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November 28, 2011

BY HAND-DELIVERY

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

ENTERED
Office of Proceedings
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Re: *Western Coal Traffic League—*
Petition for Declaratory Order,
STB Finance Docket No. 35506

Dear Ms. Brown:

Enclosed for filing in the above-referenced proceeding are an original and ten copies of the Reply Evidence and Argument of BNSF Railway Company. Also enclosed is a CD that contains the document. Please note that this filing includes color images.

Please date-stamp the enclosed extra copy of the Reply Evidence and Argument and return it to our representative. Thank you.

Sincerely yours,

Robert M. Jenkins III

RMJ/bs

Enclosures

CONTAINS COLOR IMAGES

RECEIVED

BEFORE THE
SURFACE TRANSPORTATION BOARD

FINANCE DOCKET NO. 35506

WESTERN COAL TRAFFIC LEAGUE—
PETITION FOR DECLARATORY ORDER

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Public Record

REPLY EVIDENCE AND ARGUMENT
OF BNSF RAILWAY COMPANY

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Dated: November 28, 2011

TABLE OF CONTENTS

JOINT VERIFIED STATEMENT OF A. LAWRENCE KOLBE
AND KEVIN NEELS

JOINT REPLY STATEMENT OF MICHAEL R. BARANOWSKI AND
BENTON V. FISHER

BEFORE THE
SURFACE TRANSPORTATION BOARD

FINANCE DOCKET NO. 35506

WESTERN COAL TRAFFIC LEAGUE—
PETITION FOR DECLARATORY ORDER

REPLY EVIDENCE AND ARGUMENT
OF BNSF RAILWAY COMPANY

Pursuant to the decision of the Surface Transportation Board ("STB" or "Board") served September 28, 2011, in the above-captioned proceeding ("Decision"), BNSF Railway Company ("BNSF") files here its reply evidence and argument. Attached in support of BNSF's reply argument are (1) the verified statement of John P. Lanigan, Executive Vice President and Chief Marketing Officer for BNSF, (2) the verified statement of Professor Roman L. Weil, the V. Duane Rath Professor Emeritus of Accounting at the Chicago Booth School of Business of the University of Chicago, (3) the joint verified statement of Dr. A. Lawrence Kolbe and Dr. Kevin Neels, Principals of The Brattle Group, and (4) the joint reply verified statement of Michael R. Baranowski and Benton V. Fisher, Senior Managing Directors of FTI Consulting, Inc.

I. INTRODUCTION AND SUMMARY

A number of parties filed opening comments in this proceeding opposing the application of GAAP purchase accounting to the acquisition of BNSF by Berkshire Hathaway, Inc. ("Berkshire").[1] None of these parties, however, demonstrated any change in circumstances that

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[1] These parties include Western Coal Traffic League, et al. ("WCTL"), Alliance for Rail Competition, et al. ("ARC"), National Industrial Transportation League ("NITL"), National Corn Growers Association ("NCGA"), Consumers United for Rail Equity" ("CURE"), and the United

would justify the Board's reversing over two decades of precedent and its own rules requiring that a railroad's net investment base be measured using GAAP purchase accounting after a merger or acquisition transaction. These parties fail to distinguish the Berkshire/BNSF transaction in any relevant way from the substantial number of major merger and acquisition transactions in which the STB and its predecessor, the Interstate Commerce Commission ("ICC"), have consistently applied GAAP.

The principal argument of the shippers is that it is "unfair" to allow the purchase accounting adjustment, since that adjustment will lead to higher rates for "captive" shippers. There are two fundamental flaws with the shippers' argument. First, the Railroad Accounting Principles Board ("RAPB"), the ICC, the STB, and the courts have repeatedly endorsed the use of GAAP acquisition cost for general purpose costing and revenue adequacy calculations, because current acquisition cost data are economically superior to "predecessor cost" data. There is nothing "unfair" about using economically accurate asset values to make regulatory decisions, regardless of any impact on rates. As the RAPB determined, while ideally current costs would be assessed every year for all railroads, the use of GAAP purchase accounting is a practicable way to identify the fair value of railroads involved in merger and acquisition transactions. As Professor Weil explains, insofar as the STB's goal is practicably measuring economically accurate costs, GAAP purchase accounting is demonstrably superior to the "predecessor cost" regulatory approach rejected repeatedly by the RAPB, the ICC, and the STB—yet advocated by WCTL and other shipper parties once again in this proceeding.

States Department of Agriculture ("USDA"). The Association of American Railroads ("AAR") and the United States Department of Transportation ("USDOT") filed comments supporting BNSF's position.

Second, the assumption that the purchase accounting adjustment will lead to higher rates for captive shippers is unfounded and incorrect. There is no reason to believe that the purchase accounting adjustment will have any material impact on rates. Almost none of BNSF's rates are set through Board regulation. As explained by Mr. Lanigan, even as to rates that are potentially subject to regulation, BNSF's rates are not the function of a "rate base" or the product of regulatory standards. BNSF sets its rates on the basis of market demand, and market demand does not change because BNSF's variable costs change.

Moreover, as Messrs. Baranowski and Fisher explain, the purchase accounting adjustment would have little or no effect on the outcomes of rate reasonableness cases even where there is rate reasonableness litigation or the threat of such litigation. The results of a SAC test, which is the Board's primary rate reasonableness test, are unaffected by the purchase accounting adjustment. And since there have never been any rates prescribed for BNSF under the Board's simplified standards, the impact of the purchase accounting adjustment on any future case brought under those standards is entirely speculative. In any event, due to the limits on relief available to shippers under those standards, the impact of the purchase accounting adjustment in such cases would necessarily be de minimis.

The shipper parties make much of one case concerning BNSF's rates to Western Fuels Association and Basin Electric Power Cooperative ("WFA/Basin"). But the WFA/Basin case is a unique circumstance in which rates were prescribed prior to the Berkshire transaction using R/VC ratios. That unique circumstance can and should be addressed in the ongoing WFA/Basin proceedings.

The parallels that the shipper parties attempt to draw between the ratemaking regimes of other agencies—particularly the Federal Energy Regulatory Commission ("FERC")—and the

STB's deregulatory regime are baseless. As Dr. Kolbe and Dr. Neels explain, in the rail industry only a handful of rates are set through rate regulation, and none are set by the STB based on the original-cost approach that is used by FERC and some other agencies for classically regulated monopoly utilities. The overwhelming majority of railroad rates, whether wholly unregulated or subject to regulation, are set on the basis of the demand a railroad perceives for its services. Thus, as the RAPB, the ICC, the STB, and the courts have repeatedly found, there is no "circularity" involved in using GAAP purchase accounting, instead of predecessor cost, to determine a railroad's investment base.

The bottom line is that the parties opposed to the acquisition cost principle have not carried their heavy burden of showing why the STB should reverse the agency's settled position and apply different regulatory standards to BNSF than to any other major railroad that has been involved in a merger or acquisition transaction over the past 25 years. The STB's use of GAAP purchase accounting to measure a railroad's net investment for URCS costing and revenue adequacy calculations is correct as a matter of law and good regulatory policy, and the STB's policies and rules should be applied evenhandedly.

II. THE SHIPPER PARTIES HAVE NOT DEMONSTRATED WHY BERKSHIRE'S ACQUISITION OF BNSF SHOULD BE TREATED DIFFERENTLY THAN OTHER RAIL MERGERS AND ACQUISITIONS

As BNSF detailed in its Opening Evidence and Argument, the STB is not writing here on a blank slate. BNSF Br. at 5-10. *See also* Opening Comments of AAR at 3-4; Opening Comments of USDOT at 4-5. The ICC and the STB have consistently used GAAP purchase accounting for mergers and acquisitions, consistent with Congress' expectation and the RAPB's recommendation. In their opening statements, the shippers point to no changes in the law that would support a departure from long-standing precedent, and their attempts to distinguish that precedent as applied to the Berkshire acquisition are unavailing.

Congress established the RAPB in the Staggers Rail Act of 1980 ("Staggers Act") for the express purpose of developing accounting principles for the ICC's use. Staggers Act, 49 U.S.C. §§ 11161-63. The RAPB determined after lengthy proceedings that the use of GAAP purchase accounting for railroad mergers and acquisitions represented the superior method for measuring economically accurate costs for both general purpose costing and revenue adequacy purposes. RAPB Final Report, Volume 2—Detailed Report (Sept. 1, 1987) ("RAPB Report"), at 46-47.[2]

The ICC adopted the RAPB's recommendations. *Railroad Revenue Adequacy—1988 Determination*, 6 I.C.C.2d 933, 935-42 (1990) ("*Revenue Adequacy—1988*"). The D.C. Circuit affirmed the ICC's decision. *Assoc of Amer. RR's v. ICC*, 978 F.2d 737, 741-43 (D.C. Cir. 1992) ("*AAR*"). After the ICC and the STB had handled a number of railroad merger and acquisition transactions using GAAP purchase accounting, the STB specifically addressed objections to GAAP purchase accounting in *CSX Corp.—Control—Conrail, Inc.*, 3 S.T.B. 196 (1998) ("*Conrail*"). The STB in *Conrail* reaffirmed that GAAP purchase accounting was the economically superior method for URCS costing and revenue adequacy purposes, and consistent with Congressional intent. The Second Circuit affirmed the STB's decision. *Erie-Niagara Rail Steering Comm. v. STB*, 247 F.3d 437, 442-43 (2d Cir. 2001) ("*Erie-Niagara*").

In Ex Parte No. 582 (Sub-No. 1), *Major Railroad Consolidation Procedures* (served June 11, 2001), the Board confirmed again that "there is no sound economic justification" for valuing properties obtained through a merger based upon predecessor book values rather than acquisition

[2] Pertinent sections of the RAPB Report are attached to BNSF's Opening Evidence and Argument for the Board's convenience.

cost. Slip op. at 28, 2001 WL 648944, *18. *See also Western Coal Traffic League v. Union Pacific Railroad Co.*, 4 S.T.B. 685, 686-95 (2000) and *FMC Wyoming Corp. and FMC Corp. v. Union Pacific Railroad Co.*, 4 S.T.B. 699, 709 (2000) (reiterating that the Board's Uniform System of Accounts ("USOA") requires railroads to use acquisition cost to report their expenses and net investment to the Board after a merger or acquisition transaction).

Nothing has changed since those decisions to warrant any reconsideration of the STB's position. The Board's rules still require railroads to use GAAP purchase accounting in their R-1 Reports to the Board after a merger or acquisition transaction. 49 C.F.R. § 1201, Instruction 2-15(c)(1). The statute still requires the STB to use GAAP accounting for USOA and cost accounting purposes "to the maximum extent practicable." 49 U.S.C. §§ 11142 and 11161. Thus, it is incumbent upon the parties opposed to applying GAAP purchase accounting to Berkshire's acquisition of BNSF to show why this particular transaction should be singled out for different treatment.

WCTL and other shipper parties claim that all of the other merger and acquisition transactions are distinguishable because they involved "merger synergies" that the STB thought would reduce or eliminate the effects of the write-up in the investment bases of the railroads involved. WCTL Br. at 33-36; NITL Br. at 6-7; ARC Br. at 2-3; NCGA Br. at 14-15; CURE Br. at 5. Their argument about "merger synergies" is an element of their broader claim that the purchase accounting adjustment will lead to higher rates for captive shippers. The shippers' assumption is that the asset write-up produces higher variable costs and therefore will lead to higher rates unless the acquisition also produces "merger synergies" that result in offsetting lower costs. As we explain in the following section of this reply brief, the assumption that the asset write-up will lead to higher rates is unfounded and incorrect.

In any event, the shipper parties mischaracterize existing precedent in claiming that the consideration of "merger synergies" was integral to the ICC's and STB's decisions requiring the use of GAAP purchase accounting. In most of those cases, the ICC and the Board concluded that GAAP accounting was appropriate without any consideration of merger synergies, and in none of those cases did the validity of its conclusions turn on the existence of merger synergies. In fact, there is only one case, *Conrail*, that even mentions merger synergies in connection with the application of GAAP purchase accounting.

The Board in *Conrail* did observe, among other things, that the increases in URCS variable costs that would result from the acquisition cost in the Conrail/CSX/NS transaction would be offset over time by the merger synergies expected by NS and CSX. 3 S.T.B. at 263. But the Board stressed several fundamental reasons for using GAAP purchase accounting for regulatory purposes regardless of whether there are merger synergies. In the first place, the Board emphasized:

> [Parties arguing for the use of predecessor cost] have asked us to change our basic accounting rules to disregard the increased valuation of the former Conrail assets based on their recent sales price when we make revenue adequacy and jurisdictional threshold determinations. That relief would be inappropriate, and will not be granted. The Board's Uniform System of Accounts (USOA), adopted in conformity with generally accepted accounting principles (GAAP), requires that the former Conrail assets be valued based on their recent acquisition cost, not upon Conrail's book value. Indeed, the ICC's decision to follow the recommendation of the Railroad Accounting Principles Board (RAPB) to use acquisition cost, not book value, in this precise context, supported by NITL and others, was judicially affirmed. *See*, *Association of American Railroads v. ICC*, 978 F.2d 737 (D.C. Cir. 1992).

In addition, with respect to the jurisdictional threshold, the Board emphasized:

> 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.

Id. at 264.

Further, with respect to revenue adequacy, the Board emphasized:

> [T]he 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). . . . [C]arriers 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. . . . [T]he purchase price agreed to by these commercially sophisticated railroads represents by far the best evidence of the current market value of these properties.

Id. at 265. None of these conclusions was based on merger synergies.[3]

In *Erie-Niagara*, the Second Circuit upheld the STB's decision in *Conrail* without any reliance on merger synergies. 247 F.3d at 442-43. Furthermore, that same year the STB in *Major Railroad Consolidation Procedures* reconfirmed the same economic and statutory reasons for using acquisition cost in rail merger and acquisition proceedings—and the STB made no reference to merger synergies. Slip op. at 28, 2001 WL 648944, *18.

As BNSF pointed out in its Opening Evidence and Argument, the ICC and then the STB from the late 1980s consistently applied the acquisition cost principle to value railroads' assets in many significant merger and acquisition transactions in which the purchase price was above book value. BNSF Br. at 8-9. In none of these proceedings was the railroads' use of GAAP

[3] The ICC's decision in *Revenue Adequacy—1988* also did not turn on merger synergies. Although the ICC there was considering a pair of merger transactions in which the acquiring railroad had paid less than book value, the ICC observed: "No one suggests that we use old book values in cases where railroads are sold for more than these book values. Such an approach would potentially short-change those recent investors who have paid a premium above the old book value with a return below the cost of capital for their investment." 6 I.C.C.2d at 940.

purchase accounting even raised as an issue, much less justified on the basis of "merger synergies." This included *Blackstone Capital Partners L.P.-- Control Exemption CNW Corporation and Chicago and North Western Transp. Co.*, 5 I.C.C.2d 1015 (1989) ("*Blackstone*"), where 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. There was no discussion of merger synergies there. The ICC held there that "as a practical matter, this transaction will only effect a change in the identity of the holding company which controls CNWT. Neither CNWT's management nor the basic operations of the commonly controlled transportation subsidiaries will change." *Id.* at 1025-26.

WCTL's witnesses Crowley and Fapp suggest nevertheless that something akin to "merger synergies" were present in the *Blackstone* transaction, because CNWT planned a "cost reduction program" and also the sale of some assets, and this would have a "financial benefit to CNW." Crowley/Fapp VS at 31, citing 5 I.C.C.2d at 1034-35. But nothing about the *Blackstone* case suggests that "merger synergies" or a "financial benefit to CNW" was the basis for the agency's use of acquisition cost to value CNWT's assets.

WCTL also argues that Berkshire's acquisition of BNSF is different from prior merger and acquisition transactions because the dollar amounts of the "acquisition premiums" were smaller in previous mergers and acquisitions. WCTL Br. at 35, Crowley/Fapp VS at 29-30. Nothing in GAAP, the RAPB's Report or prior cases suggests that the size of an asset write-up (or write down) affects its validity under GAAP purchase accounting. And WCTL does *not* claim that the $8.1 billion purchase accounting adjustment was incorrect as a matter of GAAP purchase accounting. Rather, WCTL suggests that an increase of $8.1 billion in BNSF's net investment base is materially different from the adjustments made in prior transactions. If the accounting treatment is correct, the magnitude of the asset write-up should not matter. Many of the prior transactions, of course. involved much smaller rail systems. In any event. as Messrs. Baranowski and Fisher showed in their opening statement, it is not the *dollar* amount of the change in a railroad's investment base, but the *percentage* change in various asset categories that affects the Board's URCS cost and revenue adequacy calculations. Baranowski/Fisher VS at 3-5.

That the percentage change is what affects the Board's regulatory costs can readily be seen from the data in the opening statement of Messrs. Baranowski and Fisher. Although, for example. the dollar amount by which BNSF's net investment increased was significantly greater than the dollar amount by which NS's and CSXT's net investment increased as a result of the *Conrail* transaction, the percentage increase for NS and CSXT was actually higher than for BNSF. Baranowski/Fisher VS, Table 3. Using the approach the STB used in *Conrail* to calculate the average increase in NS's and CSX's variable costs, Baranowski and Fisher showed that the average increase in NS's URCS variable cost (7.9%) was considerably higher than the average increase in BNSF's URCS variable cost, while the increase in CSXT's URCS variable cost (4.9%) was in the same range as BNSF's. *Id.* at 4; 3 S.T.B. at 264.

Overall, the percentage increase in BNSF's net investment base is lower than the percentage increase in virtually all of the prior merger and acquisition transactions in which GAAP purchase accounting has been used to measure the railroads' net investment bases. Baranowski/Fisher VS, Table 3. As a general matter, therefore, the impact of the purchase accounting adjustment in this case on BNSF's regulatory costs is relatively smaller than in most other merger and acquisition cases. Accordingly, WCTL is simply wrong to assert that the dollar amount of the purchase accounting adjustment for BNSF could provide a basis for distinguishing Berkshire's acquisition of BNSF from prior transactions.

III. THE SHIPPERS' FAIRNESS ARGUMENT IS FUNDAMENTALLY FLAWED

The principal argument by shippers for disregarding the Board's long practice of using GAAP purchase accounting standards in valuing BNSF's assets is that it would be "unfair" for shippers' rates to increase as a result of the acquisition of BNSF by Berkshire. WCTL states that "[i]t is fundamentally unfair for captive shipper rates to increase – automatically – simply because Berkshire paid an acquisition premium to acquire BNSF." WCTL Br. at 3. The assumption at the heart of the shippers' argument is flawed in two respects.

First, there is nothing "unfair" about the Board's use of economically accurate asset values in its regulatory calculations, regardless of its impact on rates. No one has argued that BNSF misapplied GAAP principles in valuing the assets after the Berkshire acquisition or that GAAP accounting standards are themselves flawed. No one has claimed, nor would such a claim be plausible, that the depreciated book value of BNSF's assets before the acquisition produced a more accurate estimate of the value of those assets. The asset values established after the Berkshire acquisition through the purchase accounting adjustment are clearly superior to the prior depreciated book values in assessing the fair value of BNSF's assets. There is nothing wrong or unfair with using economically accurate asset values for purposes of estimating costs.

Further, the shipper parties' claim is that it is "unfair" to use purchase accounting when asset values increase is result-oriented and could not be a valid basis for disregarding the purchase accounting adjustment here. Some of these same shipper parties argued vigorously for GAAP purchase accounting when asset values decreased, and the ICC determined to use GAAP purchase accounting to value assets regardless of whether the adjustment increased or decreased a railroad's regulatory costs.[4] It would be arbitrary to use GAAP accounting only when it favored shippers.

The second flaw in the shippers' argument is that there is no reason to believe that the use of GAAP purchase accounting will have any material impact on rates paid by captive shippers. The overwhelming majority of BNSF's and other railroads' rates are not set or regulated by the STB. Rates for all shippers, captive and otherwise, are set by railroads in the first instance based on market conditions, including the demand that railroads perceive for their services. Many such rates are exempt from regulation either because the Board has made a categorical determination that effective competition exists for the traffic involved or because the parties have negotiated a contract rate. Lanigan VS at 3-4. As to rates that are potentially subject to regulation, neither the Board nor BNSF sets rates by reference to a "rate base" that uses regulatory costs. Thus, contrary to WCTL's claim that the write-up in BNSF's asset values will lead to "automatic" rate increases for captive shippers, there is no reason to believe that a modest change in regulatory costs resulting from the use of purchase accounting will have any effect on

[4] In *Revenue Adequacy—1988*, NITL fully supported the RAPB's endorsement of acquisition cost, emphasizing that that was the appropriate valuation where railroads were acquired in arms-length transactions and "the price agreed to was the result of market forces." 6 I.C.C.2d at 639. Edison Electric Institute ("EEI") likewise argued that the agency should adopt acquisition cost, emphasizing that the ICC should "not switch methodologies simply because they happen to affect revenue adequacy determinations," and should stick to one method "regardless of the results." *Id.* The ICC observed that the same economic principles supported the use of acquisition cost when a railroad was sold for more than book value as when it was sold for less. *Id.* at 940. Accordingly, the ICC concluded that it should use acquisition cost regardless of whether the purchase price of the railroad was above or below the old book value. *Id.* On appeal, in *AAR*, NITL supported the ICC's decision, and the D.C. Circuit affirmed that decision. 978 F.2d at 741-42. Subsequently, when the STB in *Conrail* reaffirmed the use of GAAP purchase accounting, the STB observed that NITL and others had encouraged the agency to follow the recommendations of the RAPB "in this precise context." 3 S.T.B. at 262.

the level of rates for the vast majority of captive shippers. *Id.* at 3-6; Kolbe/Neels VS at 4-6, 12-19; Baranowski/Fisher Reply VS at 3-10.

WCTL and other shipper parties nevertheless make a number of assertions in their opening filings about the supposedly dire regulatory effects of applying GAAP purchase accounting to Berkshire's acquisition of BNSF. None of these assertions has any merit.

