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August 6, 2015

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Office of Proceedings
August 6, 2015
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Chairman Daniel R. Elliott III
Vice Chairman Ann D. Begeman
Member Deb Miller
Surface Transportation Board
395 E Street, S.W.
Washington, DC 20423-0001

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

Dear Chairman Elliott, Vice-Chairman Begeman, and Commissioner Miller:

Thank you for the opportunity to submit additional comments following the Board's hearings in the above-referenced matter on July 22 and 23. CSX Transportation, Inc. ("CSXT") would like to make very brief comments focused on three important issues. First, CSXT reiterates the key economic and policy principles that should govern the Board's approach toward the statutory directive that it allow railroads to earn adequate revenues. Second, the Board should not forget that changes in regulatory policy cause parties to alter their behavior, and that imposing a revenue adequacy constraint would alter incentives and cause railroads, shippers, and investors to all change their behavior in significant ways. Third, the failure to account for replacement costs and deferred taxes causes significant measurement errors in the annual revenue adequacy calculations, and the Board should consider exploring ways to correct those errors.

I. Four Pillars Should Govern The Board's Policy On Revenue Adequacy.

The proposals put forward by shipper representatives at the hearing were primarily focused on the short-term goal of finding simple ways to transfer earnings from railroads to a select group of shippers. Shippers provided no solid economic or policy justification for their requests, other than a general assertion that railroads are earning enough money now.

The Board should reject those result-oriented suggestions and instead should approach revenue adequacy questions in light of sound economic and policy principles. At the hearing CSX's Chief Financial Officer Fredrik Eliasson described these principles as four "pillars" that should govern the Board in this area:

1. **Measure Progress – Don't Constrain It.** Revenue adequacy should be a barometer of industry health, and not an arbitrary basis to limit pricing and re-investment.

2. **Address Replacement Cost Imperative.** The current revenue adequacy measurement looks at the depreciated book value of railroad track, bridges, terminals, locomotives, and rail cars. Locomotive replacement costs, for example, are four times the depreciated book value of CSXT's units today.

3. **Promote Differential Pricing.** Railroads need the freedom to price based on the marketplace value of the service they provide, which is something that all successful businesses do.

4. **Ensure Free Market Results to Foster Investment.** The Board should ensure that its policy toward revenue adequacy incorporates the free market principles that have so successfully improved the health of the railroad industry and that have created the incentives that have generated record re-investment by CSXT and other railroads.

II. Changing the Rules Will Change The Behavior of Railroads, Shippers, and Investors In Ways That Will Harm the Public Interest.

CSXT urges the Board to remember that its policies change the rules of the game by which CSXT must play as it competes with other railroads, trucks and barges in the surface transportation marketplace. Changing the rules of the game will change the behavior of railroads, shippers, and investors. Many shipper commenters advocating rate caps or revenue rebates ignored this fundamental principle and glossed over the significant and deleterious changes that parties would make to their behavior in response to such changed incentives.

For example, some shippers insisted that their policies would only apply to a small percentage of traffic because the Board does not have jurisdiction over traffic moving under contract. But of course contracts are negotiated against a particular regulatory background, and rational shippers only agree to transportation contracts if they believe that agreeing to a contract rate is preferable to seeking a regulated rate from the Board. If the Board were to adopt a rate freeze or a revenue rebate approach, shippers' incentives would change entirely. No rational shipper would agree to a new contract that limited its ability to reap the benefits of the new regulatory framework. The result will be more government regulation and less negotiated solutions—a result that is completely at odds with the policies of the Staggers Act and ICCTA. Changing the rules of the game also would change railroad incentives in ways that would harm the overall rail system. Consider the Concerned Shipper Association proposal to measure a challenged freight rate based on comparisons to "comparable traffic." Imagine that CSXT has a current movement with a

market rate of $2000. Then imagine that CSXT is presented with an opportunity to win a new piece of business currently moving by barge that is the same commodity and similar length of haul—but only if CSXT were willing to price its service at $1500.
Under the current regulatory regime, CSXT might attempt to win that new business, even if CSXT would earn lower margins on that traffic than the traffic without a barge alternative. If, however, the STB were to order that CSXT's rate on the new traffic was a "Benchmark" that would automatically constrain the $2000 rate, CSXT would have to change its analysis. CSXT would have to ask how much business moves at the $2000 rate and how much might move at the $1500 rate, and whether it would be worthwhile to attempt to win new business that would slash margins on current business. CSXT would also have to consider whether offering a $1500 rate could be used to drive down rates on other business that might be deemed "comparable."[1] Every proposal that the Board "cap" or "rebate" supposedly excessive revenues would create similarly distorted incentives against innovation and against attempts to win competitive business.

