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WESTERN COAL TRAFFIC LEAGUE—PETITION FOR DECLARATORY ORDER

OPENING ARGUMENT
OF
THE NATIONAL INDUSTRIAL TRANSPORTATION LEAGUE

The National Industrial Transportation League ("NITL" or "League") hereby submits its Opening Argument in this proceeding, which the Surface Transportation Board ("STB" or "Board") instituted in its decision in Docket No. FD 35506, served on September 28, 2011 ("Decision"). In its Decision, the Board invited public comment on the implications of BNSF Railway Company's ("BNSF") net investment base write-up as a result of the acquisition premium that Berkshire Hathaway Inc. ("Berkshire") paid for BNSF. Parties were invited to address the effect of the BNSF's net investment base write-up on the annual Uniform Rail Costing System ("URCS") and revenue adequacy determinations for BNSF beginning in the year 2010.[1]

I. BACKGROUND

The Board noted in its Decision that on February 12, 2010, Berkshire acquired BNSF for an aggregate $34.5 billion purchase price,[2] which included a $7,625,000,000 acquisition

[1] *W Coal Traffic League—Petition for Declaratory Order*, STB Docket No. FD 35506, slip op. at 2-3 (served Sept. 28, 2011).
[2] Berkshire Hathaway Inc., 2010 Annual Report, 41 (2011).

premium—an amount paid for an asset above its book value.[3] BNSF accounted for this acquisition premium in its 2010 R-1 by increasing the value of its investment base[4] by $7,625,000,000, an increase of approximately 30%.[5] Because variable costs calculated by URCS are based on costs detailed in a carrier's R-1, the acquisition premium paid by Berkshire in turn affects BNSF's variable costs calculated under URCS.

II. THE BNSF ACQUISITION PREMIUM INCREASES THE LEVEL AT WHICH RATES MAY BE FOUND UNREASONABLE

A. Inclusion of the BNSF Acquisition Premium Raises the Jurisdictional Floor for Rate Cases

Under the statute, a rate may be found unreasonable only if it equals or exceeds 180% of the variable cost of a movement, a level commonly referred to as the agency's "jurisdictional threshold." 49 U.S.C. §10707(d)(1)(A). Because an acquisition premium directly increases a carrier's investment base,[6] it therefore directly increases variable costs calculated under URCS, in two ways. Inclusion of an acquisition premium will first increase the return on investment calculated under and included in URCS variable costs; and second, it will increase a carrier's annual depreciation cost under URCS.[7] Because the jurisdictional threshold is calculated simply

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[3] *See CSX Corp.—Control—Conrail Inc.*, 3 S.T.B. 196, 261 (1998) (defining acquisition premium as the difference between the book value and the purchase price of property.)
[4] The investment base is the value of road property, equipment, current construction work, and working capital less deferred taxes and accumulated depreciation of road property and equipment.
[5] *WCTL Petition*, STB Docket No. FD 35506, slip op. at 2 (served Sept. 28, 2011). The original Western Coal Traffic League ("WCTL") petition that triggered the Board's September 28 Decision included a number for the acquisition premium of $7.65 billion based strictly on BNSF's R-1. BNSF did not dispute this number in its reply. The League understands from WCTL counsel that the revised number is now $8.1 billion, based on additional BNSF workpaper information.
[6] URCS variable costs include a return element for road property investment and, therefore, increase with an increase in a carrier's investment base. *Conrail*, 3 S.T.B. at 263 n.95. The return component of variable costs is calculated by multiplying half of the road property values by the current cost of capital. *Id.* Accordingly, all other things remaining equal, if road property values increase, variable costs increase.
[7] As noted above, the acquisition premium in the Berkshire/BNSF situation amounted to an increase of about 30% over BNSF's existing depreciated original cost investment base. While the effect on variable cost depends upon the specific movement at issue and will not be as large as the 30% spread paid by Berkshire, it will still be significant, perhaps in the range of an eight to ten percent increase in BNSF's variable cost compared to a variable cost calculation that excludes the acquisition premium write-up.

by multiplying a carrier's variable cost calculated under URCS by 1.8, an acquisition premium will have the direct effect of increasing the level at which the Board will have jurisdiction over a rate dispute. Thus, the BNSF acquisition premum drives up the jurisdictional floor for rate cases against BNSF by directly increasing BNSF's variable costs.