A. Jurisdictional Threshold

Several parties complain that shippers will be disadvantaged by the effect of the purchase accounting adjustments on jurisdictional threshold calculations for BNSF traffic. WCTL Br. at 14-15; ARC Br. at 3-4; NCGA Br. at 12; NITL Br. at 3. WCTL's witnesses Crowley and Fapp calculate that the acquisition premium will increase BNSF's URCS costs by 4%, which will lead to 122,669 carloads of BNSF traffic—out of 9,143,043 carloads—moving from above the jurisdictional threshold to below the jurisdictional threshold. Crowley/Fapp VS, Exh. 3. That is only 1.35% of BNSF's traffic base.[5] *Cf. Conrail*, 3 S.T.B. at 264 n.98 ("Only a very small percentage of CSX's and NS' traffic would no longer be subject to our maximum reasonableness jurisdiction if the existing threshold were raised in dollar terms, by 4.9% and 7.3% respectively.")

By definition, the rates on this very small percentage of BNSF's traffic are marginally above the jurisdictional threshold and would move to being marginally below the jurisdictional threshold. Whether a rate is marginally above or marginally below the jurisdictional threshold,

[5] Messrs. Baranowski and Fisher in their opening statement used a "top-down" approach employed by the STB in *Conrail* to estimate that the overall increase in BNSF's URCS variable costs would be 5.6%, and that less than 2% of BNSF's traffic base would be affected by the change in the jurisdictional threshold. Baranowski/Fisher VS at 4, Exh. 3. As they explain in their reply statement, a more precise calculation would likely yield an overall increase in BNSF's URCS variable costs between 4% and 5.1%. Baranowski/Fisher Reply VS at 2-3.

however, makes no difference in the rates that shippers are actually charged, because BNSF sets its rates based on market demand, not R/VC ratios. Lanigan VS at 2-6. Market conditions do not change because an R/VC ratio changes.

ARC's witness Fauth calculates that BNSF's URCS variable costs on average will increase by 9.59%, which he asserts will effectively increase the jurisdictional threshold for BNSF to the equivalent of 197 % of variable costs at current URCS cost levels, and potentially lead to increases in grain rates of between $147 and $657 per car. Fauth VS at 5-6. This is incorrect for two reasons. In the first place, Mr. Fauth has seriously miscalculated the average increase in BNSF's URCS costs attributable to the purchase accounting adjustment. As Messrs. Baranowski and Fisher explain, the average increase is in the range of 4% to 5.1%, not 9.59%. Baranowski/Fisher Reply VS at 2-3. More importantly, Mr. Fauth ignores that it is the market, not the jurisdictional threshold, that drives BNSF's rates. Lanigan VS at 2-6; Kolbe/Neels VS at 12-14.

Implicit in Mr. Fauth's claim is the notion that BNSF holds rates at or below the jurisdictional threshold in order to avoid rate regulation. But, as we discuss next, rates at or near the jurisdictional threshold are rarely the subject of rate reasonableness complaints, and it is rarer still that the jurisdictional threshold acts as a rate ceiling.[6] The jurisdictional threshold demarcates the *lowest level* at which the STB can even consider a regulatory challenge to a rate. No grain shipper has ever demonstrated that any BNSF grain rate was unreasonably high, much

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[6] On November 22, 2011, the Board issued a decision prescribing rates for certain BNSF/UP interline coal movements to the coal-fired electric generating facilities of Arizona Electric Power Cooperative, Inc. ("AEPCO") in Cochise, Arizona, at the jurisdictional threshold. *AEPCO v. BNSF and UP*, Docket No. NOR 42113.

less demonstrated that a rate marginally above the jurisdictional threshold was unreasonably high.

B. Rate Reasonableness

Several of the shipper parties claim that shippers will be materially disadvantaged in future rate reasonableness proceedings or in rate negotiations with BNSF if the STB does not remove the purchase accounting adjustment from BNSF's net investment base. WCTL Br. at 15-17; ARC Br. at 3-5; NITL Br. at 4. These claims are incorrect. In the first place, only a minority of rail rates are even subject to STB jurisdiction, and of those, very few are ever challenged. Market forces restrain most rail rates even when they are not categorically exempt from regulation. Lanigan VS at 4-6; Kolbe/Neels VS at 12-14. Even in the relatively few instances in which a railroad's rate is challenged as unreasonably high, the level of the defendant railroad's net investment base and URCS variable costs has little, if any, impact on most of the STB's rate reasonableness decisions. Baranowski/Fisher Reply VS at 6-10; Kolbe/Neels VS at 12-15.

The principal test of rate reasonableness under the STB's constrained market pricing ("CMP") guidelines is stand-alone cost. The stand-alone cost rate reasonableness test is not based on the book value of a railroad's assets or R/VC ratios. Instead, it is based on the replacement cost of a hypothetical railroad constructed to meet the particular needs of the complaining shipper. The shipper picks the configuration of the stand-alone railroad and the traffic included on that railroad. The application of GAAP purchase accounting to BNSF's or any other railroad's investment base has no effect on the replacement cost analysis in an SAC case. Baranowski/Fisher Reply VS at 6; Kolbe/Neels VS at 13.

Some of the shipper parties in their opening filings suggest that R/VC ratios do have a role to play in prescribing rates in major rate cases under the "MMM" approach adopted by the STB in Ex Parte No. 657 (Sub-No. 1), *Major Issues in Rail Rate Cases* (served October 30, 2006) ("*Major Issues*"). WCTL Br. at 15-16, Crowley/Fapp VS at 15; NITL Br. at 3-4. They are wrong, however, to contend that higher URCS variable costs will disadvantage shippers. As Messrs. Baranowski and Fisher demonstrate in their reply statement, the application of the MMM approach with higher URCS variable costs results in the prescription of lower R/VC ratios. Thus, the application of GAAP purchase accounting will not disadvantage any shipper bringing an SAC case today. Baranowski/Fisher Reply VS at 6-8.[7]

In small rate cases, shippers have available the Simplified SAC and 3-B tests. No Simplified SAC case and only one 3-B case has ever been brought against BNSF. WCTL's witnesses Crowley and Fapp suggest that a shipper could be disadvantaged by higher BNSF URCS costs if a rate were prescribed under either the Simplified SAC or 3-B test, for the same reason they assert that a shipper could be disadvantaged in a full SAC case. Crowley/Fapp VS at 21-23. As just discussed in connection with the MMM approach, however, it does not follow from the mere use of R/VC ratios to prescribe rates in small rate cases that there will be any "pass through" of the purchase accounting adjustment to BNSF's costs. Baranowski/Fisher VS at 9.

It is true that one element of the 3-B test, the RSAM benchmark, will be affected by the increase in BNSF's variable costs. But the effect is small. Messrs. Baranowski and Fisher

[7] As discussed below, the WFA/Basin MMM-based rate presents a unique situation. In that case, WFA/Basin's rates were prescribed using an R/VC ratio calculated using BNSF's old URCS costs. The solution to that unique circumstance is not to second-guess the settled use of GAAP purchase accounting for URCS costing and revenue adequacy purposes, but to address this unique transition issue in the ongoing WFA/Basin case.

calculate that the RSAM would increase by only 5%. Baranowski/Fisher VS at 8. Messrs. Crowley and Fapp do not calculate the impact on the RSAM at all. They assert that the effect could be significant, but their assertion is unsupported. Crowley/Fapp VS at 23-24. Given that this is only one element in the 3-B approach, it is unlikely that this small RSAM increase would have a significant effect on the ultimate rate reasonableness finding. It bears emphasizing as well that under the 3-B test, shippers are restricted to damages of $1 million indexed for inflation over a five-year period. Thus, it is unlikely that the increase in the RSAM would make any material difference to a shipper's relief in a 3-B case. Baranowski/Fisher Reply VS at 9-10.

ARC argues that the effect of the purchase accounting adjustment on the 3-B test is "pernicious," because the 3-B test is ultimately a form of comparable rates test, and "if a potential complainant's rates go up at the same time that likely comparison group rates go up," the result is "massive exposure to rate increases encompassing not just entire states but entire multi-state regions." ARC Br. at 5. This histrionic claim is baseless. It assumes, without any evidence, that BNSF's rates in broad geographic regions will go up simply because its R/VC ratios marginally increase. As we discussed earlier, however, R/VC ratios do not drive BNSF's rates—the market does. Lanigan VS at 2-6. There is no foundation, therefore, for any claim that the rates to which a shipper might choose to compare its own rate will be affected at all, much less that there will be "massive" rate increases because BNSF's R/VC ratios marginally increase.

C. Rate Negotiations

Several of the shipper parties assert that the ability of shippers to negotiate for lower rates will be adversely affected by the impact of the BNSF purchase accounting adjustment on their rate reasonableness remedies. Their argument is that BNSF will be in a position to drive a harder bargain either because the jurisdictional threshold will effectively be raised or because full SAC.

Simplified SAC, and 3-B rate reasonableness levels will be higher as a result of the increase in BNSF's URCS variable costs. WCTL Br. at 17, Crowley/Fapp VS at 25-26; NITL Br. at 3.

To the extent that BNSF and its customers take account of regulatory costs in their negotiations, it is hard to understand why it should be a problem for the parties' respective bargaining positions to be informed by the availability of more accurate regulatory costs. Moreover, we discussed earlier why the impact on the jurisdictional threshold for a sliver of BNSF's traffic with R/VC ratios near the jurisdictional threshold would not have any significant effect on BNSF's ratesetting. It is rare that rate reasonableness cases are brought with respect to rates near the jurisdictional threshold, and the jurisdictional threshold has acted as a rate floor in only a handful of cases across the entire industry since the Staggers Act was passed over thirty years ago. Baranowski/Fisher VS at 6. Thus, shippers' rate negotiating posture vis-à-vis BNSF will not be materially affected by the marginal impact of the purchase accounting adjustment on the Board's jurisdictional threshold calculations. Lanigan VS at 5-6.

As to the impact on rate reasonableness, as we discussed above, neither full SAC nor simplified SAC constraints are materially affected by an increase in BNSF's URCS variable costs, and the impact on the 3-B test will be de minimis. Thus, even assuming that BNSF's marketing department were in a position practicably to determine the likely outcome of the application of those rate reasonableness tests before entering into a negotiation, the purchase accounting adjustment would neither affect that determination nor give BNSF any negotiating advantage. *Id.*

D. WFA/Basin

WCTL leans heavily on the effects that the increase in BNSF's URCS costs would have on the R/VC rate prescriptions in the WFA/Basin case. WCTL Br. at 16, Crowley/Fapp VS at

15-21. WCTL suggests that this is an "example" of the effect that an increase in BNSF's URCS costs could have on all shippers that receive a rate prescription under the "MMM" approach adopted by the STB in *Major Issues*. *Id.* In fact, as discussed above, the increase in BNSF's URCS costs will have no material effect on any shipper bringing an SAC or Simplified SAC rate case today, and only a de minimis impact on any 3-B case that a shipper might bring. The WFA/Basin circumstance is unique, and, as we have said before, that unique situation can and should be dealt with in that case. It should not be used as an excuse to reverse over two decades of settled law and policy with respect to the standard treatment of acquisition premiums for STB regulatory purposes. Baranowski/Fisher Reply VS at 9.

E. Revenue Adequacy

The shipper parties in their opening filings devote relatively few pages to the impact of GAAP purchase accounting on the STB's revenue adequacy calculations for BNSF. WCTL Br. at 17-19, 43-46; NITL Br. at 4-6. That is for good reason. Revenue adequacy has never been used by the STB or the ICC to set railroad rates, or to limit or deny the scope of maximum rate relief. *Conrail*, 3 S.T.B. at 265. Thus, a finding of revenue adequacy or inadequacy for BNSF for 2010 would not affect BNSF's prices to shippers. Moreover, as Messrs. Baranowski and Fisher have demonstrated, BNSF would have been revenue inadequate with or without the GAAP purchase accounting adjustments to its investment base. Baranowski/Fisher VS at 6-7 and Reply VS at 10-11. *See also* WCTL Br. at 18, Crowley/Faap VS at 24 (calculating that BNSF would not reach revenue adequacy even if the purchase accounting adjustments were removed).[8]

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[8] CURE argues that the price paid for BNSF demonstrates that BNSF is revenue adequate without regard to the Board's revenue adequacy standards. CURE Br. at 11-13. WCTL also

Most importantly, the STB and the ICC have always made clear that both the statutory definition of revenue adequacy and good regulatory policy required them to use the most economically accurate costs that were practicably available to assess a railroad's revenue adequacy. *See, e.g.*, Ex Parte No. 393 (Sub-No. 1), *Standards for Railroad Revenue Adequacy*, 3 I.C.C.2d 261, 276-77 (1986); *Conrail*, 3 S.T.B. at 265. If any railroad, including BNSF, is to attract and retain the capital that is needed to maintain and replace its assets, it must be given the opportunity to be compensated for the real value of those assets, not just the book value. *Id.*; Kolbe/Neels VS at 19-20. Here, the fair value of BNSF's assets was established in a rigorous process by two large accounting firms, following established GAAP principles. As in the prior proceedings in which the STB and the ICC approved the application of GAAP purchase accounting for revenue adequacy purposes, the application of GAAP purchase accounting to Berkshire's acquisition of BNSF is mandated by law and sound economic policy.

NCGA asserts that there is an inconsistency between the STB's position in Ex Parte No. 679, *Association of American Railroads—Petition Regarding Methodology for Determining Railroad Revenue Adequacy* (served October 24, 2008), and the use of GAAP purchase accounting to determine BNSF's costs. NCGA Br. at 15. There is no inconsistency. The STB in Ex Parte No. 679 determined that it was impracticable to use replacement cost to revalue all of the railroads' assets every year to determine revenue adequacy. Slip op. at 5; 2008 WL 4695743, *5. That was not a new position for the agency. The ICC made a similar determination in Ex Parte No. 393 (Sub-No. 1), and the RAPB did as well in its Final Report. 3 I.C.C.2d at 277; RAPB Report at 60-61. At the same time, the ICC and the RAPB determined that it was

attacks the ICC's and STB's revenue adequacy standards. WCTL Br. at 45-46. Needless to say, this is not an appropriate forum for a challenge to the agency's revenue adequacy standards.

practicable to use GAAP purchase accounting to measure a railroad's current costs after a merger or acquisition transaction. Since those costs were more economically accurate than "predecessor cost," they determined that those costs should be used both for general purpose costing and for revenue adequacy purposes. *Revenue Adequacy—1988*, 6 I.C.C.2d at 939-41; RAPB Report at 40, 46-47. The STB made the same determinations in *Conrail*, 3 S.T.B.2d at 261-65, and *Major Issues*, slip op. at 28, 2001 WL 648944, *18.

CURE asserts that if a railroad's assets are revalued by a purchase accounting adjustment after a merger or acquisition transaction, then the real cost of capital, rather than the nominal cost of capital, must be used in the revenue adequacy calculation to avoid "double-counting" the effects of inflation. CURE Br. at 8-9. As Dr. Kolbe and Dr. Neels explain, there is no merit to CURE's claim. A "double-count" would only be possible if railroads, including BNSF, had consistently earned a cost of capital return on the economic value of their net investment bases. Since none of those railroads, including BNSF, has ever reached long-term revenue adequacy, much less consistently earned adequate revenues in the past, there is no "double-count" for revenue adequacy purposes involved in applying the nominal cost of capital to a railroad's net investment base determined under GAAP purchase accounting. Kolbe/Neels VS at 20.[9]

IV. THE ORIGINAL-COST RATEMAKING REGIMES OF OTHER AGENCIES HAVE NO RELEVANCE TO THE RAIL INDUSTRY

As parties have done in past proceedings in which GAAP purchase accounting for rail mergers and acquisition transactions has been challenged, WCTL and other shipper parties lean heavily in their opening filings on the argument that other regulatory agencies, particularly

[9] Furthermore, as Dr. Kolbe and Dr. Neels explain, the new book value of BNSF's assets will continue to be subject to standard accounting practices, and the straight-line depreciation of those assets will quickly eliminate even the theoretical possibility of a "double-count." Kolbe/Neels VS at 20-23.

FERC, do not permit acquisition premiums to be included in a regulated utility's investment base. They conclude, therefore, that the STB should not permit it either. WCTL Br. at 28-30; NITL Br. at 7-10; NCGA Br. at 13 n.14. WCTL attaches a verified statement by Dr. John Wilson to support its argument.[10] As Dr. Kolbe and Dr. Neels explain, however, the examples Dr. Wilson provides and the "circularity" rationale he gives for not including acquisition costs in the investment base of a regulated utility subject to cost-of-service regulation are simply inapplicable to the rail industry. Kolbe/Neels VS at 4-5, 10, 12-19. The fallacy in the shippers' argument is the same one that the RAPB, the ICC, the STB, and the courts have identified before.

Utility rates for some industries that are subject to FERC jurisdiction (e.g., electric transmission) are pervasively regulated under cost-of-service regulation using original cost. Under this type of pervasive rate regulation, the rates that a utility may charge are a direct function of the value that is assigned to the utility's regulatory assets or rate base. The utility is allowed to earn a return of and on its rate base determined basically as the product of its rate base times a reasonable rate of return. *Id.* at 4-6. Such original cost-based ratemaking is generally applied only in markets that are not subject to workable competition and in which utilities will have an opportunity for full recovery of and on their rate base under original cost-based rates. In such instances, the regulator can be confident not only that this type of mandated ratemaking is

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[10] WCTL also attaches a verified statement by Charles D. Gray, who makes some of the same "circularity" arguments as Dr. Wilson. NCGA and CURE attach a 15-year-old statement by Professor Alfred Kahn that attacks the STB's entire revenue adequacy standard. He claimed there that the alleged problems with the cost of capital standard were "magnified" by the net book value of railroads being "inflated as a result of acquisitions and/or mergers." Kahn VS at 3-4.

appropriate but also that it will provide the opportunity to earn an adequate return and not put at risk the long-term viability of regulated utilities. *Id.* at 5-6.

Under original cost-based ratemaking, a presumption applies to use original cost to value a utility's rate base. A primary reason for this presumption is that there can be a circularity problem in using acquisition costs that are greater than original cost to value the rate base for ratemaking purposes. The amount that will be paid for a company is based on how much revenue the company can be expected to earn, but if acquisition costs greater than original cost are used to value the rate base, the amount of revenue a utility can earn under original cost-based rate regulation will reflect the amount paid for the assets, so increased rates could lead to higher acquisition costs which could lead to increased rates. *Id.* at 5.

In contrast, in the rail sector, as we discussed earlier, only a handful of rates are set through rate regulation and none are set based on original cost-based ratemaking. The overwhelming majority are set based on the demand the railroad perceives for its services, and often as a result of negotiations between the railroad and the shipper.[11] In those limited circumstances where the STB sets rates, it applies a methodology based on market-based principles, where regulated rates are intended to simulate competitive market outcomes. The concerns that have led FERC and other public utility regulators to exclude acquisition premiums under original cost-based ratemaking simply do not apply in rail markets. *Id.* at 12-19.

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[11] WCTL argues nevertheless that BNSF railroad executives have suggested that the market value of BNSF and other railroads is heavily influenced by the STB's regulatory rate policies. WCTL at 30, Crowley/Fapp VS at 38-39. As Mr. Lanigan explains, that is not what he and other BNSF senior management have said. What they have said is that *if* the STB expanded its regulatory reach through artificial, uneconomic mechanisms or improper maximum rate regulation, it could have a serious adverse impact on the profitability of the industry. Today, the market value of BNSF and other railroads is predominantly driven by market demand. Lanigan VS at 6-7.

NITL notes that there are deregulated energy markets where FERC permits acquisition premiums to be included in a utility's net investment base. NITL Br. at 8. Still, NITL says that when FERC sets rates for captive customers, FERC does not permit acquisition premiums to be included in the utility's cost base. *Id.* NITL suggests that the STB should follow the same course. But this ignores that the STB has never engaged in original cost-based rate regulation of rates to captive shippers; accordingly, there is no "circularity" issue that would militate in favor of substituting predecessor cost for a railroad's actual current costs. Kolbe/Neels VS at 16-19.[12]

That is why the RAPB, the ICC, the STB, and the courts have consistently rejected the analogy to original cost-based regulatory regimes. *See* RAPB Report at 46-47; *Revenue Adequacy*—1988, 6 I.C.C.2d at 938-39; *AAR*, 978 F.2d at 442-43; *Conrail*, 3 S.T.B. at 262; *Erie-Niagara*, 247 F.3d at 442-43. Instead, they have chosen to endorse and apply the approach that yields the most economically accurate result that they have found is practicable for the rail industry.[13]

[12] WCTL and Dr. Wilson say that there does not need to be "total circularity" for the STB's ratemaking to be tainted by an acquisition premium. WCTL Br. at 30; Wilson VS at 19-20. But neither Dr. Wilson nor any of WCTL's other witnesses demonstrates *any* significant circularity issue arising from the STB's application of market-based principles to regulate rail rates in the relatively small number of instances in which the maximum reasonableness of a rail rate is challenged. As the STB concluded in *Conrail*, "[g]iven the fact that very few rail shippers are captive shippers whose rates ever require regulatory intervention, paying too much for a property in hopes of extracting increased rents would be a self-defeating strategy in the rail industry." 3 S.T.B. at 262.

[13] In addition to claiming that other regulatory agencies would not permit an "acquisition premium" to be included in a railroad's net investment base, WCTL asserts that utility rate regulatory law is clear that BNSF's customers should not be required to pay higher rates when there has been no change in BNSF's rail service. WCTL Br. at 24-27. This is simply a repackaging of WCTL's "circularity" argument. As just discussed, the public utility law that WCTL refers to assumes an original cost-based rate regulatory system, which bears no relation to the STB's deregulatory regime. Further, as discussed in Part III, the purchase accounting adjustments to BNSF's investment base will have little impact on the rates to BNSF's customers.

V. ACQUISITION COST, AS IMPLEMENTED BY GAAP PURCHASE ACCOUNTING, IS SUPERIOR TO "PREDECESSOR COST" AS THE MEASURE OF THE ECONOMIC VALUE OF A RAILROAD'S ASSETS

WCTL argues that GAAP does not require that regulators follow any particular accounting convention for their regulatory purposes. WCTL Br. at 36-38. WCTL attaches a verified statement by Professor Robert Verrecchia to make that argument as well. Verrecchia VS at 2. But that argument misses the point. As Professor Weil explains, the question here is not whether GAAP requires a particular regulatory approach, but whether acquisition cost, as implemented by GAAP purchase accounting, is preferable to "predecessor cost" for the STB's general costing and revenue adequacy purposes. Weil VS at 3.

