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Cynthia Brown
Chief, Section of Administration
Office of Proceedings
Surface Transportation Board
395 E Street, SW
Washington, DC 20423

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Re: Petition for Declaratory Order
STB Finance Docket No. 35506

Dear Ms. Brown:

Enclosed for filing the in the above-referenced proceeding are an original and ten copies of "Reply of BNSF Railway Company." Please date-stamp the enclosed extra copy and return it to our representative. Thank you.

Sincerely yours,

Robert M. Jenkins III

RMJ/bs

Enclosure

BEFORE THE
SURFACE TRANSPORTATION BOARD

FINANCE DOCKET NO. 35506

PETITION OF THE WESTERN COAL TRAFFIC LEAGUE
FOR A DECLARATORY ORDER

REPLY OF
BNSF RAILWAY COMPANY

Introduction

BNSF Railway Company ("BNSF") replies here to the petition of the Western Coal Traffic League ("WCTL") for declaratory order, filed May 2, 2011. WCTL asks the Board to initiate a proceeding to consider restating BNSF's costs under the Uniform Railroad Costing System ("URCS") to exclude the increase in BNSF's net investment base that results from the application of Generally Accepted Accounting Principles ("GAAP") to the purchase of BNSF in 2010 by Berkshire Hathaway Inc. ("Berkshire"). WCTL limits its request to the question of restating BNSF's URCS variable costs and not BNSF's revenue adequacy. WCTL suggests that the Board invite interested members of the public to participate in the case and suggests a procedural schedule for that purpose.

BNSF believes that the agency's precedent on this subject is well-settled and does not believe that it is necessary for the Board to exercise its discretion to institute a declaratory order proceeding.[1] The Board, the ICC, the Railroad Accounting Principles Board ("RAPB"), and the

[1] *See Delegation of Authority—Declaratory Order Proceedings*, 5 I.C.C.2d 675 (1989); *Intercity Transp. Co. v. United States*, 737 F.2d 103 (D.C. Cir. 1984) (ICC has broad discretion under 5 U.S.C. § 554(e) and 49 U.S.C. § 721 to grant or deny requests that it initiate declaratory order proceedings).

courts have repeatedly determined that acquisition costs are an economically accurate measure of current market value, which is why they make sense for both GAAP and regulatory purposes. WCTL has presented no evidence or argument that merits a general proceeding to revisit the use of acquisition cost for URCS costing or any other regulatory purpose. If an individual shipper can point to a situation in a particular case where the use of GAAP does not produce an economically appropriate result under the standards governing that dispute, that shipper can seek relief in that case.

If the Board determines nevertheless to initiate a declaratory order proceeding concerning acquisition cost adjustment issues, as we discuss below, BNSF would request that the proceeding not be limited to URCS costing issues. The fundamental acquisition cost issues are largely the same for revenue adequacy and URCS costing purposes, and the Board has considered the issues together before. There is little point in initiating a proceeding now with respect to URCS costing alone if parties are going to raise many of the same issues in the context of computing revenue adequacy.[2]

WCTL Has Not Justified A Declaratory Order Proceeding

At the outset, BNSF believes that WCTL has not identified any circumstances which have changed that would warrant revisiting the appropriateness of accounting for acquisition cost adjustments under GAAP. The "acquisition premium" issue raised by WCTL has been thoroughly litigated and repeatedly resolved in favor of GAAP accounting by this agency and the courts. *See Major Railroad Consolidation Procedures,* STB Ex Parte No. 582 (Sub-No. 1), slip

[2] WCTL suggests that "Berkshire's acquisition of BNSF also impacts the Board's calculation of the rail industry's cost of capital." WCTL Pet. at 9. It is true that BNSF will no longer be included in the railroad sample base used in calculating the industry cost of capital. *See Railroad Cost of Capital—2010*, STB Dkt. No. EP 558 (Sub-No. 14) (served Feb. 22, 2011), slip op. at 2. But that does not raise an acquisition cost adjustment issue.

op. at 28, 2001 WL 648944, *18 (served June 11, 2001) ("*Consolidation Procedures*"); *CSX Corp.—Control—Conrail, Inc.*, 3 S.T.B. 196, 262-65 (1998) ("*Conrail*"), aff'd sub nom. *Assoc. of Amer. RR's v. ICC*, 978 F.2d 737, 741-43 (D.C. Cir. 1992) ("*AAR*") ; *Railroad Revenue Adequacy—1988 Determination*, 6 I.C.C.2d 933, 935-42 (1990) ("*Revenue Adequacy—1988*"), aff'd sub nom. *Erie-Niagara Rail Steering Comm. v. STB*, 247 F.3d 437, 442-43 (2d Cir. 2001) ("*Erie-Niagara*"). Virtually every Class I railroad merger or acquisition that has taken place in the past two decades has involved an "acquisition premium," and in every instance the acquisition cost has been booked by the ICC and the STB using GAAP accounting.