Such an increase will directly insulate certain rates from a rate challenge before the Board, since rates now subject to Board jurisdiction will, solely as a result of the acquisition premium write-up, not be subject to challenge at the Board at all. While this will directly affect rate challenges, the effect of the write-up is also likely to be felt more broadly in contract negotiations, since BNSF will know that a rate that it proposes to a captive shipper will not be subject to regulatory review except at an increased level.

B. The BNSF Acquisition Premium Increases the Maximum Reasonable Rate That the Board Can Prescribe

An increase in the value of BNSF's investment base will also drive up the lowest rates that the Board can prescribe, because the Board cannot prescribe a rate that is lower than the jurisdictional threshold.[8] Since, as noted above, the jurisdictional threshold increases as BNSF's investment base increases, the BNSF acquisition premium raises the floor of any rate prescription against BNSF. In past cases, the agency has found, for example, that the Stand-Alone Cost ("SAC") calculation resulted in rates below the jurisdictional threshold, and therefore prescribed a maximum reasonable rate at the jurisdictional threshold.[9] If the BNSF's acquisition premium is recognized, the maximum reasonable rate in any such SAC case will automatically increase.

Moreover, when prescribing rates, the Board uses variable costs to calculate the rate prescription level, because under procedures adopted by the Board, the Board prescribes not a

[8] *Major Issues in Rail Rate Cases*, STB Docket No. Ex Parte 657, slip op. at 6 (served Oct. 30, 2006).
[9] *E g , W. Tex Utils Co v Burlington N R R*, 1 S.T.B. 638, 677-78 (1996).

specific rate, but an R/VC percentage based on a comparison of the SAC rate and the SARR's variable cost, applied to the defendant rail carrier.[10] Accordingly, if BNSF's variable costs rise, any BNSF rate prescribed by the Board will also increase.

Finally, recognition of the acquisition premium write-up will directly affect the rate prescription available to shippers in Three-Benchmark cases. In Three-Benchmark cases, the Board calculates a rate prescription by determining the revenue to variable cost ratio for "comparable" rates, the so-called "R/VC_{COMP}" ratio.[11] The Board then adjusts that R/VC_{COMP} figure by a fraction, the numerator of which is the carrier's Revenue Shortfall Allocation Method ("RSAM") figure, and the denominator of which is the average revenue to variable cost ratio for all the carrier's traffic whose R/VC ratio exceeds 180%, the so-called "$R/VC_{>180}$" figure.[12] The RSAM is determined by determining the revenue to variable cost ratio of the rate that the carrier would have to charge its captive traffic in order to reach revenue adequacy.[13] Thus, the RSAM figure is directly determined by calculating how far the carrier is below or above revenue adequacy.

The value of BNSF's investment base is "crucial" to BNSF's revenue adequacy.[14] Whether or not a carrier is "revenue adequate" is determined by comparing the carrier's rate of return on its investment base to the cost of capital.[15] A carrier is revenue adequate if its rate of return equals or exceeds the cost of capital.[16] Thus, if the a carrier's investment base increases, its rate of return will decrease, all other things being equal. In such a situation, carriers that are

[10] *See W Fuels Ass'n, Inc v BNSF Ry*, STB Docket No. 42088, slip op. at 31 (served Feb. 18, 2009); *Major Issues in Rail Rate Cases*, STB Docket No. Ex Parte 657, slip op. at 14 (served Oct. 30, 2006).
[11] *Simplified Standards for Rail Rate Cases*, STB Docket No. Ex Parte 646, slip op. at 21 (served Sept. 5, 2007).
[12] *Id.*
[13] *Id* at 20.
[14] *Standards for R R Revenue Adequacy*, 364 I.C.C. 803, 811 ("If we are to use the cost of capital to measure rate of return, and rate of return to measure revenue adequacy, then accurately measuring the investment base on which the rate of return is predicated is crucial").
[15] *Id* at 821.
[16] *Id.* at 821.

not revenue adequate will become "further" from revenue adequacy, and carriers whose rates of return are above the revenue adequacy standard will either become revenue inadequate or will at least have the amount by which their return exceeds the revenue adequacy standard reduced.