Professor Verrecchia asserts that GAAP purchase accounting is a technique for "balancing" a company's books that does not change the "economic substance" of the assets acquired. Verrecchia VS at 2. This is misleading. GAAP financial reporting is not an empty bookkeeping exercise. GAAP purchase accounting specifically records fair values of identifiable net assets at the time of a transaction. Fair values have economic substance. Weil VS at 3-5. Both GAAP purchase accounting and the STB's regulatory accounting seek to be as economically accurate as is practicable. GAAP is a transaction-based system that relies on arm's length transactions to establish the fair value of companies. *Id.* at 3-4. The STB requires that GAAP purchase accounting be used for the same reason—because it reflects a railroad's real economic cost. *Conrail*, 3 S.T.B. at 265. [14]

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[14] Professor Verrecchia also asserts that the "mechanical" application of GAAP accounting in ratemaking proceedings may produce "unintended and skewed regulatory results." Verrecchia VS at 2. But there has been nothing "mechanical" about the RAPB's, the ICC's, and the STB's

NITL and NCGA nevertheless take issue with allowing a purchase accounting adjustment to BNSF's investment base for URCS costing and revenue adequacy purposes, on the ground that the costs involved were costs to Berkshire, not to BNSF. NITL Br. at 6; NCGA Br. at 5-6. What this ignores, first, is that the asset values at issue in this proceeding determined in the GAAP purchase accounting process are BNSF's asset values. They represent the real values on which the railroad must have the opportunity to earn a competitive return if it is going to continue to attract and retain capital.[15] *Conrail*, 3 S.T.B. at 265. Second, regardless of whether railroads are acquired by other railroads or by non-railroads, they must provide the same opportunity to investors for a competitive return. Those investors may be the shareholders of a publicly traded railroad or the shareholders of a publicly traded non-railroad like Berkshire. The economic costs are the same, and they should be treated the same by the STB. *See* 49 U.S.C. § 11164 ("To obtain expense and revenue information for regulatory purposes," Board may prescribe rules for rail carriers "consistent with [GAAP] *uniformly applied to such carriers*.") (emphasis added).

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application of GAAP purchase accounting. The issue has been thoroughly explored and an advertent decision made to use acquisition cost for general costing and revenue adequacy purposes.

[15] It bears reiterating that the $8.1 billion purchase accounting adjustment was calculated on the basis of the fair value of BNSF's assets. Hund VS at 3-8. In the valuation process, some assets were written down in value, while others were written up. *Id.* at 5. Most of the $22 billion premium that Berkshire paid over BNSF's old book value (i.e., $14 billion) was attributed to goodwill and other assets that do not affect BNSF's net investment base for either URCS costing or revenue adequacy purposes. *Id.* at 6-7.

VI. CONGRESS HAS SANCTIONED THE USE OF GAAP ACCOUNTING FOR RAIL MERGERS AND ACQUISITIONS

WCTL devotes several pages of its opening filing to quotes from a handful of letters written by Congressmen and Senators to the Board questioning the GAAP purchase accounting adjustments to BNSF's net investment base. WCTL Br. at 19-22, 31-33. While it is understandable that individual Members of Congress should be responsive to their constituents' concerns, the STB's focus must be on Congress's official statutory mandates.[16]

Congress has spoken twice to the GAAP purchase accounting issue. First, in the Staggers Act, Congress directed both that the ICC "prescribe[e] expense and revenue accounting and reporting requirements consistent with generally accepted accounting principles" and 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). Following those mandates, the RAPB specifically endorsed the use of GAAP purchase accounting for general purpose costing and revenue adequacy purposes, and the ICC adopted the RAPB's recommendations. *See* RAPB

[16] Chairman Elliott responded to one of those letters, from Senator Al Franken, in a letter dated March 28, 2011. He correctly observed that the agency has required railroads to use GAAP purchase accounting since the late 1980s and that "[t]he stated objective of the regulations requiring adherence to GAAP was to ensure that the railroads use the most accurate information about fair market value in reporting on their rail assets." He stated that the STB would "take appropriate action" where a railroad's cost figures "do[] not comport with GAAP, or [where] the acquisition price has been inflated and does not accurately reflect the fair market value of the[] assets." As we discussed earlier, none of the parties in this proceeding claims that the costs BNSF reported do not comport with GAAP. Further, no one claims that those costs do not accurately reflect the fair value of BNSF's assets. As discussed in BNSF's Opening Evidence and Argument, the fair value determination for BNSF's assets was made in a rigorous process. Only approximately a third of the amount that Berkshire paid over BNSF's old book value was allocated to BNSF's regulatory investment base. BNSF Br. at 14-19, Hund VS at 4-8.

Report at 46-47; *Revenue Adequacy—1988*, 6 I.C.C.2d at 935-42. The ICC thereafter consistently used GAAP purchase accounting for both regulatory purposes.[17]

Second, in the ICC Termination Act of 1995, Congress directed that the STB conduct its costing in accordance with GAAP "to the maximum extent practicable." *See Conrail*, 3 S.T.B. at 264 (citing 49 U.S.C. § 11161); *see also* 49 U.S.C. § 11142 (requiring that the USOA conform with GAAP "to the maximum extent practicable"). Significantly, Congress made this statutory direction after the ICC had been using GAAP purchase accounting for a number of years for costing and revenue adequacy purposes. Far from questioning the ICC's approach, Congress endorsed the continued use of GAAP accounting by the STB as well.

NITL claims that since the ICC once used "predecessor cost" in some cases, prior to the RAPB Report, the STB has the discretion to revert to using "predecessor cost" instead of GAAP purchase accounting. WCTL Br. at 10-11. This ignores nearly 25 years of consistent policy and practice by the ICC and the STB, with the express imprimatur of Congress. There has been no

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[17] WCTL suggests that the RAPB Report is "dated" and "non-binding." WCTL Br. at 39. *See also* NCGA Br. at 8 (same). The issue here, however, is not whether the RAPB Report is "binding," but whether it was properly implemented by the ICC and still has authority. The STB recently summarized its position on that issue in Ex Parte No. 679:

> The RAPB was established by Congress to evaluate issues associated with rail costing and to propose principles to govern the estimation of such costs. *See* former 49 U.S.C. 11161-63 (1995). The RAPB set forth its costing principles in its report, *Railroad Accounting Principles* (Sept. 1987). Pursuant to the statute, the ICC gave great weight to the recommendations of the RAPB. *See* former 49 U.S.C. 11163 (1995); *Railroad Cost Recovery Procedures—Productivity Adjustment*, 5 I.C.C.2d 434, 440 (1989). While former sections 11161-63 are no longer in our governing statute, and the RAPB no longer exists, we continue to accord great weight to the recommendations of the RAPB.

Slip op. at 2 n.3; 2008 WL 4695743, *2 n.3.

change in circumstances that could possibly justify reversing that settled policy and practice in this proceeding.

VII. CONCLUSION

The arguments that WCTL and others have made in their opening filings for rejecting the application of GAAP purchase accounting to Berkshire's acquisition of BNSF have almost all been made before. None of those arguments has any more cogency today than they had when they were rejected before. Every rail merger and acquisition transaction for almost 25 years has been accounted for under GAAP purchase accounting, and nothing about Berkshire's acquisition of BNSF distinguishes it in any relevant way from those earlier transactions. The regulatory effects are modest, with one exception that can and should be addressed in that particular case. The STB should reject WCTL's request that the agency deviate from its rules and settled policy with respect to GAAP purchase accounting.

Respectfully submitted,

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Dated: November 28, 2011

CERTIFICATE OF SERVICE

I hereby certify that copies of the foregoing Reply Evidence and Argument of BNSF Railway Company were served on November 28, 2011, by U.S. mail or hand-delivery on all parties of record.

Robert M. Jenkins III

VERIFIED STATEMENT OF JOHN P. LANIGAN

BEFORE THE
SURFACE TRANSPORTATION BOARD

FINANCE DOCKET NO. 35506

WESTERN COAL TRAFFIC LEAGUE—
PETITION FOR DECLARATORY ORDER

VERIFIED STATEMENT OF
JOHN P. LANIGAN

My name is John P. Lanigan. I am Executive Vice President and Chief Marketing Officer for BNSF Railway Company. I have been in this position since I joined the company in 2003. I received an undergraduate degree from the United States Coast Guard Academy in 1977 and a Masters of Business Administration from Baldwin-Wallace College in Ohio in 1989. Prior to joining BNSF, I spent over sixteen years with Schneider National, Inc., one of the largest truckload motor carriers in the United States. In total, I have spent almost 28 years in the transportation industry.

In my position as Executive Vice President and Chief Marketing Office for BNSF, I have overall responsibility for the marketing and sales of BNSF's rail transportation services. I lead the activities of the four business groups within our Marketing Department: Agricultural Products, Coal, Consumer Products, and Industrial Products. I am ultimately responsible for determining how the rates we charge for transportation are set by our company's sales and marketing teams. I am involved in an ongoing dialogue with my team members regarding the marketing of our transportation services and am regularly informed about our rate setting strategies and the policies and trends for rates charged to customer groups and major movements.

I am submitting this verified statement in support of BNSF's reply comments in this proceeding, which I understand has been initiated in response to the requests of certain shipper interests that the Board depart from its prior precedent and exclude the impacts of the Berkshire purchase of BNSF on BNSF's financial statements from certain of the Board's regulatory functions, including the Board's regulatory costing program, URCS. In this statement, I will specifically comment on assertions made in several of the opening filings in this proceeding that BNSF's transportation rates will increase as a result of the application of GAAP purchase accounting to Berkshire's acquisition of BNSF. The short answer to these assertions is that BNSF's policy is to set its rates based on market conditions. With the limited exception of movements that are subject to an existing rate prescription, which is addressed below, the application of GAAP purchase accounting will not affect the rates that BNSF charges to its shippers.

I was also asked to comment on contentions in some of the opening filings in this proceeding that I and other BNSF senior management have suggested that the market value of BNSF and other railroads is predominantly determined by the STB's policies regarding the regulation of rail rates. That is not what we have said. What we have said is that *if* the STB embraced a regime of involuntary and uneconomic competitive access and STB maximum rate regulation divorced from market principles, it could have a serious adverse impact on the profitability of the industry. Today, the market value of BNSF is predominantly a function of shipper demand for our services and the operating efficiencies that we have been able to achieve.

I. BNSF's Transportation Rates Are Determined Based on Market Demand

Several shipper groups oppose the use of GAAP accounting to account for the Berkshire acquisition of BNSF, which is the Board's standard practice, because they claim it will result in

BNSF shippers paying higher rates. These shippers are wrong for the simple reason that BNSF does not generally determine rates based on the costs used for accounting purposes. Instead, BNSF determines rates based on market conditions and demand for service.

The shippers' assertions regarding rate increases lack a logical foundation. They argue that BNSF's rates will increase because the use of GAAP accounting will produce a marginal increase in BNSF's variable costs as calculated by the Board's regulatory costing system, URCS. If BNSF's variable costs increase, the revenue-to variable cost ratios (R/VCs) that are used by the STB in certain regulatory functions will decrease at existing rate levels. But the shipper groups do not explain why this would affect the rates that shippers pay. In fact, slight changes in R/VC ratios calculated by the Board for certain regulatory functions would only impact shippers' rates in the very rare cases where an existing rate prescription has been expressed in terms of an R/VC ratio.

These shipper groups ignore the broader commercial context in which BNSF prices its transportation services. As an initial matter, the majority of BNSF's rates are not regulated at all by the Board. The majority of the traffic that is carried by BNSF involves commodities that have been exempted from regulation because of the competitive nature of the transportation environment. Those commodities include our intermodal business, which accounts for more than 45 percent of the traffic moved by BNSF in 2010, our box car traffic, and traffic falling within the individual commodity exemptions, such as stone, sand, gravel, lumber and wood products. As I explained in my Verified Statement in Ex Parte 704, *Review of Commodity, Boxcar, and TOFC/COFC Exemptions*, BNSF competes vigorously with other railroads, trucking companies, and barge companies on a daily basis for this exempt traffic, and as a result, BNSF's rail rates are determined by market forces.

The same considerations apply to BNSF's transportation under rail transportation contracts, which are not subject to Board regulation. BNSF sets rates for contract movements based on market conditions and demand for service. Since the Board does not regulate the rates charged for these contract movements, the R/VC ratios on these movements that would be calculated by the Board using regulatory costs are irrelevant to the amount that the shipper pays. Any change in variable costs calculated by the Board as a result of the Berkshire acquisition of BNSF would have no effect at all on these contract rates. In total, more than 80 percent of the traffic moving on BNSF falls within these two categories of movements not subject to regulation by the STB.

Even for non-exempt, non-contract traffic, BNSF faces extensive intramodal, intermodal, geographic and product competition that often keeps rate levels down well below the level at which the Board has jurisdiction to regulate the rates. For these movements, BNSF must set rates based on market conditions or it will lose the business. Changes in BNSF's URCS costs would not affect the rates for these movements. BNSF would risk losing the business if it tried to increase rates based on changes in the Board's regulatory costs.

Only a small percentage of BNSF's traffic is even potentially subject to rate regulation by the Board. BNSF establishes rates for this traffic in the same way that it sets rates on its other traffic—in accordance with market conditions. BNSF understands that if a common carrier shipper of non-exempt commodities meets certain conditions, it may seek rate relief by filing a complaint with the Board. But BNSF still sets its rates for these shippers based on market conditions and demand for BNSF's service, not based on the Board's regulatory costs for BNSF. A small change in the Board's regulatory costs would not affect the rates we charge. In the rare case that the shipper believes that these rates are unreasonable, BNSF is prepared to defend the market-based rates that it has set under the Board's rate reasonableness standards. The Board's most widely used rate reasonableness standard is the stand-alone cost (SAC) test. I understand that the SAC test involves the costs of a hypothetical railroad and the results of the SAC test do not turn on the R/VC level of the challenged rate.

The shipper groups suggest that if BNSF's URCS costs increase as a result of the use of GAAP purchase accounting, some rates that are now potentially subject to rate regulation by the Board because the R/VC ratio on the movement exceeds the jurisdictional threshold would move below the jurisdictional threshold. While this could be the case for a very small number of movements that happen to have R/VC ratios that are very close to the Board's jurisdictional threshold. it would have no impact on the rates that these shippers pay. BNSF did not set its rates before the Berkshire acquisition on the basis of whether or not the rates were above or below the jurisdictional threshold, and it does not set them today on that basis. If a rate was above the jurisdictional threshold before the Berkshire acquisition, it was set at that level because BNSF thought that the rate was appropriate based on market conditions for the movement. The fact that the rate is now below the jurisdictional threshold does not change BNSF's calculus of the appropriate rate for that market. Thus, even if ARC's witness Fauth had properly calculated the impact on the jurisdictional threshold (which he did not, as BNSF's witnesses Baranowski/Fisher explain), the specter he presents of BNSF's grain rates increasing substantially because of the shift in the jurisdictional threshold is imaginary. If market conditions permitted BNSF to realize increased contribution by raising its rates, we would have done so already.

It bears emphasizing that the jurisdictional threshold is just that—the threshold at which the STB can consider whether a rate is reasonable if a rate case is brought. But few shippers ever bring a rate case, and even fewer rate cases are brought challenging rates at or near the jurisdictional threshold. In very limited instances, we might look at the R/VC level of a specific rate, such as when a customer calls it to our attention in a negotiation, or the even rarer instances where there appears to be a risk that we might become involved in rate reasonableness litigation.[1] However, as a general matter, in carrying out the day-to-day activities of marketing our services and establishing our transportation rates, we do not set rates based upon R/VC ratios. The small changes in R/VC ratios that result from the use of GAAP accounting will not affect the rates paid by shippers, whether those shippers' rates are at or near the jurisdictional threshold.

Mr. Crowley and others discuss extensively a single case in their opening filings—that is, the WFA/Basin case. But that is a unique situation in which the STB prescribed a rate at the end of a stand-alone cost case using an R/VC ratio based upon BNSF's URCS costs prior the Berkshire acquisition. The STB can and should address that unique situation in that proceeding. It has nothing to do with the rates that BNSF sets for other shippers or for the rates that BNSF will be able to set in the markets for its rail services going forward.

II. BNSF's Market Value Is Not Predominantly Driven By STB Rate Policies

Some of the shippers also make the argument that GAAP purchase accounting should not be used to determine BNSF's asset values because there is a partial "circularity" in allowing the amount paid by Berkshire for BNSF to determine the rates that BNSF's shippers will pay. The short answer to this claim is that, as explained above, the change in BNSF asset values that

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[1] In one case, the TMPA proceeding, BNSF voluntarily elected to maintain a rate at a level below the statutory jurisdiction threshold level while the case was pending before the Board. The case involved a rate prescription that had expired, and a claim by the shipper, TMPA, that the prescription should nonetheless continue to apply. BNSF's approach of maintaining rates at lower than 180 R/VC was in response to a unique issue arising in that case that is unlikely to occur again.

results from the Board's use of GAAP accounting does not affect the rate levels paid by BNSF's shippers, with the exception of a single coal shipper whose rates have already been prescribed.

The shippers wrongly claim that I and other BNSF senior management have suggested otherwise. They point to statements that we have made that the value of our business could be adversely affected by improper STB regulatory policies. They quote my concern about overzealous or inappropriate application of the SAC test in coal cases, and others' concerns about expanded STB regulatory initiatives in the form of liberalized competitive access rules that would drive down rail rates from current market levels.

These shipper parties completely misunderstand our statements. Our point is that expanded involuntary and uneconomic competitive access remedies and maximum rate regulation divorced from market principles *could* have a serious adverse effect on the railroads, *if* imposed by the STB. In fact, BNSF today is subject to only three maximum rate prescriptions established in SAC cases[2], and to date there has been no "small rate" case finding under either the Three Benchmark test or the Simplified SAC test that any of BNSF's rates was unreasonably high. The relative lack of direct STB involvement confirms that competitive market forces drive our rates. As a result, the predominant factor determining the value of our business is, and should continue to be, market demand for our services.

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[2] On November 22, 2011, the Board issued a decision prescribing rates for certain BNSF/UP interline coal movements to the coal-fired electric generating facilities of Arizona Electric Power Cooperative, Inc. ("AEPCO") in Cochise, Arizona, at the jurisdictional threshold. *AEPCO v. BNSF and UP*, Docket No. NOR 42113.

VERIFICATION

I declare under penalty of perjury that the foregoing is true and correct. Further, I certify that I am qualified and authorized to file this Verified Statement.

Executed on November 28, 2011

John P. Lanigan

VERIFIED STATEMENT OF ROMAN L. WEIL

BEFORE THE
SURFACE TRANSPORTATION BOARD

FINANCE DOCKET NO. 35506

WESTERN COAL TRAFFIC LEAGUE—
PETITION FOR DECLARATORY ORDER

VERIFIED STATEMENT OF
ROMAN L. WEIL

I. QUALIFICATIONS

I am the V. Duane Rath Professor Emeritus of Accounting at the Chicago Booth School of Business of the University of Chicago. In addition, I am Co-Director and co-founder of the Chicago Booth/Stanford Law School/Tuck Directors' Consortium. I founded the Chicago Booth/Stanford Law School Advanced Curriculum for Fund Directors. During 2011, I have been Visiting Professor of Accounting, Taxation, and Law at New York University and Visiting Professor at Southern Methodist University.

I received a BA in Economics and Mathematics from Yale University in 1962. I received an MS in Industrial Administration in 1965 and a Ph.D. in Economics in 1966, both from Carnegie Mellon University. I joined the faculty at the University of Chicago in 1965, where I have held positions in Mathematical Economics, Management and Information Sciences, Accounting, and in the Law School.

I have been a CPA in Illinois since 1973. I have served on the faculties of the Georgia Institute of Technology, New York University Law School, and at Stanford University in its Graduate School of Business, Economics Department and Law School. At Stanford, I have organized the sessions on Audit Committee duties at the Directors' College since its inception. I have served on the Board of Academic Advisors of the U.S. Business School in Prague and have taught there. I have served on the accrediting committee of the American Association of Collegiate Schools of Business. I have designed and implemented continuing education programs for partners at the accounting firms of Arthur Andersen and PriceWaterhouseCoopers as well as for employees at Goldman Sachs, Montgomery Wards, Merck, and William Blair, and for business executives in Great Britain and Singapore.

I have served as editor or associate editor of the Accounting Review, Communications of the Association for Computing Machinery, Management Science, Journal of Accounting and Economics, and the Financial Analysts Journal. I have co-edited four professional reference books for McGraw Hill, Simon Schuster, Prentice Hall, and John Wiley & Sons. I have co-authored over a dozen textbooks for Holt, Rinehart, and Winston; The Dryden Press; Harcourt, Brace & Jovanovich; Thomson Learning; and Cengage Publishing. I have published over 80 articles in academic and professional journals. I have served as the principal investigator on various research projects of the National Science Foundation.

I have served on the Securities and Exchange Commission Advisory Committee on Replacement Cost Accounting. At the Financial Accounting Standards Board, I have served on two task forces—one on consolidations and the other on interest methods. I have served on the Financial Accounting Standards Advisory Council. I have consulted with government agencies, including the U.S. Treasury Department and the Securities and Exchange Commission ("SEC"), and a variety of other clients. I have recently been appointed to a two-year term, commencing in 2012, on the Standing Advisory Group of the Public Company Accounting Oversight Board. I serve on the Board of Directors of mutual funds affiliated with New York Life Insurance Company and have chaired the Audit Committee.

I have previously testified as an expert witness before federal and state courts, including the U.S. Tax Court, and administrative agencies, such as the Interstate Commerce Commission and the SEC, on matters of accounting principles. From the mid-1980s, I have taught and written about accounting and regulation of freight-carrying railroads.

I have attached to this report my academic curriculum vitae, as Appendix A, which contains a list of all my publications.

II. ASSIGNMENT

BNSF Railway Company ("BNSF") has asked me to comment on the October 28, 2011, verified statement of Professor Robert E. Verrecchia for The Western Coal Traffic League and others in this proceeding. In addition to reviewing Professor Verrecchia's statement, I have reviewed BNSF's opening statement, including the attached excerpts from the Final Report of the Railroad Accounting Principles Board ("RAPB"), the verified statement of BNSF's Chief Financial Officer Thomas N. Hund, and the joint verified statement of Michael R. Baranowski and Benton V. Fisher of FTI Consulting.