WCTL asserts that it is "fundamentally unfair" for URCS variable costs to be set at higher levels "simply because Berkshire decided to pay a substantial acquisition premium in purchasing BNSF." WCTL Pet. at 5. This contention is not new. The same argument was made to the Board and twice rejected in *Conrail* and *Consolidation Procedures*. In *Conrail*, several parties, including two large shipper groups, claimed that the Board should change its basic accounting rules to avoid the impact that the use of GAAP accounting would have on the Board's URCS costing and revenue adequacy determinations. 3 S.T.B. at 262. Observing, among other things, that the ICC had followed "the recommendation of the [RAPB] to use acquisition cost, not book value, in this precise context," the Board determined to use acquisition cost for both URCS costing and revenue adequacy purposes. 3 S.T.B. at 262, 265. The Board stressed that "the purchase price agreed to by these commercially sophisticated railroads represents by far the best evidence of the current market value of these properties." 3 S.T.B. at 265. In *Consolidation Procedures*, the Board reiterated its view that "there is no sound economic justification" for valuing properties obtained through a merger based upon predecessor book values rather than acquisition cost. Slip op. at 28, 2001 WL648944, *18.

Citing a letter from a group of U.S. Senators, WCTL also claims that Congress did not intend the Board to incorporate an acquisition premium into its URCS costing. WCTL Pet. at 4. As the Board pointed out in *Conrail*, however, Congress *by law* specifically "directs that [the Board] conduct [its] costing in accordance with GAAP to the maximum extent possible." 3 S.T.B. at 264 (citing 49 U.S.C. § 11161). Moreover, Congress earlier not only specifically directed that the ICC "prescrib[e] expense and revenue accounting and reporting requirements consistent with generally accepted accounting principles" but that it "promulgate such rules pursuant to accounting principles established by the [RAPB]." *See AAR*, 978 F.2d at 741-42 (citing then Section 11166). That is exactly what the ICC did when it adopted acquisition cost as the measure of value for purchases of rail property based upon the specific recommendation of the RAPB.[3]

At several points in its petition, WCTL cites authority applicable to other regulatory regimes, particularly that of the Federal Energy Regulatory Commission ("FERC"), for the proposition that it is improper to use acquisition cost, as opposed to predecessor cost, in a regulated entity's rate base. WCTL Pet. at 6-7 and n.7. This argument has been repeatedly rejected before. It was considered, and expressly rejected, by the RAPB in its 1987 Report (Vol. 2 at 46-47), by the ICC in *Revenue Adequacy—1988* (6 I.C.C.2d at 941), by the D.C. Circuit in *AAR* (978 F.2d at 741), by the STB in *Conrail* (3 S.T.B. at 262), and by the Second Circuit in *Erie-Niagara* (247 F.3d at 442-43). In every instance, the RAPB, the ICC, the STB, and the circuit courts determined that while the use of current market value in setting rates in a heavily regulated industry can be circular—because the company's value likely will be largely determined by the very rates being set by the regulator—this is *not* an issue in the rail industry,

[3] *See* RAPB Final Report Volume 2—Detailed Report at 45-48 (Sept. 1, 1987).

since railroads operate in largely competitive markets and their value and prices derive from market demand for their services rather than rates set by the Board. *Id.*