In either case, if the BNSF's acquisition premium is recognized, the BNSF's RSAM will decline, thus resulting in a rate prescription in Three Benchmark cases lower than that which would have been calculated without recognition of the acquisition premium. For a revenue inadequate carrier, either the increase as a result of applying the RSAM/ $R/VC_{>180}$ fraction will be higher, or for a revenue adequate carrier, the decrease as a result of applying the same fraction will be lower.

Most importantly, in <u>all</u> of the cases above, the effect on the Board's rate prescription will come <u>not</u> because of any changes in BNSF's costs, or BNSF's income, or BNSF's underlying competitive position or economic situation, but solely because Berkshire purchased BNSF for an amount greater than its book value.

III. RECOGNITION OF THE BNSF'S ACQUISITION PREMIUM UNFAIRLY PENALIZES CAPTIVE SHIPPERS

In acquiring BNSF, Berkshire acquired the right to BNSF's future profits. Warren Buffet, Berkshire's chairman, stated that not only did he expect Berkshire's earning power to increase by 40% pre-tax and over 30% after-tax as a result of the transaction, but Berkshire also quickly replenished the $22 billion in cash that it used to complete the transaction.[17] From this perspective, it may have made economic sense for Berkshire to pay a multi-billion dollar acquisition premium to prompt BNSF's then-existing shareholders to sell their shares to Berkshire. However, the fact of the matter is that <u>BNSF itself</u> emerged from the transaction unchanged—the transaction had no direct impact on BNSF's plant and operations.

[17] Berkshire Hathaway Inc.. 2010 Annual Report, 3 (2011).

Yet, despite the lack of changes to BNSF's railroad business, if the acquisition premium is recognized, BNSF's URCS costs will be able to increase significantly, weakening the regulatory constraints on its rates. This underscores the pitfalls of using acquisition costs to value the investment base. Although the acquisition premium represented a cost to Berkshire, it did not and does not represent any "cost" to BNSF. If the acquisition premium is recognized, property purchased by BNSF immediately before the Berkshire acquisition is effectively "revalued" afterward for regulatory purposes, not because it would cost more to buy afterward (or could be sold for more), but solely because Berkshire decided, for its own purposes, to pay more for BNSF than the depreciated original value of the assets of the company. Thus, if BNSF's URCS costs are adjusted by the acquisition premium that Berkshire paid for BNSF, BNSF's URCS costs will simply include the costs to Berkshire of the right to BNSF's future stream of profits.

Since URCS costs essentially form the lower level of and the basis for the Board's prescription of "reasonable" rates in various settings, if the acquisition premium is recognized BNSF will able to increase its rates above the previously constrained limit and effectively force captive shippers to finance the acquisition premium that Berkshire paid for the right to BNSF's potential profits. Moreover, as discussed further below, while Berkshire may see a benefit from its acquisition of BNSF, captive shippers are unlikely to see any direct benefits. The Board should not permit Berkshire to require captive shippers to pay for the cost of the acquisition premium, thus permitting Berkshire have its cake and eat it too.

Board precedent dealing directly with acquisition premiums does not sanction such a nonsensical result where shippers pay for a premium that does not afford them or the rail system any benefit. For example, in the Conrail acquisition and merger, the Board allowed the acquisition premium to be factored into URCS costs, noting the operational benefits and efficiencies that flowed from the transaction.[18] In 1997, Norfolk Southern Railway Company ("NS") and CSX Transportation ("CSXT") acquired Conrail after paying an $11.6 billion acquisition premium, based on asset price.[19] This premium, however, was substantially offset by $1 billion in merger synergies, the new traffic that would be developed as a result of the transaction, and expected productivity growth.[20] Moreover, the premium only resulted in relatively smaller increases in the jurisdictional threshold (4.9% for CSXT and 7.26% for NS, even if no merger synergies were achieved).[21]

The types of benefits that flowed from the Conrail merger are absent from the BSNF acquisition. Because Berkshire's purchase had no impact on BNSF's plant or operations, BNSF will enjoy no transaction-related synergies and cannot expect to gain new traffic as a result of the transaction. Further, railroad productivity has been declining in recent years and cannot be expected to offset any increase in the jurisdictional threshold.[22] Accordingly, if the acquisition premium is recognized in the Berkshire case, the only benefit of the BNSF acquisition inures to Berkshire shareholders, who have acquired a right to BNSF's future profits at the expense of BNSF's captive shippers.