As I understand it, Berkshire Hathaway Inc. ("Berkshire") acquired BNSF in 2010 for $35 billion. As required both by the reporting requirements of the SEC and the accounting rules of the Surface Transportation Board ("STB"), BNSF and Berkshire used GAAP purchase accounting to allocate the purchase price of the acquisition to BNSF's assets and liabilities. They hired Ernst & Young to assess the fair value of BNSF's identifiable assets and liabilities, and Deloitte & Touche subsequently audited the valuation results. The result was that BNSF and Berkshire reported fair values for BNSF's identifiable assets and liabilities that were approximately $8.1 billion more than the predecessor values and allocated the rest of the purchase price (approximately $14 billion) to goodwill.

The issue in this proceeding is whether the STB should deviate from its rules and disallow the $8.1 billion write-up of BNSF's net investment base for regulatory purposes. In his testimony, Professor Verrecchia argues that GAAP does not require that regulators follow any particular accounting convention for their regulatory purposes. He asserts that GAAP purchase accounting is a technique for "balancing" a company's books that does not have any "economic substance." Verrecchia at 5. I address these assertions below.

III. SUMMARY

Professor Verrecchia's argument that GAAP does not require the STB to use any accounting convention for its regulatory purposes, although correct, misses the point. The STB must use some type of system to measure railroad costs. GAAP is almost universally used in this country for financial reporting, and Congress requires that the STB's cost accounting rules conform to GAAP "to the maximum extent practicable." 49 U.S.C. § 11161. The proper question here is whether GAAP purchase accounting is practicable and preferable to the "predecessor cost" accounting proposed by WCTL for regulatory applications like the STB's general purpose costing system and revenue adequacy calculations. Insofar as those regulatory applications seek to use the most up-to-date information that is practicably available about a railroad's current costs, then GAAP purchase accounting is superior to "predecessor cost" accounting.

Professor Verrecchia's claim that GAAP purchase accounting has no "economic substance" is simply wrong. GAAP financial reporting is not an empty bookkeeping exercise. GAAP purchase accounting specifically records fair values of identifiable net assets at the time of a transaction—the amounts a willing buyer pays a willing seller in an arm's length transaction. Fair values have economic substance. For reasons of objectivity and practicality, GAAP relies on acquisition cost in arm's length market transactions. That such information is not objectively and practicably available for all companies every year is no reason to ignore it when it is available, whether for financial reporting or regulatory purposes.

IV. ANALYSIS

GAAP, as Professor Verrecchia recognizes, is the standard for financial reporting in this country. As he summarizes it, the SEC requires both regulated and unregulated companies to use GAAP "to ensure consistency in accounting practices: the accurate, full, and timely reporting of financial data; reporting continuity; and fairness to companies, investors, creditors, and the public who rely on statements to make sound decisions and determine a company's financial health." Verrecchia at 3. Although Professor Verrecchia does not mention it, Congress also requires the STB to use GAAP "to the maximum extent practicable" for its own uniform accounting system (49 U.S.C. § 11142) and for its cost accounting rules (49 U.S.C. § 11161).

Professor Verrecchia asserts GAAP does not require that regulators follow any accounting convention for their regulatory purposes. Verrecchia at 4. But that is not the issue before the STB in this proceeding. The issue here is whether, as a matter of law and good regulatory policy, the STB should apply the same GAAP purchase accounting standards to Berkshire's acquisition of BNSF that I understand the agency has applied to every other major rail merger and acquisition transaction, for both general purpose costing and revenue adequacy purposes, since the RAPB issued its Final Report on those issues in 1987. In particular, the question is whether the STB should use the "predecessor cost" approach advocated by WCTL instead of the GAAP acquisition cost approach endorsed by the RAPB.

I will leave the law to lawyers, but assuming the STB's goal is practicably calculating economically accurate costs, then GAAP purchase accounting is preferable as a policy matter to "predecessor cost." GAAP is based on acquisition cost principles: that the amounts recorded in a balance sheet should reflect what the company paid for those items. When a company is acquired in a purchase transaction, the numbers recorded in the subsequent balance sheet are best estimates of the fair values at the time of the acquisition.

GAAP recognizes that investors and managers make better forward-looking decisions if they make their decisions using current costs, not obsolete predecessor costs. But continually revaluing a company's investment base is impracticable, so GAAP does not require the quarterly or annual collection of fair value data for all items for each balance sheet. Still, GAAP recognizes that when the company derives fair values, as it does at the time of a purchase—because, by definition, a purchase price negotiated at arm's length by willing buyers and willing sellers is a fair value—then using those data in financial statements is superior to using older, out-of-date costs. Ideally, we would use fair values all of the time, but we do not let the best be the enemy of the good. Using fair values when we have them is better than ignoring them when we have them.

The debate in this case between using "predecessor costs" or GAAP purchase accounting costs for STB regulatory purposes after a merger or acquisition is not a new one. The RAPB analyzed the issue in 1987 and concluded that GAAP purchase accounting represented the superior method for measuring economically accurate costs. At the time, the question of using GAAP accounting was complicated by the fact that if a business combination required "pooling of interests" accounting, then the subsequent balance sheet reflected predecessor costs, not current fair values. In 2001, however, GAAP discontinued pooling accounting and required purchase accounting for M&A transactions. The Financial Accounting Standards Board decided that purchase accounting would "better reflect the underlying economics of those transactions." FASB Summary of FAS141 (Issued June 2001). Further, in 2008 GAAP required that all business combinations follow the same GAAP acquisition accounting method that firms use in recording the acquisition of other assets and incurrence of liabilities.[1] Thus, the acquisition principle has become even more firmly established since the RAPB issued its report.

Nevertheless, Professor Verrecchia suggests that the acquisition method does not change the economic substance of the acquired company's identifiable assets or liabilities. To illustrate this, he posits two companies, Company A and Company B, that he says have the same value. He then posits that Company A is acquired, at a price above its book value, and Company B is not. Although Company A's book value is written up to reflect its fair value, he suggests that the difference in the two companies' books has no economic meaning. Verrecchia at 5.

Once again, Professor Verrecchia's analysis misses the relevant point. Assuming, as the RAPB assumed, that the STB's goal is practicably measuring economically accurate costs, the difference between Company A and Company B is that Company A was acquired in an arm's length transaction, so that we have an objective, practical basis on which to measure the current value of Company A's business. Professor Verrecchia suggests that we should assume that Company B's business has the same value as Company A's, but GAAP relies on actual transactions to make that determination. Even accepting Professor Verrecchia's assumption that the economic value of Company A and Company B are the same—if by "value," we mean current fair value—then

[1] The modern terms are now *acquisition accounting* and *acquisition method*, rather than *purchase accounting* and *purchase method*. Since the RAPB wrote before GAAP substituted the word *acquisition* for the word *purchase*, I have generally used the word *purchase* also. Note, however, that the RAPB used the term *acquisition cost* in connection with GAAP purchase accounting. I think the words *acquisition* and *purchase* have no differences that matter for the current proceeding.

Company B's balance sheet amounts are undervalued, not reflecting fair values. When all companies use GAAP purchase accounting, over time their books will tend to reflect the fair value of their assets. As I understand it, the accounting for every major railroad merger or acquisition transaction over the past two decades has used GAAP purchase accounting, so that the railroads' regulatory books reflected the fair value of those railroads' assets at the time of the merger or acquisition. Professor Verrecchia has provided no rationale for why the STB should treat the acquisition of BNSF by Berkshire any differently.

VERIFICATION

I declare under penalty of perjury that the foregoing is true and correct. Further, I certify that I am qualified and authorized to file this Verified Statement.

Executed on November 22, 2011

Roman L. Weil

Roman L. Weil

APPENDIX A

ROMAN L. WEIL 06-May-11

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DEGREES AND CERTIFICATES

B.A., Yale University, 1962; Economics and Mathematics.
M.S., Carnegie Mellon University, 1965; Industrial Administration.
Ph.D., Carnegie Mellon University, 1966; Economics.
CPA, State of Illinois, 1973; #239.002457
CMA, 1974-2007

ACADEMIC AFFILIATIONS

1965– Instructor and Assistant Professor of Mathematical Economics (1965–70), Associate Professor of Management and Information Sciences (1970–76), Professor of Accounting and Sigmund E. Edelstone Professor of Accounting (1976–97), V. Duane Rath Professor [Emeritus since 2008] of Accounting (1997–), and Director of The Institute of Professional Accounting (1978–89), Lecturer in Law (1988–89, 2000–01, 2008), Director of Directors' College (1998–2002) and Director of The Directors' Consortium (2002–) at The University of Chicago. Emeritus (2008--)

2005- Visiting Professor, Visiting Scholar, University of Washington, Seattle

2008 Visiting Profesor, Haas School of Business, Univ California, Berkeley

2008- Program Fellow, Stanford University Law School.

2009 Visiting Professor, Harvard Law School

2009 Visiting Professor, Tepper School of Business, Carnegie Mellon University

2009 Visiting Professor, King Fahd University of Petroleum and Minerals

2010 Visiting Professor, Princeton Universty, Department of Economics

2010-- Visiting Professor of Accouting, Taxation, and Law, Stern School of Business, New York University

2011-- Adjunct Professor, Cox School of Business, Southern Methodist University

1990–95 Visiting Professor of Law, Stanford University Law School. (Edwin A. Heafey, Jr. Visiting Professor in 1991 and 1992.)

1985 George R. Olincy Visiting Professor of Accounting and Law, New York University School of Law.

1984, 1985, 2004 Visiting Professor of Accounting, Visiting Professor of Economics, Stanford University, Economics Department and Graduate School of Business..

1974–76 Mills B. Lane Professor of Industrial Management, College of Industrial Management, Georgia Institute of Technology.

1963–65, 1971–72 Instructor of Mathematics and Economics, Visiting Associate Professor of Industrial Administration, Carnegie-Mellon University.

PROFESSIONAL SOCIETIES AND SERVICE

American Accounting Association (Associate Editor of *The Accounting Review*, 1975–79, Committee to Nominate Outstanding Contributions to the Accounting Literature, 1975–76, Resource Allocation Committee, 1976–77; Outstanding Educator Committee, 1982–83, 1983–84); American Economic Association; American Institute of Certified Public Accountants; Association of Computing Machinery (Department Editor of *Communications of ACM*. 1971–73); The Institute of Management Sciences (Associate Editor of *Management Science*, 1970–76, Insurance Liaison Designate, 1972–), National Association of Accountants; Illinois Society of CPAs (Committee on Accounting Principles, 1976–77), Securities and Exchange Commission, Advisory Committee on Replacement Cost Implementation. 1976–77; Editorial Board of *Journal of Accounting and Economics*, 1979–81; Editorial Board of *Financial Analysts Journal*, 1980–88, American Assembly of Collegiate Schools of Business Accounting Accreditation Committee, 1987–88. Financial Accounting Standards Board· Task Force on Consolidations, 1985–89; Task Force on the Role of Discounting in Accounting. 1989– ; Financial Accounting Standards Advisory Council, 1989–93 Task Force on Financial Instruments, 1994–97. Steering Committee of the American Assembly's Program on the Future of the Accounting Profession, 2001– . Investment Company Institute, Director Services Committee, 2002–2004; Independent Directors' Council, 2004– . Mutual Fund Directors' Forum, 2003 .

CORPORATE GOVERNANCE

MainStay Group of funds—advised by New York Life Investments LLC.

MainsStay VP Series Fund, 1994-2007. Chairman of Audit Committee, 1995-2007.

MainStay Group of Funds (consolidated Board of five registered fund companies, including MainStay VP Series Fund Inc.) 2007- . Member, Consolidated Audit Committee: Audit Committee Financial Expert.

Stanford University Directors' College

Organizer, Chair, Panelist of Sessions on Audit Committee, Backdating Stock Options: 1994–2006, continuing.

University of Chicago

Organizer and Director of Directors' College, 1998–2002.

Organizer and Director of Directors' Consortium, 2002– .

Investment Company Institute. Independent Directors' Council, 2004–2008.

Ygomi, LLC
Board member and chairman of Audit Committee, 2006– .

GRANTS

NDEA (TITLE IV) Pre-Doctoral Fellowship. 1962–1965.

Principal Investigator for National Science Foundation Grants on "Economic Programming" and "Inflation Accounting." July 1967 – March 1982.

Discounting in Accounting. Coopers & Lybrand. 1987–90.

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JOINT VERIFIED STATEMENT
OF
A. LAWRENCE KOLBE
and
KEVIN NEELS

BEFORE THE
SURFACE TRANSPORTATION BOARD

FINANCE DOCKET NO. 35506

WESTERN COAL TRAFFIC LEAGUE—
PETITION FOR DECLARATORY ORDER

JOINT VERIFIED STATEMENT
OF
A. LAWRENCE KOLBE
AND
KEVIN NEELS

I. Introduction

This is a joint statement.

A. Lawrence Kolbe: I am a Principal of The Brattle Group, Inc. ("Brattle"), an economic, environmental and management consulting firm with offices in Cambridge, San Francisco, Washington, Brussels, London, Madrid and Rome. My work concentrates on financial and regulatory economics. I hold a B.S. in International Affairs (Economics) from the U.S. Air Force Academy (1968) and a Ph.D. in Economics from the Massachusetts Institute of Technology (1979). I left active duty in the Air Force in 1977. Before co-founding Brattle in 1990, I was a Director of Putnam, Hayes and Bartlett, and before that, a Vice President of Charles River Associates.

I am co-author of three books and author or co-author of a number of articles. The principal topics of these publications involve investment issues such as the cost of capital, risk, and valuation. My latest book is entitled *Capital Investment and Valuation*. It is one of a two-volume set that lists "The Brattle Group" as third author with Professors Richard A. Brealey and Stewart C. Myers. This set adapts their leading textbook, *Principles of Corporate Finance*, now in its tenth edition,[1] for business professionals, rather than graduate students.[2] Numerous other publications, including both of my other books, address issues related to regulatory economics and finance.

Clients for my work have included federal, state and local government agencies, industry organizations, and many private firms, in a variety of industries. I have testified on financial and regulatory issues in many forums. These include international arbitrations in The Hague, London and Melbourne, Australia; lawsuits in U.S. courts; U.S. arbitrations; and regulatory proceedings before seven U.S. and Canadian federal regulatory bodies and twenty state and provincial regulatory bodies. I have more than 30 years of experience in rate regulation, beginning in the late 1970s when the U.S. Federal Energy Regulatory Commission ("FERC") was first considering how to regulate oil pipelines. I have testified in matters before the FERC myself and assisted others with testimony before the FERC numerous times, on matters relating to oil pipelines, gas pipelines, and electric utilities.

Appendix A provides more detail on my professional qualifications.

Kevin Neels: I am an expert in regulatory economics and in particular, STB regulation of rail markets. I hold a Ph.D. from Cornell University. I am also a Principal at The Brattle Group, where I direct that company's transportation consulting practice. I have more than 30 years of experience providing economic analysis, research, and consulting to a wide range of clients. These clients have included federal, state and local transportation agencies, as well as firms in the postal, trucking, railroad, airline, and auto and aircraft manufacturing industries. My work has frequently addressed issues relating to competition, regulatory policy and the proper relationship between the public and private sectors. I have previously submitted testimony before a number of different regulatory bodies, including the Surface Transportation Board (STB). I have also testified in international arbitrations, and in state and federal courts. Prior to

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[1]Prof. Franklin Allen joined Profs. Brealey and Myers as an author as of the eighth edition. The full current citation is Brealey, Myers and Allen, *Principles of Corporate Finance*, 10th ed., New York: McGraw-Hill/Irwin (2011).

[2]The companion volume, *Financing and Risk Management*, was adapted by another Brattle Principal. Both of these volumes are published by McGraw-Hill.

joining The Brattle Group I served on the staff of a number of other institutions, including the Rand Corporation and the Urban Institute. I also served as a Director of the consulting firm of Putnam, Hayes & Bartlett and Vice President of Charles River Associates, where I directed that firm's transportation practice. I am a member of the American Economic Association and Chairman of the Committee on Freight Transportation Economics and Regulation of the Transportation Research Board, an arm of the National Academy of Sciences.

A copy of my resume is included as Appendix B.

II. Scope of Our Testimony

We are filing a joint statement to describe the differences between the regulatory regimes administered by the FERC and the STB and why those regulatory regimes treat acquisition costs differently. In doing so we will also address certain arguments that have been advanced by witnesses offering testimony on behalf of shippers that reflect an incorrect understanding of the FERC and STB regulatory regimes. We also clarify the economic principles that should be used to assess the issues raised in this proceeding.

III. Background

On February 12, 2010 Berkshire Hathaway acquired the corporate parent of BNSF Railway Company (BNSF), paying a premium over what was then the company's book value.[1] Following this transaction, and in accordance with GAAP purchase accounting requirements, BNSF allocated the purchase price premium to its assets and liabilities. This process resulted in the allocation of approximately two thirds of the purchase price premium over book value to goodwill, and one third to write-ups of various railroad assets.[2] These updated asset values were reflected in BNSF's Class I Railroad Annual Report (R-1 cost report) for the year ending December 31, 2010, which was filed with the STB on March 31, 2011.

The Western Coal Traffic League (WCTL) initiated this proceeding on May 2, 2011with a request that in connection with Berkshire Hathaway's purchase of BNSF, the STB should abandon its prior practice and instead follow the practice of public utility regulators, and the FERC in particular, and exclude acquisition premiums from BNSF's R-1 cost report, from

[1] Verified Statement of Thomas N. Hund, page 3.
[2] Verified Statement of Thomas N. Hund, page 4.

variable cost calculations carried out using the Uniform Rail Costing System (URCS) and from determinations of revenue adequacy.[3] On September 26, 2011 the Board initiated a declaratory order proceeding to consider the request of the WCTL.

Initial statements for this proceeding were filed on October 28, 2011. In its filing the WCTL included statements by various witnesses arguing that permitting BNSF to include acquisition premium related asset write-ups in its cost reports would subject shippers to excessive rates, and would be inconsistent with the practice of other regulators, including, in particular, the FERC.[4]

IV. Summary of Our Conclusions

Utility rates for some industries that are subject to FERC jurisdiction (e.g., non-merchant electric transmission) are pervasively regulated under cost-of-service (C-O-S) rates based on original cost. As we explain below, it is true that in the context of original cost C-O-S regulation ("OC regulation"), acquisition premiums are typically excluded from a utility's rate base. However, the reasons that an acquisition premium would be excluded in markets where rates are regulated under OC regulation do not apply to industries like rail carriers, in which material competition constrains the rates the carriers can charge.

In the rail sector, there is no "rate base" for rate regulation purposes. All rail rates are set by the rail carriers themselves in the first instance based on market conditions and the demand they perceive for their service. Only a handful of rates are ever set by the STB and no rail rate is set based on OC regulation. In those limited circumstances where the STB does set rates, it applies a methodology based on market-based principles, in which regulated rates are intended to simulate competitive market outcomes. The concerns that have led FERC and other public utility regulators to exclude acquisition premiums under OC regulation simply do not apply in rail markets.

Moreover, it would be economically inappropriate to try to impose OC regulation on railroads, where competition is so extensive, because OC regulation is incompatible with prices set in competitive markets. One way this can be seen is by reviewing the economic principles we discuss in this statement. It can also be seen in the actions of the FERC itself, which does not

[3] Petition of the Western Coal Traffic League for a Declaratory Order, May 2, 2011.

[4] See, in particular, the Verified Statements of Charles D. Gray and John W. Wilson.

rely on strictly applied OC regulation in cases where material competition has always existed (oil pipelines) or has arisen in recent years (new gas production). Nor does the FERC generally rely on OC regulation in natural gas, electric energy or electric capacity markets. As discussed further below, use for railroads of the OC regulation standard that underlies the shippers' testimony would guarantee that railroads could not be earn a fair return over the lifetime of the investments they make.

V. Applicable Regulatory Principles

The shippers' expert witness, John W. Wilson, asserts that "[u]niversally, no other agencies as a general rule allow the inclusion of acquisition premiums in the rate base. . . ."[5] The examples he cites, and the rationale he describes for the treatment of acquisition costs in those examples, pertain to classic regulated monopolies. Dr. Wilson correctly notes that under C-O-S regulation, the standard approach employed is to use original cost to value a utility's rate base.

An important reason for this standard is the possibility (depending upon the regulatory treatment of costs) of a circularity problem in using acquisition costs that are greater than original cost to value the rate base for C-O-S ratemaking purposes. The amount that a rational investor will pay for a company will be based on how much revenue the company can be expected to earn. However, if acquisition costs greater than original cost are used to value the rate base, the amount of revenue a utility can earn under C-O-S rate regulation will reflect the amount paid for the assets, so increased rates could lead to higher acquisition costs which could lead to increased rates. For a variety of reasons set forth below, we do not believe there is a potential for such a circularity problem in the railroad industry.

OC regulation cannot be used in industries facing material competition. Under OC regulation, a regulated monopolist is entitled to charge rates that will earn a return of and on the capital invested in its rate base. The value of the rate base is generally determined as the original cost less depreciation of the regulated monopolist's assets. Under OC regulation, rates are determined by applying a rate of return that the regulator deems to be reasonable to the book asset values used to determine the rate base. It is important to note that there is generally no question about the ability of the regulated monopoly to earn a return of and on the capital

[5] Verified Statement of John W. Wilson, at page 10.

invested in its rate base. Indeed, the reason for subjecting a monopoly to OC regulation is concern that as a monopoly it would, absent regulation, earn more than a fair return on and of the capital invested in its rate base.

OC Regulation Versus Competition

Strict OC regulation can be applied only in markets where the regulated company does not face material competition. Original cost regulation has not been and cannot be applied in markets where material competition exists, because the rates set under OC regulation are incompatible with prices determined by competition.

The problem arises in the way OC regulation sets the return on and of capital. Under this form of regulation, capital charges usually equal (1) a book-value rate base times a rate of return that includes compensation for inflation, plus (2) depreciation and taxes. Competition does not set capital charges explicitly: instead, they are implicit in competitive prices. A basic feature of competition is the fact that the price of a competitive good does not depend on the age of the assets used in its production. That is, the price of tomatoes does not depend on the age of the tractor.[6] In general, the price of a regulated service traditionally does depend on the age of the assets employed. Therefore, the capital charges implicit in competitive prices logically must differ from those under rate regulation.

