232132

Finance Docket No. 35506: WCTL Petition

Surface Transportation Board Public Hearing

March 22, 2012

BNSF RAILWAY

BNSF Panel of Speakers

- Tom Hund, BNSF Executive Vice President and Chief Financial Officer
- Rick Weicher, BNSF Vice President and General Counsel – Regulatory
- Rob Jenkins, Mayer Brown LLP
- Prof. Roman Weil, Booth School of Business at University of Chicago
- Dr. Kevin Neels, The Brattle Group

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Key Points

- GAAP is the foundation of consistent financial reporting in US
- Purchase accounting is required by GAAP
- Purchase accounting adjusts historical book value to purchase price
- Berkshire Hathaway and BNSF appropriately applied purchase accounting

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Key Points (cont'd.)

- Historic book value is not a better measure of assets than purchase accounting results
- Two thirds of write-up recorded to Goodwill that does not impact the regulatory base
- 100% of premium paid by Berkshire over <u>market value</u> of stock recorded to Goodwill

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Valuation Process

- Role of Ernst & Young
- Audited by Deloitte & Touche
- Duplicative assets not considered
- Low point in economic cycle

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Purchase Price Allocation

BRK Acquisition Price	$35B
BNSF Historical Book Value	-$13B
Purchase Price in Excess of Historical Book Value	$22B

Source: Hund Verified Statement (BNSF Opening), p.6

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Purchase Price Allocation

BRK Acquisition Price	$35B
BNSF Historical Book Value	-$13B
Purchase Price in Excess of Historical Book Value	$22B
Net Assets Affecting BNSF Regulatory Costs	$8B
Goodwill - No Affect on BNSF Regulatory Costs	$14B
Total	$22B

Source: Hund Verified Statement (BNSF Opening), p.6

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Comparison of Book Value to Market Value to Berkshire Acquisition Price

	Historic Book Value
Per Share	$38
Total Value (In Billions)	$13

Source: Hund Verified Statement (BNSF Opening), p.8

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Comparison of Book Value to Market Value to Berkshire Acquisition Price

	Historic Book Value	BNI Stock Value Immediately Prior to Purchase Announcement
Per Share	$38	$76
Total Value (In Billions)	$13	$26
Premium over Book		$13

Source: Hund Verified Statement (BNSF Opening), p.8

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Comparison of Book Value to Market Value to Berkshire Acquisition Price

	Historic Book Value	BNI Stock Value Immediately Prior to Purchase Announcement	BRK Acquisition
Per Share	$38	$76	$100
Total Value (In Billions)	$13	$26	$35
Premium over Book		$13	$22
BRK Premium over Market			$9

Source: Hund Verified Statement (BNSF Opening), p.8

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Comparison of Book Value to Market Value to Berkshire Acquisition Price

	Historic Book Value	BNI Stock Value Immediately Prior to Purchase Announcement	BRK Acquisition
Per Share	$38	$76	$100
Total Value (In Billions)	$13	$26	$35
Premium over Book		$13	$22
BRK Premium over Market			$9
Net Asset Write-up Impacting BNSF Ry. Regulatory Costs		$8	
Goodwill[1] Implied by the Market		$5	
Goodwill[1] Implied by BRK Premium over Market			$9
Total Goodwill[1] Write-up		$14	

[1]Goodwill is $15 billion of net liabilities not affecting BNSF Railway regulatory costs.

Source: Hund Verified Statement (BNSF Opening), p.8

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Goodwill

- Goodwill is an intangible asset.
- Goodwill does not impact URCS or other STB regulatory frameworks.
- In the Berkshire/BNSF transaction, almost two-thirds of the premium paid over BNSF's asset book value went to Goodwill.
- That premium over book has no impact at all on BNSF's regulatory costs, transportation rates, or the Board's regulatory functions.

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BNSF Market Based Pricing

- BNSF sets rates based on market conditions
- Shipper groups ignore the broader commercial context in which BNSF prices its transportation services.
  - Majority of BNSF's rates are not regulated at all by the Board.
- BNSF establishes rates for STB regulated traffic the same as for other traffic - in accordance with market conditions
- Purchase accounting has a minimal impact on URCS and the Board's regulatory functions.
- A small change in the Board's regulatory costs would not effect the rates we charge.

Source: Lanigan Verified Statement (BNSF Reply)

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Summary

- Treat acquisitions consistently using GAAP
- Deal with the few transitional anomalies on a case-by-case basis to mitigate impacts of purchase accounting
- Leave the long standing practice in place

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Richard E. Weicher

Vice President and General Counsel – Regulatory

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PA Does Not Have a Meaningful Effect on Regulatory Remedies

- Full Stand Alone Cost (SAC) Rate Cases
  - The regulator is comparing relative R/VCs only when SAC revenues exceed SAC costs.
  - In the Maximum Markup Methodology, the R/VCs of all the movements would similarly reflect the PA adjustment.
  - This would be the case for all such future cases.

- Simplified SAC Cases
  - Like Full SAC, results are driven by the relative elements of SAC.

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PA Does Not Have a Meaningful Effect Regulatory Remedies

- 3 Benchmark Small Rate Cases
  - Results reflect relative R/VCs of comparable group.
  - Even with RSAM, unlikely there would be any meaningful impact.

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PA Does Not Have a Meaningful Effect Regulatory Remedies

- 180% R/VC Jurisdictional Threshold
  - Applies to all rate cases as a safety net driven by statute.
  - Few rates are even close to the threshold.
  - If a given rail rate were to be driven down to 180 R/VC, it should be on the most accurate costs.