Other regulatory agencies uniformly reject attempts to purchase assets of regulated companies at prices greater than book value and recover the cost of such acquisition premiums from captive customers, at least without some showing of investment prudence and benefit to

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[18] *CSX Corp.—Control—Conrail Inc.*, 3 S.T.B. 196, 263 (1998).
[19] *Erie-Niagara Rail Steering Comm. v. S.T.B.*, 247 F.3d 437, 442 (2d. Cir. 2001)
[20] *Conrail*, 3 S.T.B. at 263, 265.
[21] *Id.* at 264.
[22] Bureau of Labor Statistics, *Multifactor Productivity Trends for Detailed Industries, 2009* at 12 (Sept. 23, 2011), *available at* http://www.bls.gov/news.release/prin3.t03 htm (indicating an 8.6% decline in productivity for railroads from 2008-2009).

consumers.[23] For example, the Federal Energy Regulatory Commission ("FERC") prohibits the recovery of acquisition premiums through increased rates unless "a utility can show that the investment decision is prudent and . . . can demonstrate that the acquisition provides measurable benefits to ratepayers."[24] FERC adopted this approach because utilities were acquiring other utilities for significant acquisition premiums since the rates they could charge were based on the value of their investment base, which the acquisition premiums increased.

Moreover, it is most important to note that FERC has adapted and continued its acquisition premium policy even after the deregulation of energy markets, when utilities operate in partially captive and partially competitive markets, exactly like the railroad industry.[25] In *Duke Energy Moss Landing LLC*, FERC applied a revised acquisition premium policy to an acquisition of a generating facility that supplies a power market that bears striking similarities to the U.S. rail market, in that certain customers in the market were not captive and rates to such customers were market-based; regulated rates applied to captive customers.[26] In the *Moss Landing* case, Duke Energy had paid a significant acquisition premium for the generating facility and was seeking FERC's permission to increase the rates of captive shippers to reflect the acquisition premium.[27] FERC permitted Duke Energy to recover the acquisition premium to the extent it was recoverable from its market-based rates, noting that the decision to purchase an asset "at a price above book value is based on [the] perception of the 'profitability' of the [asset]

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[23] *Duke Energy Moss Landing LLC*, 83 F.E.R.C. ¶ 62,297, 62,304 (1998) ["*Moss Landing*"].
[24] *Id. See also Mo. Pub. Serv. Comm'n v. FERC*, 601 F.3d 581, 586 (D.C. Cir. 2010) (summarizing FERC's requirements for satisfying this "measurable benefits" test, which FERC indicates involves a "heavy burden" on the regulated entity).
[25] *Moss Landing*, 83 F.E.R.C. at ¶ 62,304.
[26] *Id.* at 62,303-04.
[27] *Id.* at 62,303.

in making sales at market-based rates."[28] However, FERC refused to allow Duke Energy to recover the acquisition premium from the rates that applied to captive customers, stating that:

> Allowing the acquisition premium to be used in determining rates in non-competitive market conditions, [where a cost-based cap applies,] would lessen the discipline on the prices offered for assets from which such cost-based sales would be made. Potential buyers would have incentives to pay inflated prices for such assets, knowing they could recoup their costs from customers with limited or no choices.[29]

The same reasons that informed FERC's decision to exclude any acquisition premium in determining rates to captive customers even where energy markets are partially competitive should inform the Board's own policy. Like the energy rates in *Moss Landing*, rail rates to captive customers ultimately are determined, directly or indirectly, by regulatory constraints, while rail rates to competitive customers are appropriately market-based. Any purchaser of a railroad knows that the Board's cost-based reasonable rate constraints will ultimately limit the rates to captive customers. It would be inconsistent with the regulatory scheme and would, in FERC's words, "lessen the discipline on prices offered for assets," thereby distorting the competitive market within which such purchasers operate, to permit such purchasers to circumvent the Board's reasonable rate constraints through the use of an acquisition premium. Allowing an acquirer to include an acquisition premium into a railroad's URCS costs is not only unnecessary, but also it allows acquirers to unfairly force captive shippers to finance acquisition prices that are disconnected from the value of the firm's competitive assets.

