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SURFACE TRANSPORTATION BOARD

DECISION

STB Ex Parte No. 646 (Sub-No. 2)

SIMPLIFIED STANDARDS FOR RAIL RATE CASES—
TAXES IN REVENUE SHORTFALL ALLOCATION METHOD

Decided: May 8, 2009

This decision establishes the appropriate methodology to calculate railroad specific tax rates to be included in the Revenue Shortfall Allocation Method (RSAM).

BACKGROUND

The RSAM figure is one of three benchmarks that together are used to determine the reasonableness of a challenged rail rate. Each benchmark is expressed as a ratio of revenues to variable costs (R/VC ratio). RSAM is intended to measure the average markup that the railroad would need to collect from all of its "potentially captive traffic" (traffic with an R/VC ratio above 180%) to earn adequate revenues as measured by the Board under 49 U.S.C. 10704(a)(2) (i.e., earn a return on investment equal to the railroad industry cost of capital).[1]

In Simplified Standards for Rail Rate Cases, STB Ex. Parte 646 (Sub-No. 1) (STB served Sept. 5, 2007) (Simplified Standards), the Board changed the way the RSAM benchmark is calculated to address a flaw in that calculation.[2] Under the RSAM formula revised in Simplified

[1] The $R/VC_{>180}$ benchmark, the second of the three benchmarks, measures the average markup over variable cost currently earned by the defendant railroad on its potentially captive traffic. The third benchmark, the R/VC_{comp} benchmark, is used to compare the markup being paid by the challenged traffic to the average markup assessed on other comparable potentially captive traffic.

[2] Previously, RSAM had been calculated by computing the uniform markup above variable cost that would be needed from all potentially captive traffic "for the carrier to recover all of its URCS fixed costs." Rate Guidelines—Non-Coal Proceedings, 1 S.T.B. 1004, 1027 (1996). When a carrier is not "revenue adequate" under the Board's annual calculations, its RSAM figure (what it needs to collect) should be greater than its $R/VC_{>180}$ figure (what it is actually collecting) and, conversely, when a carrier is "revenue adequate" its RSAM figure should be less than or equal its $R/VC_{>180}$ figure. The problem was that this relationship between RSAM and $R/VC_{>180}$ did not hold true under the Board's prior method. See, e.g., Simplified Standards at 19-20.

Standards, the Board uses the confidential Carload Waybill Sample[3] to estimate the total revenues earned by the carrier on potentially captive traffic ($REV_{>180}$) and the total variable costs of the railroad to handle that traffic ($VC_{>180}$). The Board also uses the carrier's revenue shortfall (or overage) shown in the Board's annual revenue adequacy determination ($REV_{short/overage}$). RSAM is then calculated as follows:

$$RSAM = (REV_{>180} + REV_{short/overage}) \div VC_{>180}$$

Recent cases have revealed a second flaw: the RSAM formula did not properly account for taxes. In E.I. DuPont de Nemours and Co. v. CSX Transportation, Inc., STB Docket Nos. 42099, 42100, and 42101 (DuPont cases), CSX Transportation, Inc. (CSXT) raised an issue regarding this RSAM formula. It observed that the revenue shortfall ($REV_{short/overage}$) – which is calculated as the difference between the return on net investment that a carrier needs to earn to achieve revenue adequacy and the amount that the carrier actually earns – is calculated after all taxes have been paid, and is thus stated on an "after-tax" basis. However, the revenues to which the revenue adequacy shortfall is added ($REV_{>180}$), are calculated before any allowance for taxes, and are thus stated on a "pre-tax" basis. Therefore, CSXT asserted that the inclusion of an "after-tax" revenue shortfall would not provide sufficient revenues to achieve adequate revenues once the additional revenues are subject to taxes.

In the DuPont cases, CSXT proposed that, to correct this deficiency, the Board change the RSAM formula adopted in Simplified Standards by applying the Federal statutory tax rate of 35% in conjunction with CSXT's railroad-specific state tax rate of 4.9% to convert the after-tax shortfall to a pre-tax level. But DuPont argued that no adjustment to the RSAM formula was necessary because the revenue adequacy adjustment factor is overstated due to an over-recovery of income taxes as measured by the Uniform Rail Costing System (URCS). Alternatively, DuPont argued that, if the Board were to adjust the RSAM formula to account for taxes, it should use an "effective" or "marginal" tax rate, rather than the statutory tax rate advocated by CSXT. We declined to address the matter in that proceeding because of the expedited and simplified nature of those cases, but instituted the instant rulemaking to resolve the concerns raised in the DuPont cases.

In this rulemaking, we sought public comment on whether to modify the RSAM formula adopted in Simplified Standards and, if so, what tax rate should be used to adjust the revenue adequacy shortfall.[4] We received several rounds of public comment on this issue.[5] In a decision

[3] The Carload Waybill Sample is a statistical sampling of railroad waybills that is collected and maintained for use by the Board and by the public (with appropriate restrictions to protect the confidentiality of individual traffic data). See 49 CFR 1244.