Finally, the regulatory changes proposed at the hearing would change how investors behave and how investors would expect railroads to use their available cash. As Mr. Eliasson testified, investors demand returns commensurate with their assessment of risk and reward. The owners of CSX have proven willing to allow management to invest capital in the business rather than returning it to the owners because they see the potential future returns as justifying the risk of investing in the railroad. If profits are to be capped and CSX will never be allowed to earn more than the cost of capital, investors will demand less investment in the rail network and more immediate returns so that their money can be invested elsewhere where it has better risk/reward available. Why put your money in a business whose profits are capped at an "adequate" level, without any protection for times when profits fall below that level? Many rational investors would conclude it is better to take their money out and invest it in another business.

If the rules of the game are changed, the players most certainly will change how they make decisions.

III. The Board Should Consider Ways to Correct the Measurement Errors Caused By Replacement Costs and Deferred Taxes.

The Board should also explore ways to correct the measurement errors in its current annual determinations of revenue adequacy. Perhaps the most significant measurement error is the failure of the annual determinations to consider replacement costs. As the hearing testimony made clear, using replacement costs does not mean valuing all rail assets as brand-new

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[1] While this sort of negative incentive is already a concern with the Board's Three Benchmark approach, that policy also requires proof of market dominance, the consideration of alternative comparison groups, and an opportunity to demonstrate why other factors should affect the regulatory outcome. That cannot be said for the automatic reductions proposed by some rail customers at the hearing.

substitutes for existing assets; instead, it means that assets should be valued at their actual economic value rather than an artificial accounting book value. In the past the Board has recognized that replacement costs are the proper way to value rail infrastructure, but has held that it was too logistically difficult to do so. CSXT submits that the hearing testimony demonstrated that there are logistically feasible methods to account for replacement costs. For example, the replacement cost information calculated by the U.S. Bureau of Economic Analysis ("BEA") could be explored as a feasible way to adjust revenue adequacy determinations, or the RSAM in a logistically simple and economically sound manner.

Another important measurement error discussed at the hearing is deferred taxes. While deferred taxes is an unfamiliar concept outside the accounting and economist professions, it is best understood as a function of the fact that capital investments are treated differently under accounting principles than under the tax laws. Tax laws typically allow faster depreciation of an asset for tax purposes to create economic incentives for businesses to invest. As a result, accounting depreciation often occurs at a slower rate over a longer time. As actual tax payments are reduced by virtue of the asset, and the book accounting value is reduced at a slower rate, the difference between the tax depreciation and the accounting depreciation is carried on the books as a "deferred tax liability" to make the financial statements of the company accurately reflect its financial condition. This "deferred tax liability" is an amount that (together with the depreciated book value) correctly reflects the accounting value of the investment in the asset. When the Board's revenue adequacy determination omits values carried in the deferred tax account, it is therefore excluding the accounting true value of the investment from the measurement.[2]

The speakers at the hearing were consistent in pointing out the additional inaccuracy of any measurement of railroad financial success that ignores deferred taxes. CSXT urges the Board to undertake a new rulemaking to determine whether failing to consider deferred taxes distorts the accuracy of the revenue adequacy "thermometer" and to explore logistically simple ways to account for replacement costs.

Again, CSXT thanks the Board for the opportunity to testify at the hearing and to offer these post-hearing comments.

Sincerely,

Paul R. Hitchcock

Paul R. Hitchcock

PRH/jsr

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[2] Of course, as noted above, it still does not pick up the actual economic value of the asset.