This logical inference from theoretical principles proves to be correct in practice.[7] Competition in equilibrium implicitly provides investors with a rate of return that does not include compensation for general inflation on an asset base that is worth more than its original acquisition cost because of inflation. This means that regulated rates are higher than competitive prices early in the life of a new asset, while competitive prices are higher later on. The difference between regulated and competitive equilibrium capital charges for consecutive investments in 30-year assets is illustrated generically in Figure 1, below.[8]

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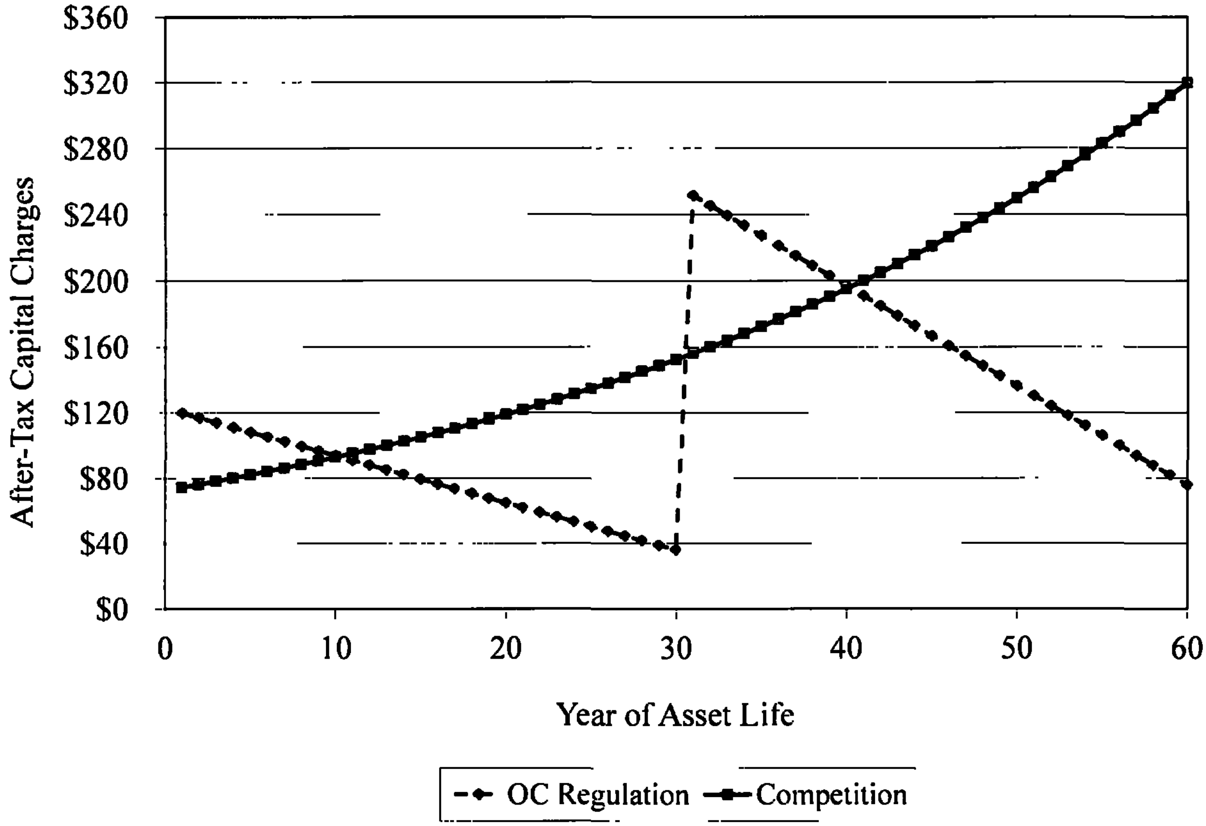
[6] We are indebted to Professor Stewart C. Myers for this particular example, which we sometimes call the "tomatoes theorem."

[7] See, for example, Stewart C. Myers, A. Lawrence Kolbe and William B. Tye, "Inflation and Rate of Return Regulation." *Research in Transportation Economics*, Volume II. Greenwich, CT: JAI Press, Inc., 1985, or A. Lawrence Kolbe, William B. Tye and Stewart C. Myers, *Regulatory Risk Economic Principles and Applications to Natural Gas Pipelines and Other Industries*. Boston: Kluwer Academic Publishers (1993), Chapter 4.

[8] If the market is not in equilibrium and there are excess capital assets, a competitive market will not allow the asset owner to earn a normal return. Inability to earn a normal return will drive asset values to below their inflation

Figure 1
Regulated vs. Competitive Capital Charges, Consecutive 30-Year Investments of $1,000 in Year Zero Dollars, Inflation Rate = 2.5%, Real Cost of Capital = 6%



The figure depicts an investment that costs $1,000 initially and has a 30-year life. After 30 years, it is fully depreciated and replaced by another investment that costs $1,000 in year-zero dollars, which is $2,098 after 30 years of 2.5 percent inflation. The dashed blue line with diamonds tracks the OC regulated capital charges over the life of the two assets, while the solid green line with squares tracks the capital charges implicit in competitive prices.[9]

Note that the capital charges for the competitive line blend smoothly, end to end. That is, the prices of the goods or services it produces do not depend on the age of the assets used.[10] OC

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adjusted acquisition costs, or (depending upon the extent of the disequilibrium) even below their nominal acquisition costs. The railroad industry found itself in this situation for many years.

[9] More details regarding the calculations in this figure and other figures in this statement are included in our workpapers.

[10] This particular pattern for competitive capital charges is level in real (constant dollar) terms and so grows at the rate of inflation in nominal (current dollar) terms. This is correct on average for competitive markets, although prices in individual markets do have real trends (for example, consumer electronics prices tend to shrink in real

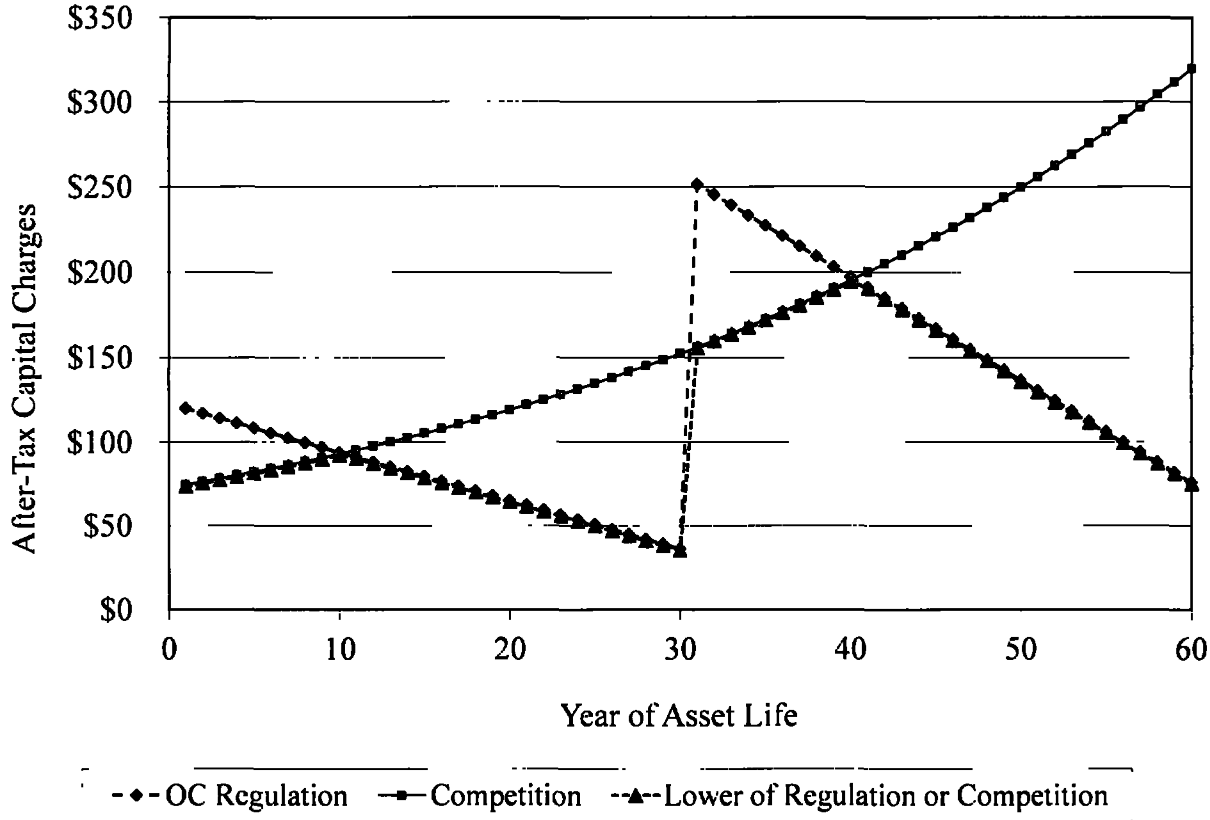
regulation, however, produces a very different picture. The capital charges start out higher, both because inflation compensation is received in the rate of return rather than in appreciation in the value of the underlying assets and because a straight-line depreciation charge exceeds that implicit in competitive prices initially.[11] The OC capital charges then decline linearly as the rate base depreciates over its 30 year life. When the new asset comes in, at a nominal cost of $2,098 but a real cost of $1,000 in Year-0 dollars, OC-based rates have to increase dramatically – a necessity that sometimes contributes to what is known as "rate shock" in utility regulation.

The particular assumptions used in the figure are not important. What is important is that if a company consisting entirely of these assets were constrained by both regulation and competition, the rates it could charge would track the "competition" line in years 1 to 10 and 31 to 40, but would otherwise track the "OC regulation" line. This result is illustrated in Figure 2, below.

terms). For general discussions of how competitive prices relate to OC regulation, see A. Lawrence Kolbe, "How Can Regulated Rates — and Companies — Survive Competition?" *Public Utilities Fortnightly* 115 (4 April 1985) and William B. Tye and A. Lawrence Kolbe, "Optimal Time Structures for Rates in Regulated Industries." *Transportation Practitioners Journal* 59, 176-199 (Winter 1992).

[11] As discussed in more detail below, the economic depreciation schedule implicit in competitive prices in equilibrium is akin to the principal repayment schedule for a home mortgage (which starts out small and gets bigger with every payment), but in real rather than nominal terms.

Figure 2
The Lower of Regulated or Competitive Capital Charges is Inadequate Compensation



The cash flows for a company constrained by both OC regulation and competition track the dotted red line with triangles. Since each of the other two lines provides cash flows with a present value just equal to the initial cost ($1,000 in Year 0 and $2,098 in Year 30), capital charges constrained to whichever line is lower do not offer adequate compensation to investors. That is, a company facing both OC regulation and competition can end up getting "the lower of cost or market," to borrow the accounting phrase. A regulated company constrained by both original cost regulation and competition cannot earn its cost of capital on average, because competition will sometimes restrain rates that regulation would permit, and regulation will sometimes restrain rates that competition would permit.

Of course, actual OC regulated companies are certainly more complicated than the simple examples depicted in the graphs. Real companies are composed of many different vintages of assets, and real companies are rarely in perfect equilibrium, with asset bases perfectly sized to meet current demands. Also, fluctuations in the business cycle affect OC regulated and competitive companies differently. In general, competitive cash flows are more variable than OC regulated cash flows. For a company facing both OC regulation and competition, this variability means competition may undercut regulated rates even at times when regulation would produce lower capital charges, all else equal.

All of this complicates the problem facing any particular company subject to both regulatory and competitive constraints, without changing the basic message: companies facing material competition cannot earn a fair return over the lives of their investments if they are also forced to comply with the standards of OC regulation.

Relevance for Railroads

OC regulation is generally applied only in markets that are not subject to workable competition (i.e., the absence of market power on the part of market participants or the mitigation of such power) and in which utilities will have an opportunity to recover fully the return of and on their rate base under original cost-based C-O-S rates. In such instances, the regulator can be confident not only that OC ratemaking is appropriate but also that it will provide the opportunity to earn an adequate return and not put at risk the long-term viability of the regulated company.

OC regulation is currently neither necessary nor appropriate for railroads. The railroad industry is not subject to strict OC regulation of the type that is described by Dr. Wilson. Since the passage of the Staggers Act in 1980, railroads have been free to set prices based on market conditions and the demands they perceive for their services. The STB exercises limited regulatory authority to assure that captive shippers do not pay excessive rates. Within this system there is no "rate base," because most rail rates are set competitively. In competitive markets, assets of different vintages and with different historical acquisition costs provide equivalent services that must, under competitive conditions, be sold at the same prices. OC regulation instead prices assets of different vintages at different prices. Overlaying OC regulation on competitive railroad markets would therefore guarantee inadequate returns over the lifetime of railroad investments.

VI. FERC's Current Use of Original Cost Regulation

The paradigm of a regulated monopoly, which underlies Dr. Wilson's discussion of regulatory principles, reflects an era that, in many regulated industries, is long past. While the FERC does generally rely on OC rate regulation for non-merchant electric transmission, it does not do so for many other industries it regulates, including wholesale sales of electric energy and natural gas. electric capacity markets, and "merchant" electric transmission facilities. In addition, the oil pipeline industry is now subject to a form of regulation by exception.

Thus, wholesale electric power markets are under FERC jurisdiction and yet do not rely on OC regulation. The design of wholesale power markets varies from region to region, but relies on market-based energy and electric capacity prices (with monitoring and mitigation to prevent market disruptions or manipulation), not OC regulation.[12]

Also, even when the oil pipeline industry was fully regulated, oil pipelines had been subject to material competition for so long that neither the FERC nor its predecessor for oil pipeline regulation, the Interstate Commerce Commission ("ICC"), ever adopted an OC rate base for the industry. Instead, the ICC used a "fair value" rate base that grew with inflation, and the FERC adopted a "trended original cost" rate base for oil pipeline equity which also grew with inflation.[13] The use of a trended or partially trended rate base mitigates some of the problems discussed in the previous section. Following subsequent federal legislation, the FERC's Order No. 561 established that oil pipelines could have initial rates that were cost-based or negotiated with at least one unaffiliated shipper, and that these initial rates would be indexed annually based on a measure of inflation.[14] FERC's Order No. 572 established the foundations for how the

[12] The 2007 *Report to Congress on Competition in Wholesale and Retail Markets for Electric Energy* by the Electric Energy Market Competition Task Force provides useful overviews of the reasons C-O-S regulated service was replaced by competition for wholesale electric power and of the status of the industry as of that time.

[13] For a discussion of some of the factors leading to the FERC's use of a partially trended rate base for U.S. oil pipelines, see Stewart C. Myers, A. Lawrence Kolbe and William B. Tye, "Regulation and Capital Formation in the Oil Pipeline Industry," *Transportation Journal* (Spring 1984). The approach itself is described in Myers, Kolbe and Tye, "Inflation and Rate of Return Regulation," *op cit* (Prof. Myers's evidence in FERC proceeding OR79-1, *Williams Pipe Line Company*, Phase I, recommended the use of a trended rate base, which was adopted by the FERC for the equity part of the rate base in Opinion 154-B, issued June 28, 1985, as clarified by Opinion 154-C, issued December 5, 1985.)

[14] Order No. 561, *Revisions to Oil Pipeline Regulations Pursuant to the Energy Policy Act of 1992*, 58 Fed. Reg. 58,753 (Nov. 4, 1993).

Commission would analyze pipelines applying for market-based rates.[15] Since Order No. 572, numerous refined products pipelines have applied for and been granted market-based rates.[16]

VII. STB's Market-Based Regulation

Many of the arguments that have been advanced by witnesses testifying on behalf of the shippers simply do not apply to railroads. Railroads are not subject to OC rate regulation. They have nothing that functions as a "rate base" as that term is traditionally understood in regulatory economics.

Nature of the Regulatory Structure Applicable to the Railroad Industry

Comprehensive regulation of railroad rates – cost-based or otherwise – was eliminated by the passage of the Staggers Act. In the railroad industry the vast majority of rates are currently set by market conditions, and not by cost or by cost-based regulatory rulings. These market conditions reflect both the value of the service to shippers and the competition provided by other railroads and other transportation alternatives. BNSF's witness John Lanigan explains that BNSF sets market-based rates for all of its traffic, including traffic that is potentially subject to rate regulation.[17]

Consistent with the principle established by the Staggers Act that markets should be the primary determinant of rates in rail markets, very few rates are actually set by the STB in rail markets. The STB functions as a "stand-by" regulator with the authority to reduce rates only in limited circumstances. Under the governing statute, only a subset of a railroad's rates are thus even subject to rate regulation. Rates set forth in contracts that have been negotiated between railroads and shippers are exempt from regulation. In addition, the Board has exempted certain categories of traffic that are subject to extensive competition, such as intermodal movements and traffic involving movement of certain commodities.[18] Other traffic is subject to STB regulation only if it can be shown that the railroad carrying that traffic is market dominant, and that the

[15] *Market-Based Ratemaking for Oil Pipelines*, Order No. 572, FERC Stats. & Regs. ¶ 31,007, at 31,180, *order on reh'g*, Order No. 572-A, 69 FERC ¶ 61,412 (1994), *pet for rev. denied*, *AOPL v. FERC*, 83 F.3d 1424 (D.C. Cir. 1996). A summary of the current regulatory system for oil pipelines may be found on the FERC's website: http://www.ferc.gov/help/pub-ref-rm/oil-ratemaking.pdf.

[16] See, for example, *Sunoco Pipeline L.P.*, 114 FERC ¶ 61,036 (2006).

[17] Verified Statement of John P. Lanigan, pages 3-4.

[18] Verified Statement of John P. Lanigan, pages 3-4.

rates being charged for movement of that traffic exceed the jurisdictional threshold of 180 percent of variable costs.[19]

In keeping with this system, very little of BNSF's traffic that is potentially subject to rate regulation actually moves under rates that are set by the STB. BNSF currently has only three movements where rates it is able to charge have been set by the STB.

When the STB does establish the rates that a railroad can charge, it does not apply OC rate regulation. The STB's rate reasonableness standards assess rates by simulating competitive market conditions and determining the rates that would be charged in such a competitive market. The theory of Constrained Market Pricing (CMP) that informs the STB's rate-setting procedures reflects market-based rate regulation, not OC rate regulation.

Under the stand-alone cost constraint of CMP, the standard most often applied to assess the reasonableness of rail rates, the value of BNSF's asset base is not relevant to the STB's evaluation of the reasonableness of the rates BNSF charges. Under the stand-alone cost test, the costs that a hypothetical entrant would incur do not depend on the book value of BNSF's assets. Rather, these costs reflect the current prices that would be paid by the shipper to a hypothetical, efficient competitor.[20] This is a critical difference from OC ratemaking, and it is one of the primary reasons that the principles of OC rate regulation described by Dr. Wilson are not relevant in rail markets.

Competition in the Railroad Industry

It has long been recognized that OC rate regulation is not appropriate in rail markets. This is because most rail markets are workably competitive. Many origin-destination pairs are served by more than one railroad. Other movements served by only a single railroad could also potentially travel via some other mode, such as truck or barge. A considerable volume of traffic (including most intermodal traffic) is trucked to the point where it is loaded onto a railroad. Movements such as these can generally be trucked to any of a number of different railroads able to carry the shipments to their final destinations. In addition, there is widespread product and geographic competition in rail markets. U.S.-bound goods manufactured in Asia can and do

[19] 2010 STB Annual Report, page 33.
[20] 2010 STB Annual Report, page 34.

enter the country via a number of different ports served by different railroads. Many power plants are able to switch fuels in response to changes in delivered costs. All of these factors constrain the rates that railroads are able to charge.

In the presence of competition, the age and acquisition costs of a railroad's assets do not affect the rates that it is able to charge. Consider the case of an origin-destination pair served both by BNSF and by another railroad with a shorter and more efficient route. If BNSF wishes to win the business of a shipper moving traffic between these points, BNSF will have to match the rate offered by its more efficient competitor. Writing up the value of the assets used to serve this movement as part of a purchase accounting process (or not doing so) will have no effect on this competitive reality.

This is not to say that costs have no influence over rates that are subject to competition. There will always be some variable costs that a railroad will incur in carrying a specific piece of traffic, and it would be economically irrational for a railroad to carry traffic for a rate that failed to cover those variable costs. There will also generally be fixed costs associated with particular routes or facilities. An efficient and economically rational railroad operator will keep a facility or route in service only if the contribution (that is, the difference between revenue and variable cost) generated collectively by the traffic that depends on that facility or route is able to cover the fixed costs of keeping it in service. The necessity of covering costs thus affects whether or not a railroad will compete for business, and how aggressively it will compete for business. However, the costs that influence rates in this way are not book values, but rather, current costs – e.g., the current costs of repairing or replacing worn out rolling stock, or of restoring grading that has been washed out by a storm.

The Railroad Accounting Principles Board has recognized that it is current asset values that influence the rates charged in competitive markets:

> A competitive firm establishes an upper limit on prices on the basis of the economic costs (including cost of capital) experienced by a new entrant. When that firm charges more than the new entrant's costs, new competitors enter the

market. Prices will be driven to a point of equilibrium as the supply is increased.[21]

Characterizing rail markets as workably competitive does not mean that there is competition for all traffic, or that when competition is present it is equally effective in constraining the rates railroads are able to charge. There are movements where a railroad enjoys market dominance. and where as a result it would be able, absent regulatory constraints, to charge up to the monopoly price. Markets that are subject to competition can differ substantially in the number, nature and quality of the competitive alternatives that are available, and hence also in the rates that railroads are able to charge. However the passage of the Staggers Act and the regulatory policies of the STB are predicated on a belief that *most* rail markets are workably competitive, that that this competition is generally effective in constraining the rates railroads are able to charge and the revenues they are able to earn, and that those instances in which a railroad does enjoy market dominance can be dealt with on a case by case basis.

BNSF's Asset Values Under Purchase Accounting

As explained by BSNF witness Hund, the parts of the acquisition premium booked as goodwill do not affect asset value for STB purposes.[22] Thus, only the value of BNSF's non-goodwill assets is relevant to STB determinations.