[4] See Simplified Standards for Rail Rate Cases – Taxes in Revenue Shortfall Allocation Method, STB Ex Parte No. 646 (Sub-No. 2) (STB served June 27, 2008).

[5] On opening we received comments from the Association of American Railroads (AAR) and joint comments submitted by: American Chemistry Council; American Forest and Paper Association; American Soybean Association; Agricultural Retailers Association; Colorado

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served on November 21, 2008, we found that there was a material error in the RSAM formula, in that the revenue shortfall (or overage) was stated on an after-tax basis, while the other aspects of the RSAM formula were stated on a pre-tax basis.[6] Having found material error, we determined that an adjustment to the RSAM formula was necessary, and we revised the RSAM formula to use the marginal tax rate of the carriers. To best approximate the marginal tax rates of the carriers, we concluded that using the statutory federal tax rate, combined with a railroad-specific state tax rate was appropriate.[7] We determined that we would account for taxes by calculating a tax-adjusted shortfall or overage, where the Adjusted $REV_{short/overage} = REV_{short/overage} \div (1 - (\text{State Tax Rate} + (1 - \text{State Tax Rate}) \times \text{Federal Tax Rate}))$. Therefore, we determined to calculate RSAM as follows:

$$RSAM = (REV_{>180} + \text{Adjusted } REV_{short/overage}) \div VC_{>180}$$

Because the state tax rates vary depending upon the railroad and the state(s) in which it operates, in the November 21 Decision, we proposed to calculate a weighted average state tax rate for each railroad using the route-miles of track for each railroad in each state in which it operates. We noted, however, that we did not have all the necessary information needed to calculate each railroad's average state tax rate. On January 30, 2009, we served a decision directing AAR to submit the evidence and calculations necessary to establish carrier-specific

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Wheat Administrative Committee; Corn Refiners Association; The Fertilizer Institute; Glass Producers Transportation Council; Idaho Barley Commission; Idaho Wheat Commission; Institute of Scrap Recycling Industries; Iowa Soybean Association; Montana Wheat and Barley Committee; National Association of Wheat Growers; National Barley Growers Association; National Corn Growers Association; National Council of Farmers Cooperatives; National Farmers Union; National Grain and Feed Association; National Sorghum Producers; The National Industrial Transportation League; National Oilseed Processors Association; National Petrochemical & Refiners Association; Nebraska Wheat Board; North American Millers Association; North Dakota Grain Dealers Association, North Dakota Pubic Service Commission, North Dakota Wheat Commission; Oklahoma Wheat Commission; Paper and Forest Industry Transportation Committee; PPL EnergyPlus, LLC; South Dakota Wheat Commission; Texas Wheat Producers Board; USA Rice Federation; Washington Wheat Commission; Alliance for Rail Competition; Consumers United for Rail Equity; and The Honorable Brian Schweitzer, Governor, State of Montana (collectively, Interested Parties). We received reply comments from the AAR and rebuttal comments from the Interested Parties.

[6] See Simplified Standards for Rail Rate Cases—Taxes in Revenue Shortfall Allocation Method, STB Ex Parte No. 646 (Sub-No. 2) at 3 (Nov. 21, 2008) (November 21 Decision).

[7] See id., at 4.

average state tax rates for each Class I railroad.[8] Specifically, we directed AAR to supply the state corporate income tax rates and the number of miles operated by each carrier in each state for each year from 2002-2007.[9] We proposed that for calculating the route-mile portion of the average state tax equation, the AAR use information from the railroads' respective R-1 Schedule 702 (Miles of Road at Close of Year—By States and Territories (Single Track)), specifically proposing that AAR use column (g) of Schedule 702, which lists the total miles operated, including both "line owned" and "line operated under trackage rights."[10] AAR filed its evidence on February 19, 2009, in accord with the procedural schedule set forth in the January 30 Decision. No party filed a reply.

DISCUSSION AND CONCLUSIONS

To calculate the Adjusted $REV_{short/overage}$, there are two necessary figures: the number of miles operated by each carrier in each state and the corporate income tax rates for those states. In its supplemental evidence, AAR explained that it used two sources for establishing these two major components for calculating the carrier-specific average state tax rates for each Class I railroad. First, as proposed in the January 30 Decision, to determine the route miles operated in each state for each railroad, the AAR used column (g) of Schedule 702 of the Annual Report Form R-1. As requested, AAR submitted these figures for each Class I railroad for each year from 2002-2007.[11]

Second, with regard to the state tax rates, AAR began with the state corporate tax information published on the website of the Tax Foundation, then AAR and each Class I railroad reviewed those tax rates to ensure the accuracy of the information. The carriers made several changes due to a variety of state-specific factors. These revisions to the Tax Foundation's information were as follows:

1. Franchise Taxes – Connecticut, Michigan, New Jersey, and New York impose franchise taxes that are not reported as income taxes, per the Generally Accepted Accounting Practices (GAAP), but are treated as franchise fees or similar items and reported as operating expenses. AAR, therefore, changed the state income tax rates reported by the Tax Foundation to zero.