This policy should be used to prohibit the adjustment of BNSF's URCS costs by the amount of the acquisition premium that Berkshire paid for BNSF. Berkshire's decision to pay an acquisition premium for BNSF was based on BNSF's potential profitability earning the

[28] *Id.* at 62,305
[29] *Id.*

maximum rates it could extract from shippers—market rates for non-captive shippers and reasonable rates, pursuant to the Board's cost-based reasonable rate standards, for captive shippers. It would be fundamentally unfair to captive shippers to allow BNSF to extract higher profits by using the acquisition premium paid by Berkshire to readjust the costs that are at the core of the Board's reasonable rate constraints.

IV. THE BOARD HAS DISCRETION TO ALTER ITS POLICY AND SHOULD EXCLUDE THE BNSF ACQUISITION PREMIUM FROM URCS' CALCULATION OF VARIABLE COST AND FROM THE DETERMINATION OF BNSF REVENUE ADEQUACY

Regulatory agencies are not constrained to continue their past policy choices. In fact, an agency may change its position with or without a change in circumstances.[30] The only limitation on the Board is that it must provide a reasoned analysis.[31]

Further, a policy change regarding acquisition premiums is not unprecedented and was anticipated by the ICC. In the 1980s, the Interstate Commerce Commission ("ICC" or "Commission") evaluated railroad investment bases using predecessor costs (book value to the seller), instead of acquisition costs, on multiple occasions.[32] One reason for using original costs was that carriers were being acquired at prices well below their book values and the write-downs in the acquiring carriers' investment bases masked the acquiring carriers' return on investment needs by making them appear more revenue adequate.[33] However, in 1990, the ICC reversed course and determined that it would value railroad investment bases using acquisition cost. It reasoned that acquisition cost is generally more accurate evidence of value than predecessor

[30] *BNSF Ry v STB*, 526 F.3d 770, 779-80 (2008) ("The Board has license to change how it implements its statutory duties 'either with or without a change in circumstances,' so long as it supplies a 'reasoned analysis.'") (quoting *Motor Vehicle Mfrs Ass'n v State Farm Mutual Auto. Ins. Co*, 463 U.S. 29, 57 (1983)).
[31] *Id.*
[32] *See, Farmers Union Cent. Exch., Inc. v. F.E.R.C.*, 584 F.2d 408, 414 n.9 (D.C. Cir. 1978); *R.R. Revenue Adequacy—1988 Determination*, 6 I.C.C. 2d 933, 939 (1990)
[33] *R R. Revenue Adequacy—1988 Determination*, 6 I.C.C. 2d at 935.

cost.[34] Still, the Commission recognized that acquisition cost may not always be an appropriate measure of the value of an investment base and expressed a willingness to revisit the issue where the use of acquisition costs artificially impacts rates.[35]

Accordingly, the Board has the discretion to remove, and should remove, the BNSF acquisition premium from URCS' costing and in the determination of BNSF's revenue adequacy, in light of the fundamental unfairness and unreasonableness of requiring captive shippers to bear the burden of the financial decisions that Berkshire chose to make.

V. CONCLUSION

The League appreciates the Board's invitation to provide comments in this proceeding. For the foregoing reasons, the League believes that the Board should not permit BNSF to write up its investment base in URCS as a result of the acquisition premium that Berkshire paid to acquire BNSF, and should exclude the value of the write-up from BNSF's R-1 and its calculation of URCS costs and from the determination of revenue adequacy.

[34] *Id.* at 939-40.
[35] *Id.* at 939.

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Certificate of Service

I hereby certify that on this 28th day of October 2011, the foregoing Opening Argument of the National Industrial Transportation League was served via first-class mail upon:

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