interests of private parties or the general public." Gilbertville Trucking Co. v. United States, 371 U.S. 115, 130 (1962) (quoting United States v. Am. Tobacco Co., 221 U.S. 106, 185 (1911)).

Specifically, we are directing BNSF to refile its 2010, 2011, and 2012 R-1 reports to exclude the effects of this markup within 60 days of the effective date of this decision. Once it has done so, and we have verified those certified reports, the Board will reissue its revenue adequacy determinations for 2010 and 2011, as well as restate the RSAM benchmarks and reissue URCS for those two years. For 2012, the Board will issue its revenue adequacy determination, restate the RSAM benchmarks, and reissue URCS based on BNSF's revised 2012 R-1 report. BNSF may begin to include the effects of this markup in its 2013 R-1 reports, subject to the transitional steps described below.

IV. Transitional Steps

Although we are delaying the $8.1 billion markup of the rail assets until 2013 due to Berkshire's noncompliance with § 11323, we are nonetheless concerned about the near-term impacts resulting from the full markup of rail assets in one year under the unique circumstances of this case. Typically, purchase accounting is applied in railroad acquisitions where the Board has had the opportunity to review and approve the transaction on the merits and to attach oversight or other conditions, where only a portion of the assets of the merged company are revalued, and where the acquiring carrier expects to achieve offsetting synergies that benefit shippers as well as shareholders. Here, the assets of the entire railroad are being revalued (primarily upwards), there is no opportunity for the Board to consider the transaction on its merits and attach conditions, and there are no merger synergies. While these factors do not justify the rejection of GAAP for acquisitions and our precedent, we have already noted that, by authorizing the agency to employ GAAP in railroad accounting systems to the maximum extent practicable, Congress gave us the discretion to take appropriate steps to produce meaningful regulatory results in certain situations, including adjustments to valuation as a transitional step, in order to create "the most accurate and reasonable valuation in [a] particular case." Revenue Adequacy—1988, 6 I.C.C. 2d at 941; see also RAPB Report, Vol. 2, at 46. Even BNSF has recognized that it may be appropriate to phase-in the purchase accounting adjustments through a gradual inclusion of the adjustment in calculating ROI, moderating any impact upon revenue adequacy determinations.[72]

Among our primary concerns is whether the impact on the 180% R/VC threshold will affect the ability of shippers to bring rate disputes to this agency. As we explained earlier, other things being equal, if a railroad is acquired at a price below the predecessor's book value, the write down of the railroad's assets will reduce the rate level of the 180% jurisdictional threshold. Conversely, if a railroad is acquired at a price above the predecessor's book value, the write-up of the railroad's assets will increase the level of 180% jurisdictional threshold. These effects follow mathematically from using updated asset values as required by GAAP purchase accounting under 49 U.S.C. §§ 10707(d)(1)(A), 11161, and our longstanding interpretation of 49 U.S.C. § 10704(a)(3) as requiring the Board to determine the market return on the amount

[72] Letter from BNSF to Sen. John Hoeven (R-N. Dak.) and Sen. Kent Conrad (D-N. Dak.) (April 25, 2012).

that the investors paid for their investment in the railroad assets, rather than the original book cost of the assets.

We therefore will exercise our discretion to take reasonably measured steps designed to help mitigate and smooth the impact of the acquisition premium. The statute provides that in calculating the jurisdictional threshold, the Board is to use its URCS model, "with adjustments specified by the Board." 49 U.S.C. § 10707(d)(1)(B). In 1989, when the ICC replaced Rail Form A with URCS as its general purpose costing system, the agency was concerned about that change's impact on the jurisdictional threshold. To transition between the old costing model and URCS, the ICC established a single "bridge mechanism factor" (0.9934) so that the change in costing systems would not affect the amount of traffic that potentially would be subject to its rate reasonableness jurisdiction. Unif. R.R. Costing Sys., 5 I.C.C. 2d 894, 923-24 (1989); see also Modifications to General Purpose Costing Sys.—GPCS, 5 I.C.C. 2d 880, 885-93 (1989).

Like the ICC in 1989, we have some concerns about the impact on the rate jurisdictional threshold from BNSF's use of GAAP purchase accounting. The overall impact of the markup on URCS variable costs varies among estimates, including increases of 4% and 5.1%, as projected by WCTL and BNSF, respectively, and a 9.8% increase, as projected by the Board. But because of the one-time impact on the jurisdictional threshold and the absence of any countervailing synergies, even small changes to the variable costs can have an impact on the small subset of captive shippers located within a few points of the jurisdictional threshold. These potential impacts include reductions in the ability of shippers to contest the reasonableness of BNSF's rates due to the write-up of BNSF's assets and may reduce leverage in the negotiation of contract rates. As we have said, we find that excluding the asset write-up entirely would not conform with our statutory directive to follow GAAP, and also fails to acknowledge that the new asset valuation does reflect the better estimate of the true valuation of those assets. But we believe it is appropriate to impose measured steps to help smooth the impact of the asset markup on the subset of shippers that would otherwise be immediately removed from the agency's rate review jurisdiction.

Therefore, to help protect captive shippers who may find their rates suddenly outside our purview, we will require BNSF to transition the full markup to its rail assets equally over a four-year period, beginning with the 2013 R-1 data the carrier will file in 2014. We have chosen to mitigate the impact of BNSF's asset write-ups over a seven-year period (combining the three-year delay and four-year transition period) so as to capture a full business cycle. See Major Issues in Rail Rate Cases, EP 657 (Sub-No. 1), slip op. at 62 (STB served Oct. 30, 2006) (noting that since 1960, the average length of a business cycle was approximately seven years). The decision to impose a four-year transitional period is an exercise of our judgment over how best to balance the directive to follow GAAP and use the best available evidence of the value of these rail assets, while taking into careful consideration the impact that a sudden asset write-up would have on shippers near our jurisdictional threshold.