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[8] See Simplified Standards for Rail Rate Cases—Taxes in Revenue Shortfall Allocation Method, STB Ex Parte No. 646 (Sub-No. 2) at 2 (STB served Jan. 30, 2009) (January 30 Decision).

[9] We required 2002 through 2007 tax information in order to correct the error in the 2005 RSAM calculation, Rate Guidelines – Non Coal Proceedings, STB Ex Parte No. 347 (Sub-No. 2) (STB served Dec. 20, 2007), and to calculate the 2006 and 2007 RSAM figures.

[10] See January 30 Decision, at 2.

[11] See AAR Response, at 2-3, Workpapers Part 3.

2. Texas Taxes – The applicable taxes for railroads in the state of Texas changed in 2007. Prior to 2007, Texas had a franchise tax system with two components and required the taxpayer to pay the higher of either a franchise tax or an earned surplus tax. As noted above, GAAP treated the franchise tax as an operating expense; however, the earned surplus tax is treated as income tax. Therefore, in 2006, for BNSF Railway Company (BNSF), which paid the franchise tax, its Texas taxes are reported as zero. In all other years for BNSF between 2002-2005 and for all other railroads in all years between 2002-2006, the earned surplus tax was paid and reported as income tax. For 2007, Texas taxed railroads using a 1 percent tax rate on 70 percent of gross receipts, which were reported as income taxes. AAR, then, calculated a carrier specific tax rate for each railroad operating in Texas, where the calculation assumes the ratio of Operating Revenue to Net Income Before Taxes is the same in all locations. AAR calculated the 2007 tax rate by multiplying 70 percent of operating revenue from the R-1 by the 1 percent tax rate, then dividing that number by Net Income Before Taxes from the R-1.

3. Ohio Taxes – Ohio is phasing out its corporate income tax and replacing it with a tax similar to the franchise fees discussed above. Therefore, beginning in 2005, AAR reduced the corporate tax rate using the state's phase-out formula, specifically, 80 percent in 2005, 60 percent in 2006, and 40 percent in 2007. AAR did not compute the new tax because, like the franchise fees noted above, it is reported as an operating expense.

4. Utility Franchise Tax – For railroads in Massachusetts, a utility franchise tax on income is paid in lieu of the corporate income tax rate, which is reported as an income tax in R-1. Therefore, AAR changed the rates for Massachusetts from what the Tax Foundation reported, as the utility franchise tax is lower than the corporate tax.

5. Updated Data – For certain states, Alabama, Indiana, Kentucky, North Dakota, Tennessee, and West Virginia, the Tax Foundation's information was not updated to reflect changes in those states' tax rates. AAR made those changes using individual state tax web sites.

6. Two Income Taxes or Tax Surcharges – The District of Columbia, Illinois, and Kansas either had two income taxes or tax surcharges that, although noted by the Tax Foundation, were not shown in its table. AAR used state tax web sites to adjust these figures.

7. Rounding – For Arizona, the District of Columbia, and Pennsylvania, the Tax Foundation rounded the tax rate. AAR adjusted these figures using these states' tax web sites.

Having made these changes to the state corporate tax rates reported by the Tax Foundation, AAR calculated the weighted average state income tax rate for each Class I railroad

for each year from 2002-2007.[12] AAR's calculations and adjustments to the Tax Foundation's information were not contested by any party and, upon evaluation, appear reasonable. We will therefore adopt AAR's evidence for the calculation of railroad-specific state tax rates to be included in the RSAM benchmarks for 2002 through 2007. The railroad-specific average state tax rates are set forth in the table below.

Average State Tax Rates

Railroad	2002	2003	2004	2005	2006	2007
BNSF	5.487%	5.471%	5.238%	5.196%	5.183%	5.650%
CNGT	6.512%	6.582%	6.738%	6.703%	6.701%	6.684%
CSXT	5.960%	6.362%	6.312%	6.101%	5.941%	5.702%
KCS	5.791%	5.805%	5.839%	4.728%	5.992%	6.494%
NS	6.213%	6.583%	6.589%	6.376%	6.194%	5.986%
SOO	7.890%	8.346%	7.828%	7.635%	7.591%	7.501%
UP	5.443%	5.405%	5.406%	5.393%	6.275%	6.163%

We will publish the revised values of the RSAM benchmark under a separate decision. Also, as AAR's evidence shows, state tax rates are subject to change. We will therefore institute a separate sub-docket that will propose that AAR annually update each state's tax information with regard to each Class I rail carrier.

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

It is ordered:

1. AAR's evidence for the calculation of average state tax rates for use in the RSAM benchmark in 2002 through 2007 is adopted.

2. This decision is effective on its service date.

By the Board, Acting Chairman Mulvey, and Vice Chairman Nottingham.

Anne K. Quinlan
Acting Secretary

[12] See AAR Workpapers Part 6.