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Existing Prescriptions

- For existing R/VC prescribed rates that straddle the transaction, the Board could adopt a bridging mechanism to retain the original structure of those findings.
  - A one-time linking factor could adjust a prior R/VC-based prescription.
  - The change would not effect any prior prescriptions that do not use R/VCs calculated using MMM.

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Revenue Adequacy

- In 2010, BNSF was revenue inadequate, with or without purchase accounting adjustments.
- Over the past decade, BNSF has been found to exceed its cost of capital only once.
- Cost of capital, the economy, and the company's performance will determine whether BNSF is revenue adequate in future years.
- Effect of future revenue inadequacy is undefined.

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Robert M. Jenkins, III

Partner, Mayer Brown LLP

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Comparison to Other Acquisitions

Transaction	Percent Increase in Assets	Amount of Goodwill
Berkshire BNSF (2010)	39%	$14 billion
CN and IC (2002)	288%	$0
NS and Conrail (1999)	43%	$0
CSXT and Conrail (1999)	41%	$0
UP and SP (1997)	74%	$0
BN and ATSF (1995)	72%	$0
Blackstone CNW (1985)	16%	$0

- **In percentage terms, this transaction had a smaller impact on asset values than almost all prior transactions.**
- **No other transaction generated Goodwill.**

Source: Baranowski/Fisher Verified Statement (BNSF Opening), p. 5; Historic R-1 Reports and 10Ks

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STB FINANCE DOCKET NO. 33388

CSX CORPORATION AND CSX TRANSPORTATION, INC.,
NORFOLK SOUTHERN CORPORATION AND
NORFOLK SOUTHERN RAILWAY COMPANY
—CONTROL AND OPERATING LEASES/AGREEMENTS—
CONRAIL INC. AND CONSOLIDATED RAIL CORPORATION

Decision No. 89[1]

Decided July 20, 1998

"[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 [USOA], adopted in conformity with [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 recommendations of the [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)."

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Decision No. 89[1]

Decided July 20, 1998

The Board approves, with certain conditions: (1) the acquisition of control of Conrail Inc. and Consolidated Rail Corporation (collectively, Conrail) by (a) CSX Corporation and CSX Transportation, Inc. (collectively, CSX), and (b) Norfolk Southern Corporation and Norfolk Southern Railway Company

"The statute specifically limits our rate regulation to situations where the rate exceeds 180% of the variable costs 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."

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"[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."

Assets Allocated To NYC 221
Assets Allocated To PRR 222
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F.D. No. 35506: WCTL –
Petition for Declaratory Order

Professor Roman L. Weil
Booth School of Business of the University of Chicago

Roman L. Weil
V. Duane Rath Professor Emeritus of Accounting
Booth School of Business, University of Chicago

- GAAP purchase accounting is almost universally used in this country for financial reporting, and is required by the SEC for both regulated and unregulated companies.

- The issue here is whether the STB should accept BNSF's use of GAAP purchase accounting, consistent with the STB's rules, for regulatory purposes – in particular, whether the STB should use "predecessor cost" instead of (current) acquisition cost to value BNSF's assets and liabilities for regulatory purposes.

Roman L. Weil
V. Duane Rath Professor Emeritus of Accounting
Booth School of Business, University of Chicago

- The STB's goal as an economic regulator should be practicably calculating economically accurate costs – costs that will lead to decisions that maximize the returns from using scarce resources.
- In pursuit of that goal, GAAP purchase accounting costs are preferable to "predecessor costs."
- The claim that GAAP purchase accounting has no "economic substance" is wrong, if that claim means managers make the same decisions about future cash flows whether it bases them on predecessor costs or on current acquisition costs.

The Brattle Group

Dr. Kevin Neels
Principal

The Brattle Group

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International Trade Product Liability Regulatory Finance and Accounting Risk Management Securities Tax Utility Regulatory Policy and Ratemaking Valuation
Electric Power Financial Institutions Natural Gas Petroleum Pharmaceuticals, Medical Devices, and Biotechnology Telecommunications and Media Transportation

Analogies Drawn From other Regulated Industries Do Not Apply to Railroads

- The reasons why FERC regulation prohibits use of acquisition costs do not apply to the rail industry.
- Original cost regulation doesn't just protect rate payers; it also protects investors. Railroads have no such protection.
- In the rail industry, there is no "rate base" for rate regulation purposes. Rates are set by the railroads based on market conditions and the demand they perceive for their services.
- In the limited circumstances where the STB sets rates, it applies stand-alone cost, which is not based on the investment values in the railroad's books.

Analogies Drawn From other Regulated Industries Do Not Apply to Railroads

- The "circularity" and "double-count" concerns that led FERC and other public utility regulators to exclude acquisition premiums under original cost regulation simply do not apply in rail markets.
- Original cost regulation is incompatible with prices set in competitive markets.
- There is no economically valid reason for the STB to prefer obsolete "predecessor cost" to current acquisition cost for revenue adequacy and regulatory costing purposes.

Tom Hund – Conclusion

- All post Staggers rail mergers, and industry in general, apply GAAP purchase accounting in acquisition transactions.
- The Board should not depart from decades of its established, judicially affirmed, precedent.
- There is no defensible rationale for changing the general application of this precedent.
- It would be bad public policy to go to a world of ad hoc, exception-based departures from GAAP for railroad accounting and costing.

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Conclusion (cont'd.)

- BNSF's policy and practice is to set rates based on market conditions, not regulatory costs.
- Only a minimum amount of regulated traffic is potentially affected, and only modestly (e.g., 5% average change in URCS).
- The Board has effective remedies available to address any transitional anomalies in existing cases or prescriptions, and should do so in those cases where justified.

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