Finally, WCTL claims that all of the prior acquisitions in which the Board has determined that acquisition costs were properly included in the acquiring carriers' URCS costs involved railroad mergers where the Board, in approving the mergers, found that they would produce cost reductions and synergies that would offset the increase in the railroad's net investment base. WCTL Pet. at 6. That is not right. In 1989, the Blackstone Group, an asset management and financial services company, acquired and took private CNW Corporation, which owned the Chicago and North Western Transportation Company ("CNW"). *See Blackstone Capital Partners L.P.—Control Exemption—CNW Corporation and Chicago and North Western Transp. Co.*, 5 I.C.C.2d 1015 (1989).[4] There was no discussion in the ICC's decision of the "acquisition premium" Blackstone paid or any merger synergies offsetting the acquisition cost. For that matter, with the exception of *Conrail*, there was no discussion in other cases involving "acquisition premiums" of merger synergies offsetting the acquisition cost.[5]

In *Conrail*, the Board did observe, among other things, that the increases in URCS variable costs that would result from the acquisition cost would be offset over time by the merger synergies expected by the railroads. 3 S.T.B. at 263. The Board also observed, however, that without regard to particular merger synergies, the normal productivity growth of the railroad

[4] The ICC had jurisdiction over the transaction because Blackstone indirectly controlled some Class II and III carriers and two water carriers. Most of those carriers operated in geographic areas wholly removed from CNW's territory, and the others had limited contacts with CNW. 5 I.C.C.2d at 1020-21.

[5] *See, e.g:, Burlington Northern R.R. Co.—Control and Merger—Santa Fe Pac. Corp. and The Atchison, Topeka and S.F. Ry. Co.*, 10 I.C.C.2d 661 (1995); *Union Pac. Corp, Et Al.—Control and Merger—Southern Pac. Rail Corp., Et Al.*, 1 S.T.B. 233 (1996); *Canadian National Ry. Co., Et Al.—Control—Illinois Central Corp., Et Al.*, 4 S.T.B. 122 (1999).

industry since passage of the Staggers Rail Act of 1980 had led to substantial reductions in the railroads' URCS variable costs. Indeed, although the price paid by CSX and NS for Conrail far exceeded its book value, the Board calculated that "[t]he increases in the jurisdictional threshold brought about by the acquisition premium would amount to only 2 or 3 years of normal [rail industry] productivity growth that has flowed through to URCS costing over the last 17 years." *Id.* at 264. Moreover, the STB stressed, independently of any merger benefits, that its adoption and continued use of acquisition cost was required by its Uniform System of Accounts ("USOA"), which followed the recommendation of the RAPB, and by Congress's mandate in Section 11161 that it conduct its costing in accordance with GAAP to the maximum extent practicable. *Id.* at 262, 264.

Thus, the reasons WCTL has advanced to justify the Board's initiating a declaratory order proceeding regarding the use of GAAP accounting for a railroad's acquisition have been raised before and repeatedly found without merit. Nothing has changed to warrant revisiting those prior rulings.

If The Board Initiates A Declaratory Order Proceeding, It Should Encompass Revenue Adequacy <u>As Well As URCS Costing Questions</u>

If the Board determines that it should initiate a proceeding to consider revisiting its position on acquisition cost, BNSF agrees with WCTL that other parties will have an interest in the outcome of that proceeding and should be allowed the opportunity to participate. The procedural schedule proposed by WCTL is acceptable to BNSF. BNSF also agrees with WCTL that discovery is not necessary. If the Board initiates a proceeding, BNSF will provide appropriate workpapers to WCTL, subject to the protective order that WCTL proposed to the Board in its "Motion for Protective Order" filed May 4, 2011, in this docket.

BNSF strongly *disagrees*, however, that a declaratory order proceeding addressing the fundamental fairness and accuracy of GAAP accounting for acquisitions of railroad property should be limited to URCS costing issues. The question of using economically accurate data is obviously important for revenue adequacy as well as URCS costing purposes. As the Board found when it considered the "acquisition premium" question in *Conrail*, many of the same issues are raised in applying GAAP for revenue adequacy purposes as in applying GAAP for URCS costing purposes. If parties are planning to raise the "acquisition premium" question in the Board's revenue adequacy proceedings this year, the Board should not conduct bifurcated proceedings on largely the same topic. The core issues are largely the same, and they should be considered together. Accordingly, BNSF requests that if the Board initiates a proceeding, it invite comments regarding the use of acquisition cost for revenue adequacy purposes as well as URCS costing purposes.

Respectfully submitted,

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Dated: May 23, 2011

CERTIFICATE OF SERVICE

I hereby certify that on this 23rd day of May, 2011, a copy of the forgoing Reply of BNSF Railway Company was hand-delivered to:

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