This decision will not significantly affect either the quality of the human environment or the conservation of energy resources.

<u>It is ordered</u>:

1. Within 60 days of the effective date of this decision, BNSF must refile its R-1 reports for 2010, 2011, and 2012 and remove entirely the markup of rail assets due to Berkshire's non-compliance with 49 U.S.C. § 11323.

2. For 2013 and beyond, BNSF is required to mark up the rail assets in accordance with our existing regulations and GAAP, but we are adopting certain transitional measures as described above.

3. This decision is effective on August 24, 2013.

By the Board, Chairman Elliott, Vice Chairman Begeman, and Commissioner Mulvey. Commissioner Mulvey dissented in part with a separate expression.

COMMISSIONER MULVEY, dissenting in part.

In most respects, I agree with the Board's decision in this case. Like the majority, I believe that the Board should require GAAP purchase accounting in this transaction. I also agree that it would be inappropriate to permit the revaluation of BNSF's assets for the period during which Berkshire failed to comply with the statutory requirement to seek Board authorization for its acquisition of BNSF. However, I cannot sign onto the Board's determination in Part IV to arbitrarily "phase" in the markup of BNSF's revalued assets into the carrier's URCS costs over a period of four years. The rationale cited by the majority for phasing is contrary to Board precedent, lacks sufficient explanation, and is inconsistent with other parts of the decision.

The majority decision holds that it is appropriate to phase in the markup of BNSF's rail assets for four reasons: (1) the assets of an entire railroad are being revalued upwards, (2) the Board lacked the opportunity to consider the transaction on its merits and attach conditions related to the asset markup, (3) no merger synergies will result from the transaction, and (4) the Board is concerned about how the markup will impact the number of rates that are subject to the statutory 180% R/VC jurisdictional threshold. <u>Decision</u> at 29-30. None of these rationales is sufficient to justify phasing.

First, this is not the first acquisition where the assets of a railroad are being revalued upwards and thus the transaction should not be treated differently on that basis. The acquisition of Conrail by CSX and NS, the purchase of the Chicago & North Western, and the Union Pacific/Southern Pacific merger all presented situations where the purchase price exceeded the book value of the acquired railroad's assets. <u>See</u> BNSF Opening 8. Moreover, as the majority recognizes, GAAP accounting is supposed to be neutral and should not be changed simply because the direction of valuation changes. <u>Decision</u> at 24; <u>see also</u> <u>Conrail</u>, 3 S.T.B. at 263 (rejecting a "strictly result-oriented" argument against GAAP purchase accounting).

Second, it is certainly true (and unfortunate) that the Board was not given the opportunity to review this transaction prior to its implementation due to Berkshire's failure to comply with 49 U.S.C. § 11323. But this argument rings hollow as a justification for phasing given that the Board appropriately dealt with Berkshire's noncompliance by disallowing the markup completely during the period of unlawful control.

Third, given Board precedent, the absence of merger synergies is not an adequate justification for phasing unless it is accompanied by an explanation as to why the Board is adopting a new policy. As the majority acknowledges, the presence or absence of merger synergies has not been dispositive with regard to applying GAAP, see Decision at 21, and in Conrail, 3 S.T.B. at 264, the Board based its decision to apply GAAP in part on "worst case" scenarios of no merger synergies. Nor is this the first transaction where there were no merger synergies to be had.[1] Given this history, I do not see how the absence of merger synergies in the Berkshire-BNSF transaction could justify departing so significantly from GAAP (unless the Board is simply changing its policy on that issue without sufficient explanation).

Fourth, while I am sympathetic to shippers' argument that the inclusion of the markup will raise the jurisdictional threshold, I note that such concerns have been considered and rejected by this agency before. In Conrail, the Board was successful in persuading a reviewing court that increases in URCS variable costs between 4.9% and 7.26% (assuming no efficiencies) were insufficient to justify changing the Board's implementation of GAAP. Conrail, 3 S.T.B. at 263-64; Erie-Niagara, 247 F.3d at 442-43. Here, the increase in BNSF's variable costs, estimated by the Board at 9.8%, is certainly higher than the estimates in Conrail. But once the Board has determined that it should apply GAAP to this transaction because it "provides the most accurate, up-to-date values of the railroad's assets arising out of arm's-length financial transactions," Decision at 20, I see no justification – outside of maintaining previously adjudicated rate prescriptions – to tinker with that result.

Today, the Board fundamentally alters how it implements GAAP purchase accounting without adequately explaining its departure from precedent or acknowledging the magnitude of the change. This new phasing precedent will create many questions for future transactions. For example, will every merger that produces variable cost increases above 9% be subject to phasing? Or will the trigger be 8.2%? What level of synergies will be sufficient to overcome a 9% increase in variable costs? Will railroads be entitled to phasing relief if their variable costs decrease as a result of a merger-related revaluation? The majority apparently chooses to leave these issues for another day, but I am concerned this decision will result in uncertainty for all of our stakeholders for years to come. While the Board certainly has the right to change its mind about GAAP implementation, it should do so with a reasoned analysis that adequately addresses

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[1] When a private equity fund bought the Chicago & North Western in 1989, the railroad touted its cost-saving plans but there were no apparent transaction-related synergies. Blackstone Capital Partners L.P.—Control Exemption—CNW Corp. & Chi. & N.W. Transp. Co., 5 I.C.C. 2d 1015, 1033-37 (1989). The agency considered no changes to GAAP implementation in that case.

precedent and the ramifications of its policy shift. I cannot rely upon the analysis in Part IV of the decision because it fails to do so. Therefore, I must dissent in part.