Competitive asset values equal net replacement cost in equilibrium, and both values are lower in economic downturns. As also explained by Mr. Hund, the timing of the valuation in this case occurred at a low point in the economic cycle, reducing the value of some of BNSF's assets.[23]

Moreover, the pre-acquisition stock market value of BNSF exceeded the post-acquisition value of the revalued assets by $5 billion,[24] which is consistent with there being no acquisition "premium" in the revalued assets.[25] Additionally, BNSF was revenue adequate neither in 2009,

[21] RAILROAD ACCOUNTING PRINCIPLES: FINAL REPORT, September 1, 1987, Volume 2—Detailed Report, Page 43.
[22] Verified Statement of Thomas N. Hund, page 6.
[23] Verified Statement of Thomas N. Hund, page 5.
[24] Verified Statement of Thomas N. Hund, pages 7-8.
[25] Nor would there be any premium to reflect excessive profits in the few instances where the railroad is judged to have market dominance, because STB regulation restrains rates in those cases.

before the Berkshire Hathaway acquisition, nor in 2010, regardless of whether or not purchase related asset write-ups are factored into the determination.[26]

Given all of these factors, there is every reason to believe that the value assigned to the revalued assets in the aggregate does not vary materially from competitive market value. If anything, it may be somewhat below equilibrium competitive market value, that is, net replacement cost.

There is No "Circularity" Problem in The Railroad Industry

Dr. Wilson argues that permitting BNSF to show purchase-related asset write-ups in its R-1cost report would create a potential "circularity" problem in which inflated asset values lead to increased rates, which then lead to further inflated asset values in an escalating cycle.[27] For a number of reasons, we believe such concerns are groundless.

The first reason circularity is not a problem is that (as we have noted above) most rates in the railroad industry are set by market conditions, not by book values or any regulatory construct that could legitimately be characterized as a "rate base." Rates that are determined by market conditions will not be affected by the numbers that BNSF puts in its R-1 cost report. The only rates to which Dr. Wilson's arguments might even potentially apply are the rates that are set not by market forces, but rather in regulatory proceedings.

Dr. Wilson argues that there is a potential for a circularity problem even in industries that are only partially regulated.[28] While true in the abstract, this should not be a material concern in this case. One reason is that, as we have noted above, BNSF currently has rates that are set by the STB for only three movements among the tens of thousands of movements that BNSF handles. This fact by itself suggests strongly that the circularity problem is of limited practical significance.

Another reason that circularity is not an issue, even at a *de minimis* level, is the nature of the regulatory procedures followed by the STB. As we also discussed above, when the STB has set BNSF rates, it has not done so based on the book values of BNSF's assets. Rather, it has based rates on the costs that would be incurred by a hypothetical efficient new entrant. Hence, even if

[26] Joint Verified Statement of Michael R. Baranowski and Benton V. Fisher, page 7.
[27] Verified Statement of John W. Wilson, pages 17-20.
[28] Verified Statement of John W. Wilson, pages 15.

it were the case that that the book values of BNSF's assets were somehow inappropriately inflated this would not have affected BNSF's regulated rates in a way that could have caused a valuation spiral. That is, the net replacement cost of the hypothetical standalone entrant's assets will not increase if BNSF uses the revalued assets for STB purposes, so no "feedback loop" could be created that would lead to an upward rate spiral.[29]

Nonetheless, under the Board's procedures it is true that the asset values reported by BNSF in its R-1 cost report influence a number of Board determinations. The WCTL has argued that permitting BNSF to show written-up asset values in its R-1 report will exert upward pressure on the rates paid by shippers. In particular, the WCTL has argued that written-up asset values will influence determinations of which rates are subject to STB regulation, the regulated rates that are set in response to successful challenges, the outcomes of commercial negotiations, and determinations of revenue adequacy.[30] We address these issues in turn.

We disagree with the contention of the WCTL that permitting BNSF to report written-up asset values in its R-1 cost report will influence the outcome of commercial negotiations. There is no simple formulaic relationship between the costs reported by BNSF and the outcomes of commercial negotiations between the railroad and its customers. As BNSF's witness Lanigan discusses, BNSF sets its rates on the basis of market demand, not URCS costs or "R/VC ratios". These include rates that are close to the jurisdictional threshold. BNSF did not set its rates before the Berkshire acquisition on the basis of whether rates were above or below the jurisdictional threshold, and it does not set them on that basis today.[31]

As BNSF's witnesses Baranowski and Fisher discuss, the purchase accounting adjustments to BNSF's assets values will have some impact on BNSF's URCS costs and revenue adequacy calculations. Whether these effects, regardless of their magnitudes, are desirable depends on whether it is appropriate from a conceptual, public policy and regulatory economic standpoint to use current asset values in calculating URCS costs and determining revenue adequacy. We

[29] This said, we recognize that a write-up of BNSF asset values has the potential to influence regulated rates on WFA/Basin Electric coal traffic, which have been set with reference to revenue to variable cost ratios calculated using pre-acquisition asset values. See WCTL Opening Evidence and Argument, page 16. However, we understand that this is a unique transitional issue that BNSF believes can be dealt with directly in the WFA/Basin Electric proceeding. See BNSF Opening Evidence and Argument, page 23

[30] WCTL Opening Evidence and Argument, pages 14-19.

[31] Verified Statement of John P. Lanigan, pages 4-5.

believe that in competitive markets variable costs will be more closely related to current replacement costs than to original acquisition costs. One component of variable cost is the wear and tear that traffic causes on the railroad's physical plant. This wear and tear leads eventually to the need to replace or rehabilitate the assets in question. At that time the cost that the railroad will incur will not be the original acquisition cost of the asset, but rather its current replacement cost. Thus, to the extent that the written-up asset values at issue in this proceeding reflect the replacement costs of these assets, it is economically appropriate to reflect these values in estimates of variable costs.

However, even if we were to concede for the sake of argument (wrongly, in our view) that it was not appropriate to use current asset values in calculating URCS costs and determining revenue adequacy, we would still see no potential for a circularity problem or a spiral of escalating asset values in connection with any of the points raised by the WCTL. The effects in question are simply too small to have a material effect of the value of the company, and moreover, there is no reason to believe that the purchase accounting process leads to a value that is materially different from that which would exist under competition.

As BNSF noted in its opening argument, only a small percentage of the units of the movements served by BNSF were non-exempt, non-contract moves with rates close enough to the jurisdictional threshold that the outcome of a jurisdictional threshold determination would hinge on the treatment of acquisition-related asset write-ups.[32] Of necessity, any such rate would fall close to the jurisdictional threshold. Such rates, BNSF noted, are rarely the subject of shipper rate reasonableness complaints.[33]

As we have explained above, in full standalone cost cases the total amount of rate relief judged to be appropriate is determined not based on asset book values, but rather, by the costs that would be incurred by a hypothetical, efficient competitor. In full standalone cost cases URCS costs have at most a second order effect on how rate relief is allocated between issue and non-issue traffic.

[32] See Verified Statement of Michael Baranowski and Benton Fisher, pages 5-6.
[33] BNSF Opening Evidence and Argument, page 22.

As explained by BNSF's witnesses Baranowski and Fisher, the write up in asset values that resulted from BNSF's acquisition by Berkshire Hathaway would have at most a marginal impact on the result of 3 Benchmark cases.[34] However, BNSF has only ever had one 3 Benchmark case filed against it, and it has no rates that have been set under the 3 Benchmark standard.[35] The possible impact of acquisition costs in 3B cases, which are supposed to represent simplified implementation of CMP ratemaking principles, is *de minimis*.

Thus, the nature of the purchase accounting process and the Board's procedures minimize the possibility of a circularity problem due to an upward spiral of asset values. In these conditions, there is no mechanism for escalating company purchase prices to feed into the regulatory system and drive up rates and investor valuations. Escalating purchase prices would lead, at most, to escalating amounts of goodwill. The asset values that influence variable cost estimates and revenue adequacy determinations ignore goodwill.

Viewed in this way, it is clear, once again, that the regulatory system under which the railroad industry operates is not susceptible to the creation of a "circularity" problem.

Effects of Variable Costs on Revenue Adequacy

The write up in asset values resulting from the Berkshire Hathaway acquisition does affect the return on investment calculated by the STB in annual revenue adequacy determinations. But the STB's revenue adequacy calculations have never been used as the basis of rate regulation. Rather, the STB uses the annual revenue adequacy determinations to monitor the financial health of the railroad industry and to determine whether the industry is earning its cost of capital. A railroad that is not earning its cost of capital over a sustained period will be unable to maintain and replenish its assets.

In fact, the use of the original cost of railroad assets in making the annual revenue adequacy calculations is not a conceptually correct approach to determining railroad revenue adequacy. As discussed above, prices in competitive markets are based on the current cost of assets used to produce the good or service. To determine whether a railroad operating in competitive markets is earning enough to justify reinvestment in rail assets, the railroad's return on investment should

[34] Verified Statement of Michael Baranowski and Benton Fisher, page 8.
[35] Verified Statement of Michael Baranowski and Benton Fisher, page 9.

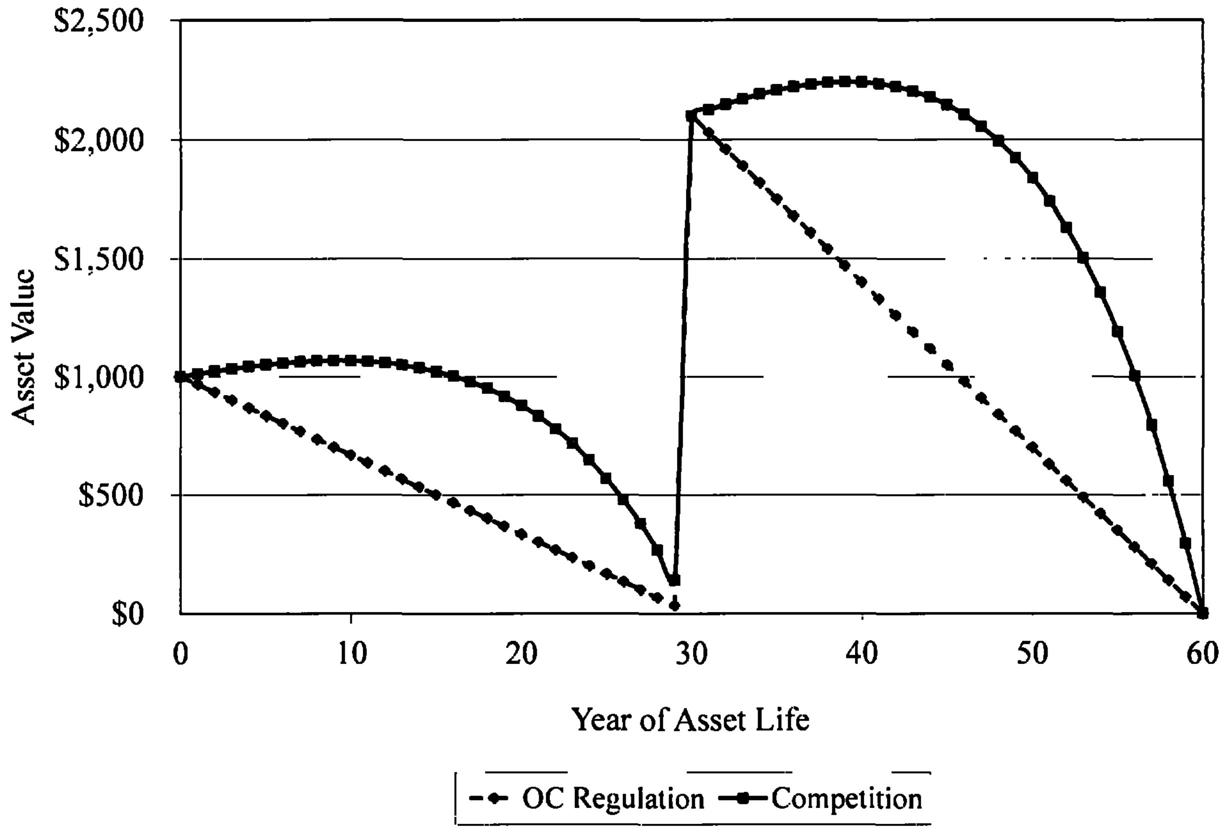
be calculated, if at all possible, using the current replacement cost of rail assets, not the original purchase price of assets that may have been acquired many years in the past. We understand that the Board has found it impractical to revalue each railroad's assets each year to current costs for purposes of the annual revenue adequacy determination. But when an acquisition occurs that produces a more accurate valuation of the railroad's assets, it would make no sense to ignore those economically accurate asset values in the revenue adequacy calculations. In fact, to hold rigidly to original cost in revenue adequacy determinations would lead to exactly the kind of joint regulatory and competitive constraints that would guarantee railroads could not earn their cost of capital on average.

Real versus Nominal Cost of Capital for Revenue Adequacy Tests

Finally, we have been asked to address the claim of some parties that if acquisition costs are used in revenue adequacy determinations, the return on investment must be compared to the real cost of capital rather than the nominal cost of capital. If, contrary to fact, railroads had been able to consistently earn a real cost of capital return on the replacement cost of their assets, revalued every year, then there would be merit to this claim. However, since the passage of the Staggers Act, no one suggests that any railroad has been able to do this on a consistent basis.

Moreover, any problems that did exist in such a comparison would vanish very quickly. To see why, we need to return to Figure 1 above, which shows the cash flows corresponding to end-to-end replacement of 30-year assets under OC regulation and competition, and ask what the corresponding asset values are. The answer to that question is in Figure 3, below.

Figure 3
Asset Values Under OC Regulation and Competitive Equilibrium



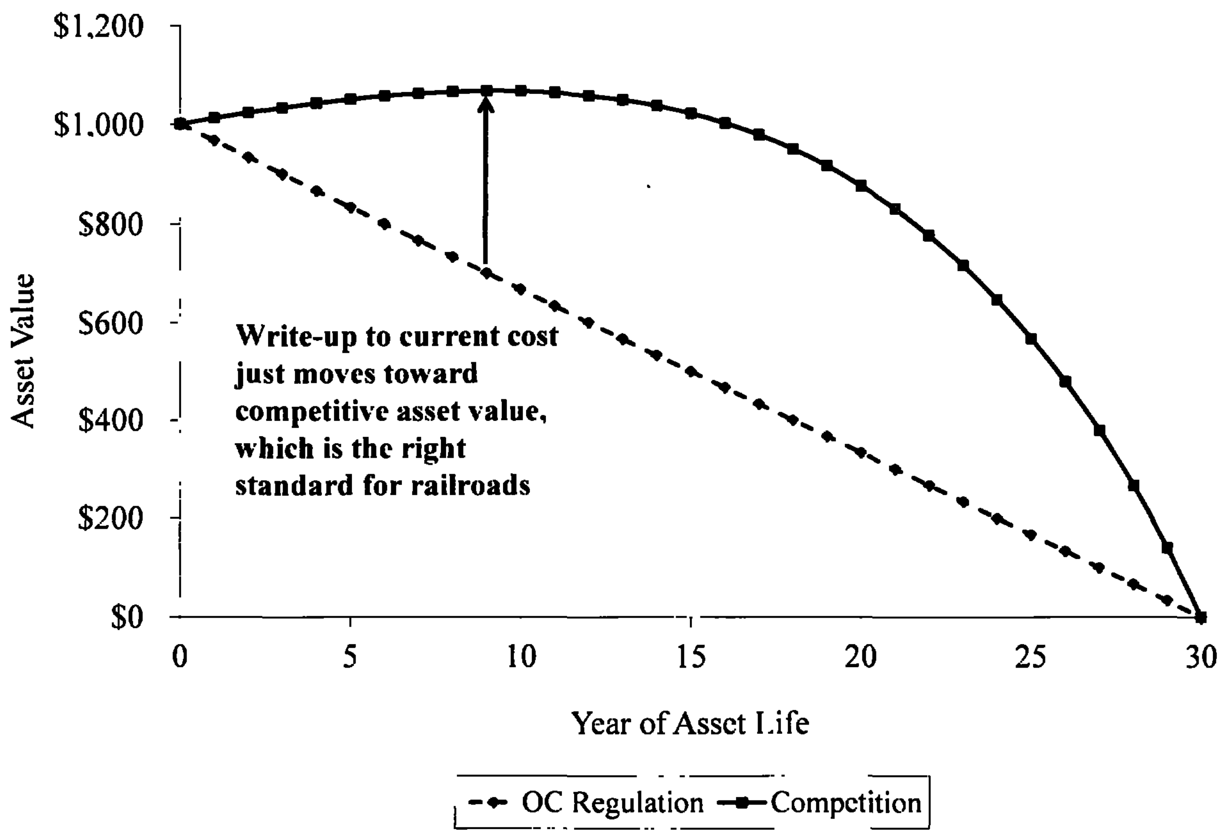
OC regulation simply tracks net book value, which for a 30-year asset depreciates at one-thirtieth of the initial cost each year.[36] However, as noted earlier, the economic depreciation charges implicit in equilibrium competitive prices are constant-dollar versions of the principal repayment schedule on a home mortgage.[37] In early years of the asset's live, when the annual inflation rate exceeds the low early economic depreciation rate, the value of the asset increases. In later years, as the economic depreciation rate accelerates, the value of the asset decreases despite ongoing inflation. The assets have the same initial values ($1,000 in Year 0 and $2,098 at the start of

[36] This statement focuses on the concepts involved, and it is not intended to address the full complexities of regulatory accounting under OC regulation, which do not affect the basic point.
[37] Technically, the "constant dollar" part of this statement requires that the expected inflation rate in the value of the assets in the particular industry exactly equals the general inflation rate on average, but this again represents unnecessary complexity for present purposes.

Year 30) and final values ($0 at the end of Years 30 and 60), but very different values in between.

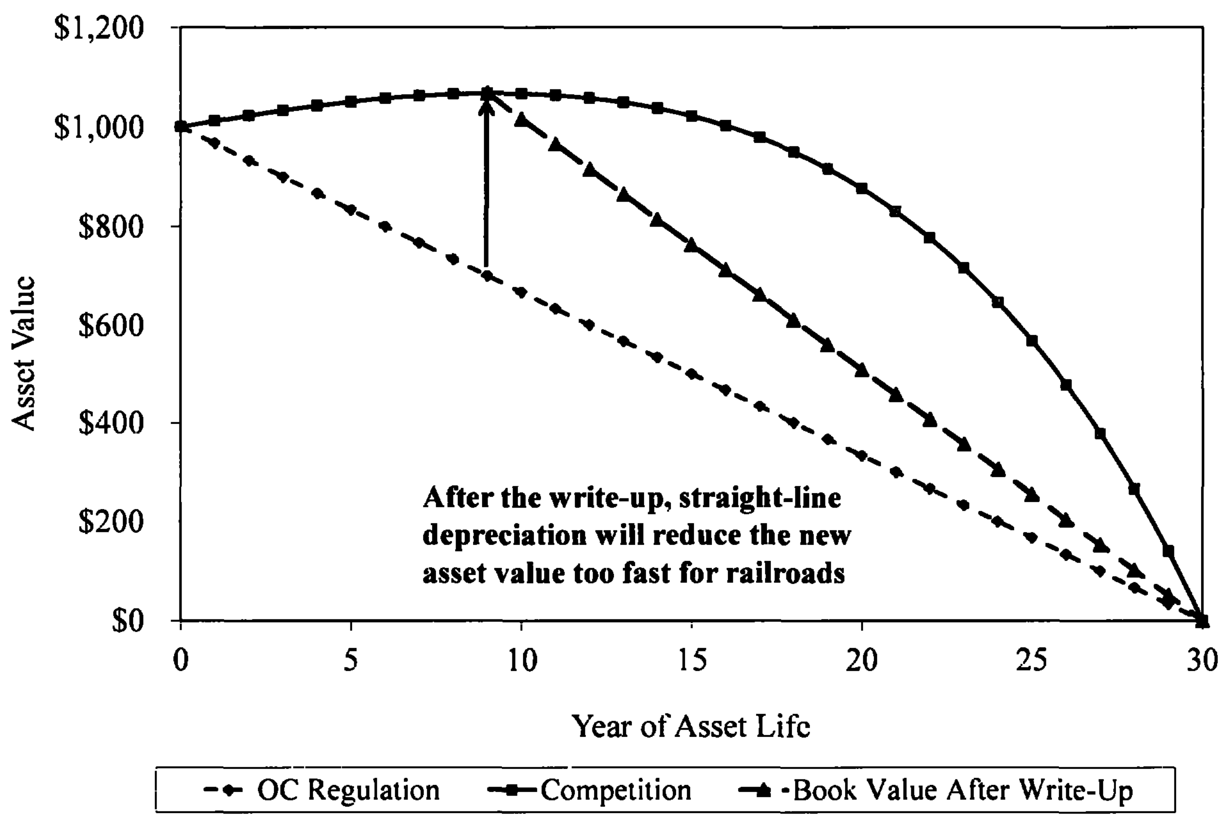
Figure 4 illustrates what happens when the asset value for the first of the two assets is written up from net book value to competitive equilibrium value in, for example, Year 9. (Note that in the actual BNSF acquisition, some assets were written down, not up. However, the shippers' objections are to the fact that there was a net write-up, so this discussion focuses on that issue. The figure also assumes that the revaluation produced the competitive equilibrium value, although the actual revaluation may be somewhat lower because of business conditions when it was made.)

Figure 4
Asset Value Increased to Current Cost in Year 9



In this illustration, the value rises to equal that of a competitive firm in equilibrium, at which point a real cost of capital would be an appropriate way to assess revenue adequacy. However, the new book value would continue to be subject to standard accounting policies, and so would be depreciated at a rate that exceeds the economic depreciation charges implicit in competitive prices. The result is depicted in Figure 5.

Figure 5
Asset Value Increased to Current Cost in Year 9, then Depreciated Using a Straight-Line Schedule



After the write-up, the book value of the railroad's assets over their remaining lives would fall too quickly, relative to the competitive standard. Any initial overstatement of the cash flow required due to use of a nominal rather than a real cost of capital would quickly disappear.

Conclusion

In the case of railroads, the lessons the shippers draw from OC regulation are inapplicable. OC regulation itself cannot be used for a company facing material competition, since to do so imposes dual constraints that guarantee the company would fail to earn its cost of capital over the lives of its assets. The FERC itself does not apply OC regulation in markets where material competition exists, either. It is economically appropriate for the Board to accept BNSF's revalued asset values for regulatory purposes.

VERIFICATION

I declare under penalty of perjury that the foregoing is true and correct. Further, I certify that I am qualified and authorized to file this Verified Statement.

Executed on November 28, 2011

A. Lawrence Kolbe

VERIFICATION

I declare under penalty of perjury that the foregoing is true and correct. Further, I certify that I am qualified and authorized to file this Verified Statement.

Executed on November 28, 2011

Kevin Neels

Kevin Neels

APPENDIX A

Appendix A: QUALIFICATIONS OF A. LAWRENCE KOLBE

A. Lawrence Kolbe is a Principal of The Brattle Group ("Brattle"), an economic, environmental and management consulting firm with offices in Cambridge (Massachusetts), San Francisco, Washington. Brussels, London, Madrid and Rome. Before co-founding The Brattle Group, he was a Director of Putnam, Hayes & Bartlett, and before that, he was a Vice President of Charles River Associates ("CRA"). Earlier, he was an Air Force officer assigned to the Office of the Secretary of Defense with the job title "Health Economist." and before that, he was assigned to Headquarters, USAF with the job title "Systems Analyst."

His work has included extensive research in financial economics, especially as it applies to rate regulation, project or asset valuation, and the decisions of private firms. Clients for this work include the California Public Utilities Commission, the Consumer Advocate in a Newfoundland proceeding, the Edison Electric Institute, the Electric Power Research Institute, the Interstate Natural Gas Association of America, the Newfoundland Federation of Municipalities, the Nova Scotia Board of Commissioners of Public Utilities, the Town of Labrador City, the U.S. Department of Energy, the U.S. Department of Justice, the U.S. Department of State, and a number of private firms.

He is the coauthor of three books and he has published a number of articles. He is coauthor of a report filed with the British Office of Fair Trading, in London, and he has been an expert witness in: proceedings before the U.S.-U.K. Arbitration Concerning Heathrow Airport Landing Charges (under the auspices of the International Bureau of the Permanent Court of Arbitration) in The Hague, the Iran-United States Claims Tribunal in The Hague, the U.S. Court of Federal Claims, U.S. District Courts in Arizona, Colorado, Florida, Massachusetts, New Jersey, Oklahoma, Pennsylvania, Texas and Virginia, U.S. Tax Court, the Supreme Court of the State of New Mexico, District Courts in Colorado and Kansas, a commercial arbitration tribunal held in London concerning a dispute in Australia, a commercial arbitration tribunal in Australia, the Minerals Management Service of the U.S. Department of the Interior, the Master Settlement Agreement Tobacco Arbitration Panels for the State of Louisiana and the Commonwealth of Massachusetts (which determined fee awards to private counsel assisting the state), and a commercial arbitration in Arizona; federal regulatory proceedings before the Canadian Radio-television and Telecommunications Commission, the [Canadian] National Energy Board, the [U.S.] Postal Rate Commission, the [U.S.] Surface Transportation Board, the U.S. Federal Communications Commission, the U.S. Federal Energy Regulatory Commission and the U.S. Federal Maritime Commission; and provincial or state regulatory proceedings in Alaska. Alberta, Arizona, Arkansas, California, Connecticut. Illinois, Maine, Massachusetts, Michigan, Montana, Newfoundland, New Mexico, New York, Nova Scotia, Ohio, Ontario. Québec, Virginia and West Virginia.

He holds a B.S. in International Affairs (Economics) from the U.S. Air Force Academy and a Ph.D. in Economics from the Massachusetts Institute of Technology. Additional information on his qualifications follows.

HONORS AND AWARDS

Sears Foundation National Merit Scholarship, 1963 (declined).
Fairchild Award, U.S. Air Force Academy, 1968 (for standing first in his class, academically).
National Science Foundation Graduate Fellowship in economics, MIT, 1968-1971.
Joint Service Commendation Medal, 1975.

PROFESSIONAL AFFILIATIONS

American Economic Association
American Finance Association
The Econometric Society
Served as Referee for *The Rand Journal of Economics*, *Land Economics*, *The Journal of Industrial Economics*

PAPERS AND PUBLICATIONS

"How to Value a Lost Opportunity: Defining and Measuring Damages from Market Foreclosure," (with William B. Tye and Stephen H. Kalos), *The Economics of Antitrust Injury and Firm-Specific Damages*, Kevin S. Marshall, ed., Tucson, Arizona: Lawyers & Judges Publishing Company, Inc. (2008). (Republication of a 1995 article.)

"Measuring Return on Equity Correctly: Why current estimation models set allowed ROE too low," *Public Utilities Fortnightly* (with Michael J. Vilbert and Bente Villadsen), August 2005.

"The Effect of Debt on the Cost of Equity in a Regulatory Setting," (with Michael J. Vilbert and Bente Villadsen, and with "The Brattle Group" listed as author), published by the Edison Electric Institute (dated January 2005, issued April 2005)

Capital Investment and Valuation, (with Richard A. Brealey and Stewart C. Myers, with "The Brattle Group" listed as third author), New York: McGraw-Hill/Irwin (2003).

"The True Hourly Rate for Private Counsel in the State of Louisiana Tobacco Lawsuit," (with August J. Baker and Bin Zhou), Brattle report prepared for private counsel to the Louisiana Attorney General in the state's lawsuit to recover health care costs from the tobacco industry (July 2000).

"The Cost of Capital for the Dampier to Bunbury Natural Gas Pipeline," (with M. Alexis Maniatis and Boaz Moselle) Brattle report submitted to the Office of Gas Access Regulation, Western Australia (October 1999).

"Compensation for Asymmetric Risks," (with others) Brattle report prepared for GPU PowerNet, Melbourne, Australia (October 1999).

"A Non-Practitioner's Guide to the State of the Art in Cost of Capital Estimation," (with others) Brattle report prepared for GPU PowerNet, Melbourne, Australia (June 1999).

"A Note on the Pre-tax Weighted Average Cost of Capital in a Regulatory Context with Australian Dividend Tax Credits and Alternative Debt Refinancing Policies" (with M. Alexis Maniatis), Working Paper in Progress.

"The Impact of Stranded-Cost Risk on Required Rates of Return for Electric Utilities: Theory and An Example" (with Lynda S. Borucki). *Journal of Regulatory Economics* Vol. 13 (1998), 255-275.

"Taxing Mutual and Stock Insurance Companies" (with Stewart C. Myers), Working Paper in Progress.

"Current Taxation of Mutual Life Insurance Companies and the 'Graetz Theory'" (with Stewart C. Myers, Susan J. Guthrie and M. Alexis Maniatis), Working Paper in Progress.

"Compensation for the Risk of Stranded Costs" (with William B. Tye). *Energy Policy*, Vol. 24, No. 12 (1996), 1025-1050.

"Impact of Deregulation on Capital Costs: Case Studies of Telecommunications and Natural Gas," (with Lynda S. Borucki). Brattle report prepared for The Energy Association of New York State (January 1996, released July 1996).

"Response to Brown," (with William B. Tye and Stewart C. Myers). *Yale Journal on Regulation*, Vol. 13 (Winter 1996). 414-417.

"How to Value a Lost Opportunity: Defining and Measuring Damages from Market Foreclosure," (with William B. Tye and Stephen H. Kalos), *Research in Law and Economics* 17, 83-125 (1995).

"Faulty Analysis Underlies Claims of Excess Card Profits", (with Carlos Lapuerta). *American Banker*, October 10, 1995.

"It Ain't In There: The Cost of Capital Does Not Compensate for Stranded-Cost Risk," (with William B. Tye). *Public Utilities Fortnightly*. May 15, 1995.

"Purchased Power: Hidden Costs or Benefits?" (with Sarah Johnson, Johannes P. Pfeifenberger and David W. Weinstein). *The Electricity Journal* 7, 74-83 (September 1994).

The Utility Capital Budgeting Notebook (with others). EPRI TR-104369, Palo Alto, CA: Electric Power Research Institute, September 1994.

"Rate of Return Recommendations in Cable Television Cost-of-Service Regulation" (with Lynda S. Borucki). Brattle report filed in Federal Communications Commission Docket No. 93-215, CS Docket No. 94-28, July 1994.

"Financial and Discount Rate Issues for Strategic Management of Environmental Costs" (with Stewart C. Myers). *Air and Waste Management Association*, Cincinnati. June 1994.

"Banking on NUG Reliability" (with Sarah Johnson and Johannes P. Pfeifenberger). *Public Utilities Fortnightly*. May 15, 1994.

"Economic Principles and a Framework For Use of the Netback Method to Value Crude Oil from the Bass Strait Development" (with M. Alexis Maniatis). Brattle report prepared for Esso Australia and BHP Petroleum, May 1994.

"Section 712 Issues: Risk Identification, Allocation and Compensation." Paper presented to National Association of Regulatory Utility Commissioners (July 1993) and published in *Presentations and Papers from the National Seminars on Public Utility Commission Implementation of the Energy Policy Act of 1992*. Columbus, OH: National Regulatory Research Institute, December 1993.

"Purchased Power Risks and Rewards" (with Sarah Johnson and Johannes P. Pfeifenberger). Brattle report prepared for Edison Electric Institute, November 1993.

"Rate Base Issues in Cable Television Cost-of-Service Regulation" (with Susan E. Vitka). Brattle report filed in Federal Communications Commission Docket No. 93-215, August 1993.

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"The Failure of Competition in the Credit Card Market: Comment" (with Stephen H. Kalos, Carlos Lapuerta and Stewart C. Myers). Working paper in progress.

"Event Study of the Effects on Pacific Gas & Electric's Debt of the Guarantee of Pacific Gas Transmission's Debt" (with Lynda S. Borucki). Brattle report prepared for Pacific Gas & Electric Company, May 1993.

"It's Time for a Market-Based Approach to DSM" (with M. Alexis Maniatis, Johannes P. Pfeifenberger and David M. Weinstein). *The Electricity Journal* 6, 42-52 (May 1993).

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"EPA's 'BEN' Model: A Change for the Better?" (with Kenneth T. Wise and M. Alexis Maniatis), *Toxics Law Reporter* 7, 1125-1129 (February 24, 1993).

"Who Pays for Prudence Risk?" (with William B. Tye), *Public Utilities Fortnightly* (August 1, 1992)."

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"EPA's 'BEN' Model: Challenging Excessive Penalty Calculations" (with Kenneth T. Wise, Paul R. Ammann and Scott M. DuBoff), *Toxics Law Reporter* 6, 1492-1496 (May 6, 1992).

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"The Fair Allowed Rate of Return with Regulatory Risk" (with William B. Tye). *Research in Law and Economics* 15, 129-169 (1992).

"Risk of the Interstate Natural Gas Pipeline Industry" (with Stewart C. Myers and William B. Tye), Washington, DC: Interstate Natural Gas Association of America (October 1991).

"The *Duquesne* Opinion: How Much '*Hope*' Is There for Investors in Regulated Firms?" (with William B. Tye). *Yale Journal on Regulation*. Winter 1991. 113-157.

"How Far Back Should Prudence Tests Reach?" (with William W. Hogan). *Public Utilities Fortnightly* (January 15. 1991).

"Practical Implications of the Supreme Court's *Duquesne* Opinion for Regulated Industries" (with William B. Tye). *Public Utilities Fortnightly* (August 30, 1990).

"Evaluating Demand-Side Options" (with Matthew P. O'Loughlin and Stephen W. Chapel) Palo Alto, CA: Electric Power Research Institute.

"Financial Constraints and Electric Utility Capital Requirements," (with Matthew P. O'Loughlin) *Proceedings of the 1989 EPRI Utility Strategic Issues Forum*. Palo Alto, CA: Electric Power Research Institute.

"When Choosing R&D Projects, Go with the Long Shot" (with Peter A. Morris and Elizabeth Olmstead Teisberg). *Research Technology Management* (January-February 1991).

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"Capital Requirements for the U.S. Investor-Owned Electric Utility Industry, 1985-2005" EPRI P-5830. (PHB report with Sarah K. Johnson and Matthew P. O'Loughlin). Palo Alto, CA: Electric Power Research Institute (June 1988).

"Are Regulatory Risks Excessive? A Test of the Modern Balance between Risk and Reward for Electric Utility Shareholders" (PHB report with Matthew P. O'Loughlin). Division of Coal and Electric Policy, U.S. Department of Energy (May 1986).

"Cash Flow Risk, the Cost of Capital. and the Fair Allowed Rate of Return." Working paper in progress.

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"How Can Regulated Rates — and Companies — Survive Competition?" *Public Utilities Fortnightly* 115 (4 April 1985).

"Inflation and Rate of Return Regulation" (with Stewart C. Myers and William B. Tye). In *Research in Transportation Economics*, Volume II. Greenwich. CT: JAI Press, Inc.. 1985.

"Annual Capital Charges That Will Survive Competition." Prepared for the 11th Annual Rate Symposium, The Institute for Study of Regulation. February 1985.

The Cost of Capital: Estimating the Rate of Return for Public Utilities (with James A. Read and George R. Hall). Cambridge, MA: The MIT Press, 1984.

"Conditions for Investor and Customer Indifference to Transitions Among Regulatory Treatments of Deferred Income Taxes" (with William B. Tye and Miriam Alexander Baker). *The Rand* (formerly *Bell*) *Journal of Economics* (Fall 1984).

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"Regulation and Capital Formation in the Oil Pipeline Industry" (with Stewart C. Myers and William B. Tye). *Transportation Journal* (Spring 1984).

"Regulatory Treatment of Deferred Income Taxes Resulting from Accelerated Depreciation by Motor Carriers" (with William B. Tye and Miriam Alexander Baker). *Transportation Journal* (Spring 1984).

"The Economics of Midstream Switches in Regulatory Treatments of Deferred Income Taxes Resulting from Accelerated Depreciation" (with William B. Tye and Miriam Alexander Baker). *ICC Practitioners' Journal* (November-December 1983).
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"The Economics of Revenue Need Standards in Motor Carrier General Increase Proceedings" (with William B. Tye and Miriam Alexander Baker). *Transportation Journal* (Summer 1981).

"Flow-Through Versus Normalization of Deferred Income Taxes for Motor Carriers" (with William B. Tye and Miriam Alexander Baker). *Motor Freight Controller* (December 1980).

CRA Reports (Often Written with Others)

"Evaluating the Effects of Time and Risk on Investment Choices: A Comparison of Finance Theory and Decision Analysis" (with Applied Decision Analysis, Inc.). Published by the Electric Power Research Institute. January 1987.

"The 'Abandonment Value' of Shorter Leadtimes" (with Applied Decision Analysis, Inc.). June 1985.

"Rate Shock and Power Plant Phase-In: Discussion Paper of Generic Issues." Published by the Edison Electric Institute. December 1984.

"Choice of Discount Rates for Utility Planning: A Critique of Conventional Betas as Risk Indicators for Electric Utilities." Published by the Electric Power Research Institute. February 1984.

"Choice of Discount Rates in Utility Planning: An Attempt to Estimate a Multi-Factor Model of the Cost of Equity Capital." December 1983.

"Southern California Edison Company Study of Conservation Potential and Goals." December 1983.
"Economic Costing Principles for Telecommunications." September 1983.

"Analysis of Risky Investments for Utilities." Published by the Electric Power Research Institute. September 1983.

"A Conceptual Model of Discount Rates for Utility Planning." July 1982.

"The Electric Utility Industry's Financial Condition: An Update." Published by the Electric Power Research Institute. June 1982.

"Choice of Discount Rates in Utility Planning: Principles and Pitfalls." Published by the Electric Power Research Institute. June 1982.

"Analysis of the Federal Residential Energy Tax Credits." April 1982.

"Methods Used to Estimate the Cost of Equity Capital in Public Utility Rate Cases: A Guide to Theory and Practice." March 1982.

"An Analysis of the Interaction of the Coal and Transportation Industries in 1990." September 1981.

"An Analysis of the Residential Energy Conservation Tax Credits: Concepts and Numerical Estimates." June 1981.

APPENDIX B

Appendix B: QUALIFICATIONS OF KEVIN NEELS

Dr. Kevin Neels directs the Transportation Practice at *The Brattle Group*. Dr. Neels has more than 30 years experience as a consultant and expert witness in the rail, trucking, courier, postal, aviation, and automotive industries. He has led many significant engagements relating to competition, market structure, pricing, revenue management, distribution strategy, regulation, and public policy. His work has addressed issues related to system planning, competition policy, privatization, and congestion management.

Prior to joining *The Brattle Group*, Dr. Neels served as Vice President and leader of the transportation practice at Charles River Associates. He has also served as a researcher in the Urban Policy Program at the Rand Corporation and the Transportation Studies Program at the Urban Institute, as a Director in the Transportation Practice at the consulting firm of Putnam, Hayes & Bartlett, as a Management Consultant in the Transportation Practice of the firm now known as KPMG. Dr. Neels is currently Chairman of the Committee on Freight Transportation Economics and Regulation of the Transportation Research Board, an arm of the National Academy of Sciences.

Dr. Neels has authored numerous research reports, monographs and articles for peer-reviewed journals. He has often been asked to offer expert testimony in legal and regulatory proceedings. He regularly serves as an invited speaker at conferences and industry forums, and his opinions and observations on industry developments are frequently quoted in the popular and trade press. Dr. Neels earned his Ph.D. from Cornell University.

A sample of the project experience of Dr. Neels is shown below.

EXPERIENCE

- For an Ex Parte proceeding before the Surface Transportation Board Dr. Neels provided written testimony regarding procedures for settling disputes over the reasonableness of rail transportation rates. His testimony related to aspects of the Standalone Cost methodology employed by the Board in resolving these disputes, focusing in particular on the role that third party traffic plays in such analyses, and the manner in the revenues associated with such traffic are assigned to different portions of the routes followed by such traffic. His testimony discussed the typical structure of North American freight rail networks, and the roles that gathering, branch and main lines play in assuring the overall economic viability of the network as a whole.

- For a major U.S. based freight railroad, Dr. Neels developed a system of models to predict traffic levels and revenues by carrier for the North American freight rail market under alternative scenarios regarding market structure and regulatory policy. This modeling system incorporated detailed representations of the North American rail and highway networks, algorithms for determining shipment routing under alternative operating policies, and a series of statistical models capturing the underlying structure of freight traffic flows.

- For a non-U.S. government client, Dr. Neels led the team serving as fairness advisors in connection with the privatization of a government owned railroad. This engagement involved review of and commentary upon the bidding procedures employed in the transaction, analysis of the extent to which different bidders addressed and resolved policy concerns expressed by government officials, and advising government officials regarding the extent to which the various bids received reflected the full market value of the operation.

- On behalf of a provider of services to long-distance trucking firms, Dr. Neels offered expert testimony on the status of the trucking market, and on the extent to which a downturn in that market affected the value and economic viability of trucking firm service providers during a period in which his client concluded a series of acquisitions.

- In testimony before the U.S. Postal Rate Commission, Dr. Neels offered expert testimony analyzing the procedures used by the U.S. Postal Service to measure the transportation costs associated with its various products. His analysis addressed a wide range of issues, including the Service's use of its dedicated air network for transportation of expedited products, fieldwork procedures used to collect data on composition of the mail stream at different points in the rail network, potential biases in the assignment of transportation costs to products, and flaws in econometric analyses of transportation cost variability introduced by other witnesses in the proceeding.

- In support of a key economic witness in a hearing regarding refined petroleum product pipeline rates before the Federal Energy Regulatory Commission, Dr. Neels conducted an analysis of the relationship between product prices in the different geographic areas linked by the pipeline system. He also examined alternative transportation modes and concentration in the pipeline's origin markets.

- For a major U.S. railroad involved in a commercial dispute over trackage rights and trackage fees, Dr. Neels conducted a detailed analysis of over-the-track incremental operating costs. This analysis involved, among other things, extensive use of the Uniform Rail Costing System maintained by the Surface Transportation Board.

- For a major North American rail car manufacturer involved in a patent infringement lawsuit Dr. Neels offered expert testimony on the economic value of an innovative car design relative to existing designs, and on the damages imposed on the manufacturer as a result of infringement of its patents on this new design.

- For an express package delivery carrier intervening in a rate case before the U.S. Postal Rate Commission, Dr. Neels conducted a critical review of econometric studies of cost variability introduced into evidence by a witness testifying on behalf of the U.S. Postal Service. He identified a number of serious conceptual and methodological flaws in this analysis, and demonstrated that the substantive conclusions of the analysis were sensitive to relatively minor change in its design. On the basis of his testimony the Commission rejected the arguments of the Postal Service in the Commission's final ruling.

- For a major U.S. network air carrier Dr. Neels was a key member of a team of consultants charged with the development of an operations research strategy aimed at improving the carrier's performance and competitive standing across a broad range of areas of operation, including financial planning, scheduling, crew management, maintenance, flight operations, air cargo sales, marketing, reservations and distribution. This engagement involved extensive onsite interviews with numerous operating personnel at the carrier's headquarters. It identified a lengthy list of investment opportunities involving the application of a variety of advanced decision support tools.

- For a major international air carrier accused of monopoly leveraging and attempted monopolization of a key market, Dr. Neels prepared a report analyzing the carrier's use of corporate discounts and travel agent override commissions, and rebutting arguments that these agreements could be construed as exclusive dealing.

- For a major U.S. air carrier, Dr. Neels conducted an extensive empirical investigation of the responses of travel agents to carriers' incentive and override programs. Using the results of this investigation, he evaluated his client's sales force management and travel agent incentive strategies to identify specific ways in which redesign and or retargeting could increase their net revenue yields.

- For a consortium of major U.S. air carriers accused of engaging in collusion and price fixing, Dr. Neels directed a major economic analysis of industry pricing strategy and pricing dynamics. Drawing upon detailed data on daily fare changes, Dr. Neels prepared testimony and exhibits demonstrating the difficulty of engaging in coordinated pricing behavior.

PUBLICATIONS

"Private Sector: Lessons for the Public Sector" in Freight Modeling:State of the Practice in Current Practice Session of *Freight Demand Modeling Tools for Public-Sector Decision Making* in Conference Proceedings 40. Transportation Research Board, September 25-27, 2006. pp. 25,26.

"Pricing-Based Solutions to the Problem of Weather-Related Airport and Airway System Delay." *Air Traffic Control Quarterly*, Vol 10(3) 261–284 (2002).

"Congestion, Pricing and the Economic Regulation of Airports." Transportation Research Board, The Federal Aviation Administration, Conference on Airports in the 21st Century (April 20, 2000).

"Estimating the Effects of Display Bias in Computer Reservation Systems." With Franklin Fisher, In *Microeconomics Essays in Theory and Applications*. Ed. Maarten-Pieter Schinkel. Cambridge University Press, 1999.

"Insurance Issues and New Treatments." *Journal of the American Dental Association*, 125 (January

1994): 45S-53S.

"Medical Cost Savings from Pentoxifylline Therapy in Chronic Occlusive Arterial Disease." *Pharmacoeconomics* 4, No. 2, (February 1994): 130-140.

"Analyzing Rent Control: The Case of Los Angeles." With M. P. Murray, C. P. Rydell, C. L. Barnett, and C. E. Hillestad. *Economic Inquiry* 29, No. 4 (October 1991): 601–625.

"Forecasting Intermodal Competition in a Multimodal Environment." With Joseph Mather. *Transportation Research Record* 1139 (1987).

"Modeling Mode Choice in New Jersey." With Joseph Mather. *Transportation Research Record* 1139 (1987).

"Direct Effects of Undermaintenance and Deterioration." With C. Peter Rydell. In *The Rent Control Debate*. Ed. Paul L. Niebanck. Chapel Hill, NC: University of North Carolina Press, 1985.

"Energy and the Existing Stock of Housing." With M. P. Murray. In *Energy Costs, Urban Development, and Housing*. Ed. Anthony Downs and Katherine L. Bradbury. Washington, D.C.: The Brookings Institution, 1984.

"Reducing Energy Consumption in Housing: An Assessment of Alternatives." *International Regional Science Review* 7, 1 (May 1982).

"Production Functions for Housing Services." *Papers of the Regional Science Association* 48 (1981).

PROFESSIONAL AFFILIATIONS

- American Bar Association
- American Economics Association
- Licensing Executive Society
- Transportation Research Board

JOINT REPLY VERIFIED STATEMENT
OF
MICHAEL R. BARANOWSKI
and
BENTON V. FISHER

BEFORE THE
SURFACE TRANSPORTATION BOARD

FINANCE DOCKET NO. 35506

WESTERN COAL TRAFFIC LEAGUE—
PETITION FOR DECLARATORY ORDER

JOINT REPLY VERIFIED STATEMENT
of
MICHAEL R. BARANOWSKI
and
BENTON V. FISHER

We are Michael R. Baranowski and Benton V. Fisher, Senior Managing Directors in FTI Consulting's Network Industries Strategies practice, with offices at 1101 K Street, NW, Washington, DC 20005. We are the same Michael R. Baranowski and Benton V. Fisher who filed a joint verified statement in the opening round of this proceeding. Statements of our qualifications are set forth in Exhibits 1 and 2, respectively, to that verified statement.

We have been asked by BNSF Railway Company ("BNSF") to reply here to some of the calculations made and conclusions reached by Thomas D. Crowley and Daniel L. Fapp ("Crowley/Fapp"), witnesses for Western Coal Traffic League, et al., and Gerald W. Fauth III ("Fauth"), witness for Alliance for Rail Competition, et al. As a general matter, the results of Crowley/Fapp's "bottom-up" calculations of the impact of GAAP purchase accounting on BNSF's URCS variable costs are close to our own results, which we calculated using a "top-down" approach. Fauth's calculations, however, suffer from a fundamental mistake that overstates the impact of the purchase accounting adjustment on BNSF's URCS costs. Both Crowley/Fapp and Fauth offer speculative and overstated estimates of the practical impact of the change in BNSF's URCS costs on the jurisdictional threshold and on any rate reasonableness case that may be brought against BNSF. Moreover, throughout their opposition to the purchase accounting adjustment, Crowley/Fapp and Fauth ignore the fact that any change in the variable cost calculations that results from the adjustment reflects the use of more economically accurate asset values in the variable cost calculations.

I. Impact on URCS Variable Costs

Although we and Crowley/Fapp took different approaches to calculating the impact of the purchase accounting adjustment on BNSF's URCS variable costs, we agree that the total amount of the purchase accounting adjustment is $8.1 billion. Crowley/Fapp VS at 5; Baranowski/Fisher VS at 2. As explained in our opening statement, we used the "top-down" approach employed by the STB in *CSX Corp.—Control—Conrail, Inc.*, 3 S.T.B. 196, 263-64 and App. N (1998) ("*Conrail*"), which is admittedly not precise, but which was a straightforward calculation in the absence of a 2010 URCS developed by the STB for BNSF. Under that approach, we calculated that the purchase accounting adjustment resulted in an overall increase in BNSF's system-wide 2010 URCS variable costs of 5.6 percent. Baranowski/Fisher VS at 4. Crowley/Fapp developed a 2010 URCS for BNSF and used a "bottom-up" approach through which they calculated that the overall increase in BNSF's system-wide URCS variable costs was 4.0 percent. Crowley/Fapp VS at Exh. 3.

Since neither we nor Crowley/Fapp are able to perform all of the calculations that the STB does when it generates the official URCS datasets, we have not attempted to scrutinize Crowley/Fapp's calculations to ascertain every respect in which their assumptions regarding the treatment of various aspects of the purchase accounting adjustment differs from ours. We do note, however, that the *Conrail* approach we used treats 100 percent of equipment costs as variable, while the more precise URCS calculation differentiates variabilities among equipment types. Computer costs, for example, are treated within URCS as approximately 50 percent variable. We have refined our calculations to separate computers from other equipment. This reduces our calculation of the increase in BNSF's URCS variable costs resulting from the purchase accounting adjustment from 5.6 percent to 5.1 percent, as shown in Exhibit A to this statement. Between our top-down approach and Crowley/Fapp's bottom up approach, we are confident that once the Board generates its official URCS dataset, the overall increase in BNSF's URCS variable costs attributable to the acquisition adjustment will fall somewhere between Crowley/Fapp's 4% and our 5.1% results.[1]

Fauth, using his own variation of a top-down approach, calculates that BNSF's 2010 URCS cost increased by 9.59% as a result of the purchase accounting adjustment. Fauth VS at 3. He fails in his calculations, however, to recognize that the vast majority of the purchase accounting write-up applies to road property and computer assets that URCS treats as only 50 percent variable. *Id.* at App. 2. By including 100 percent of the write-up in URCS and failing to account for URCS variabilities, Fauth significantly overstates the effect of the purchase accounting adjustment on URCS variable costs.

II. Impact on Jurisdictional Threshold

Crowley/Fapp and Fauth take different approaches to calculating the impact of the purchase accounting adjustment on the jurisdictional threshold, but both assume that any increase in the jurisdictional threshold is unfair or inappropriate, regardless of the reason for the

[1] Crowley/Fapp perform another calculation of URCS costs including BNSF in the STB's 2010 cost of capital determination. The STB, however, in Ex Parte No. 558 (Sub-No. 14), *Railroad Cost of Capital—2010* (served October 3, 2011), determined that BNSF would not be in the composite railroad group for determining the railroad cost of capital. Slip op. at 7-8. Crowley/Fapp offer no reason why the STB's decision can or should be disregarded.

increase. They ignore the fact that the increase in the jurisdictional threshold here results from using asset values in the variable cost calculation that are consistent with Board precedent and more economically accurate. In any event, the impact of any change in the jurisdictional threshold is very small.

For purposes of quantifying that impact. we and Crowley/Fapp agree that BNSF had approximately 9.1 million revenue units of traffic in 2010. We calculated that out of those 9.1 million revenue units and thousands of shippers involved, less than 2 percent are regulated movements that would move from above to below the jurisdictional threshold as a result of the increase in BNSF's URCS variable costs. Baranowski/Fisher VS at 5-6. Crowley/Fapp calculated that 1.35 percent of carloads (i.e., 122,669 out of 9,143,043 total revenue units) would be so affected. Crowley/Fapp VS at 10 and Exh. 3.

We noted in our opening statement that the practical impact of this shift on this small percentage of traffic would be negligible for two reasons. First, rates near the jurisdictional threshold are rarely the subject of rate cases. Thus. the small shift of traffic from just above the jurisdictional threshold to just below the threshold is unlikely to have any impact on the number or the identity of shippers that seek or obtain rate relief. Second, the small shift in the level of the jurisdictional threshold is unlikely to have any significant impact on BNSF's revenues from shippers with prescribed rates, since there have been only a few instances where the jurisdictional threshold has served as a floor on maximum rate prescriptions. Baranowski/Fisher VS at 6. Crowley/Fapp assert that the shift in the jurisdictional threshold will limit the number of shippers that may seek STB rate relief. Crowley/Fapp VS at 14-15. But those shippers, by definition, had rates only marginally above the jurisdictional threshold before the purchase accounting adjustment. Crowley/Fapp nowhere show that any of those shippers would have brought a rate case, much less that it could have succeeded.[2]

Fauth claims, relying on his mistaken calculation of the amount of the increase in BNSF's URCS variable costs, that BNSF's jurisdictional threshold will effectively be raised from 180% to 197% as a result of the adjustment. Fauth VS at Table 1. His claim appears to be that rates that previously had R/VCs between 180% and 197%, and therefore potentially were subject to a rate reasonableness challenge, are now below the jurisdictional threshold. From this analysis he concludes that because the jurisdictional threshold has supposedly increased, rate levels on BNSF grain shipments could increase significantly, by as much as $657 per car. *Id.* at 5-6.

Aside from the fact that his URCS cost calculations are mistaken, Fauth's assumption that a change in the jurisdictional threshold could lead to significant rate increases on grain traffic is wholly unfounded. Fauth assumes that BNSF will respond to the change in the jurisdictional threshold by raising rates that have now fallen below the jurisdictional threshold up to the "new" jurisdictional threshold level. But as Mr. Lanigan explains in his statement, BNSF sets its rates on grain traffic on the basis of market demand, not R/VC ratios. Market conditions do not change simply because R/VC ratios change. Since BNSF sets rates based on market conditions, the supposed change in the level of the jurisdictional threshold would have no effect on the market-based rates that BNSF can charge.

[2] Crowley/Fapp include as Exhibit 4 to their statement two hypothetical examples of the impact that the purchase accounting adjustment has on a movement's variable costs and the jurisdictional threshold. But they do not claim that either of the examples demonstrates that the hypothetical shippers involved would have succeeded in bringing a rate case to recover the marginal amount above the jurisdictional threshold without the purchase accounting adjustment. Crowley/Fapp VS at 15.

Nor is there any effective change in a shipper's ability to proceed with a rate case. If a shipper's rates were not challenged previously, and were not effectively challengeable under the Board's rate reasonableness standards when they were just above the jurisdictional threshold, that shipper loses nothing when those same rates are now just below the jurisdictional threshold. Grain shippers have rarely attempted, and never succeeded, in bringing a rate reasonableness case against BNSF.[3]

III. Impact on Rate Reasonableness

The Board's principal rate reasonableness methodology is the SAC test. The SAC test assesses the reasonableness of a challenged rate by comparing the full economic costs of a hypothetical, efficient stand-alone railroad entrant into the market to revenues generated by a subset of the defendant's traffic that would be available to that hypothetical railroad. If the revenues available to the hypothetical railroad are insufficient to cover the railroad's full costs, the challenged rates are deemed to be reasonable. The costs of the hypothetical railroad are determined based on current costs. The book value of the defendant railroad's assets as well as URCS variable costs are totally irrelevant to this rate reasonableness test.

Crowley/Fapp nevertheless argue that an increase in BNSF's URCS variable costs will adversely affect shippers that have rates prescribed in SAC cases using R/VC ratios under the "MMM" approach required by the Board in Ex Parte No. 657 (Sub-No. 1), *Major Issues in Rail Rate Cases* (served October 30, 2006) Crowley/Fapp VS at 15. This argument is misguided for two reasons. First, the MMM methodology does not even come into play in the basic inquiry into whether the stand-alone railroad generates revenues sufficient to cover its costs. MMM

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[3] This is not surprising. The calculations we performed for our opening verified statement showed that BNSF's 2010 carload grain shipments moved at an average R/VC of 165 percent. Details of our calculations are summarized in our workpapers.

becomes relevant only if stand-alone revenues exceed cost. MMM is simply a tool that the Board uses, if revenues exceed SAC costs, to allocate responsibility for the SAC costs among the users of the stand-alone railroad.

Second, *if* revenues exceed SAC costs, the allocation of responsibility for SAC cost under MMM among the users of a stand-alone railroad, including the complaining shipper, is *not* affected by changes in the defendant's variable cost that apply across the board to members of the shipper group—such as the variable cost increases that result from the use of GAAP purchase accounting. MMM allocates the stand-alone railroad's revenue requirement to the railroad's shipper group based on the *relative* R/VC ratios of each shipper using the stand-alone railroad facilities. The size of the revenue requirement (i.e., SAC costs) to be allocated does not change based on a change in the defendant's variable costs. An increase in URCS variable costs for all shippers on the stand-alone railroad within the MMM model will preserve the same relative R/VC ratios among those shippers and therefore will not materially increase or decrease the revenue that any particular shipper (including the complaining shipper) must contribute to cover the stand-alone railroad's costs.[4]

The Board uses MMM to prescribe maximum reasonable rates in the form of an R/VC ratio. Crowley/Fapp inaccurately claim that a shipper will pay higher rates because the MMM-based R/VC rate prescription must be converted to a dollar-per-ton rate using variable costs that will increase as a result of the purchase accounting write-up. Crowley/Fapp VS at 15. That is true only if the maximum R/VC ratio was originally calculated using URCS variable costs generated before the purchase accounting adjustment. A new MMM rate prescription calculated

[4] Because the effects of the purchase accounting adjustment are concentrated in the URCS return on investment costs, there will be minor differences in the relative increase in URCS variable costs for the stand-alone traffic group for shipments with different lengths of haul over the stand-alone network.

with URCS variable costs that reflect a purchase accounting write-up in asset values would not yield a higher dollar-per-ton rate than one prescribed contemporaneously without the write-up. The stand-alone revenue requirement to be allocated by the MMM methodology would not differ. As such, an MMM run that uses URCS variable costs that include the acquisition premium will produce slightly lower maximum R/VC ratios—all other things equal—that will then be applied to URCS costs for the issue traffic that are slightly higher because of the acquisition premium, resulting in the same prescribed rate level as an MMM run done that uses URCS variable costs without the acquisition premium. Table 1 below provides a simplified example of the MMM process and shows that the amount of the MMM rate prescription per ton is unaffected by shifts in the URCS variable costs.

Table 1
MMM Rate Prescription Level Is Not Affected by PAA

Simplified Example of MMM Mechanics for SARR Traffic Group Shipment:			
Description	Source	MMM w/o PAA	MMM w/ PAA (VC increased 5%)
SARR Assumptions:			
1. Revenue Requirement	Assumed	$100,000,000	$100,000,000
2. SARR Revenues	Assumed	$125,000,000	$125,000,000
3. Total VC	Assumed	$40,000,000	$42,000,000
4. MMM	L. 1 / L. 3	2.500	2.381
Movement Details:			
5. Tons	Assumed	50,000	50,000
6. Revenue	Assumed	$1,000,000	$1,000,000
7. Variable Cost	Assumed	$350,000	$367,500
8. R/VC Ratio	L. 6 / L. 7	2.857	2.721
MMM Prescription:			
9. MMM Revenue Allocation	L. 4 x L. 7	$875,000	$875,000
10. Prescription Per Ton	L. 9 / L. 5	$17.50	$17.50

Crowley/Fapp devote several pages to discussing the rate prescription in the Western Fuels Association and Basin Electric Power Cooperative ("WFA/Basin") case, but that is a unique situation in which R/VC ratios were prescribed using an MMM run that used BNSF's prior URCS costs. Crowley/Fapp VS at 15-21. The SAC analysis and MMM calculations in the WFA/Basin case were done before any changes were made in BNSF's asset base as a result of the Berkshire acquisition. Therefore, the increase in BNSF's 2010 URCS costs will result in slightly higher rates when the previously determined maximum R/VC ratios are used to calculate dollar-per-ton rates using higher variable costs. The solution to that unique situation is not to second-guess the application of GAAP purchase accounting for general purpose costing and revenue adequacy purposes, but to address the unique WFA/Basin circumstances in that case.

With respect to the rate reasonableness tests for small cases—the Simplified SAC and Three-Benchmark ("3-B") approaches—Crowley/Fapp make the same general claim that they make with respect to the MMM approach for full SAC cases. Crowley/Fapp VS at 21-23. That is, they claim that since rates are prescribed under both approaches as an R/VC ratio, increases in BNSF's variable costs resulting from the purchase accounting adjustment will "pass through" the BNSF "acquisition premium" in the prescribed rates. There has never been a rate prescribed for BNSF using either the Simplified SAC or 3-B approaches. Aside from that, for the reasons just discussed, it does not follow from the mere use of R/VC ratios to prescribe rates that there will be any "pass through" of the purchase accounting adjustment to BNSF's costs.

In our opening statement, we noted that the RSAM factor used in 3-B cases will be affected by the purchase accounting adjustment, and we estimated that the RSAM is about 5 percent higher when the purchase accounting adjustment is included. Baranowski/Fisher VS at 8. Crowley/Fapp also argue with respect to the 3-B approach that the RSAM test will be affected, although they do not calculate the impact. As we noted in our prior statement, the RSAM is only one factor used in 3-B cases, and since the Board has never carried out a 3-B analysis involving BNSF rates, it is difficult to estimate the ultimate impact of a slight change in the RSAM on the results of such a case. But even if the change in RSAM were to impact the results of some future 3-B case, the impact on shippers would be negligible. Since 3-B analyses are understood to be only rough estimates of maximum reasonable rates, the amount of relief available under such cases is limited to $1 million over a five-year period. Any slight change in the level of the prescribed rate would at most affect only the timing of rate relief – i.e., whether the $1 million maximum in rate relief is reached earlier or later in the five-year period. The slight change in RSAM is unlikely to have any impact at all on how much relief a shipper obtains under the 3-B approach.

Fauth complains that any increase in the RSAM that results from the use of purchase accounting could allow BNSF to raise rates for grain traffic, even for traffic that has R/VC ratios "well in excess of 180%." Fauth VS at 3. His premise is his speculative assertion that BNSF sets its rates based on the expected outcomes of rate reasonableness cases that have never been brought or even threatened. But as Mr. Lanigan explains, BNSF sets its rates based on market factors. Any slight impact that the purchase accounting adjustment would have on the RSAM, and therefore possibly on the result of potential future 3-B cases, would have no impact on the actual rates that BNSF charges its grain shippers.

IV. Impact on Revenue Adequacy

The Board in Ex Parte No. 552 (Sub-No. 15), *Railroad Revenue Adequacy- 2010 Determination* (served November 3, 2011), determined that BNSF's ROI in 2010 with the purchase accounting adjustments was 9.22 percent. Crowley/Fapp estimate that BNSF's ROI without the purchase accounting adjustments would be 10.05 percent. Crowley/Fapp VS at 24. We estimate that it would be 10.75 percent.[5] Either way, BNSF would not have reached the cost of capital of 11.03 percent that the STB calculated for the industry in Ex Parte No. 558 (Sub-No. 14), *Railroad Cost of Capital—2010* (served October 3, 2011).

[5] The calculation of BNSF's ROI in our opening statement included an error in the formula to calculate net investment that understated slightly the net investment and overstated ROI. Details of our calculations are summarized in our workpapers.

I declare under penalty of perjury that the foregoing is true and correct. Further, I certify that I am qualified and authorized to file this Verified Statement.

Executed on November 25, 2011

Michael R. Baranowski

Michael R. Baranowski

I declare under penalty of perjury that the foregoing is true and correct. Further, I certify that I am qualified and authorized to file this Verified Statement.

Executed on November 23, 2011

Benton V. Fisher

Benton V. Fisher

REPLY EXHIBIT A

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Effect of Transaction on BNSF's Variable Costs

Following STB Conrail Approach, presented in Appendix N to 7/20/1998 Decision

(Dollars in Millions)

	2010, excluding PAA	Purchase Accounting Adj.	2010 Year-End Balance 1/		Sources:
Total					
Net Investment	33,404	12,651	46,055		R-1 Schedules 330 & 335
Accum. Deferred Taxes	10,022	4,507	14,528		BNSF workpapers
URCS Adj. Net Inv. Base	23,382	8,144	31,527		
Way & Structures					
Net Investment	27,945	12,441	40,386		R-1 Schedules 330 & 335
Accum Deferred Taxes	8,384	4,432	12,816		Allocation
URCS Adj Net Inv. Base	19,561	8,009	27,570		
Equipment (excl. Computer Systems)					
Net Investment	5,340	(999)	4,341		R-1 Schedules 330 & 335
Accum. Deferred Taxes	1,602	(356)	1,246		Allocation
URCS Adj Net Inv. Base	3,738	(643)	3,095		
Computer Systems					
Net Investment	119	1,209	1,328		R-1 Schedules 330 & 335
Accum Deferred Taxes	36	431	466		Allocation
URCS Adj Net Inv Base	83	778	861		
Total				Pre-tax cost of capital 1/	
W&S ROI	3,208	1,314	4,522	16.4%	
Equipment ROI	613	(105)	508		
Computer Systems ROI	14	128	141		
Variable				Variability 1/	
W&S ROI	1,604	657	2,261	50%	
Equipment ROI	613	(105)	508	100%	
Computer Systems ROI	8	70	78	55%	
Total	2,225	**621**	2,846		
Variable Costs from 2010 URCS					
Operating Expenses			8,231		
Depreciation & Lease			1,916		
ROI			2,881		
Total			**13,028**		
PA Impact on Variable Costs					
Dollars	12,406	**621**	13,028		
% Increase		**5.0%**			
1 *Including impact on annual depreciation expense*				Variability 1/	
Road Accounts		(89)		50%	BNSF workpapers
Equipment Accounts		(67)		100%	BNSF workpapers
Computer Systems		217		77%	BNSF workpapers
Total		61			
Variable Portion		**56**			
2 *Including impact on annual fuel expense.*		(50)		95%	STB FSC reports
Variable Portion		**(48)**			
Overall impact	12,398	**630**	13,028		
		5.1%			

1/ Based on R-1 report and preliminary 2010 URCS