

## STB EX PARTE NO. 552

## RAILROAD REVENUE ADEQUACY - 1995 DETERMINATION

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*Decided July 10, 1996*

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Three Class I railroads, Illinois Central Railroad Company, Norfolk Southern Railroad Company, and Union Pacific Railroad Company, are found to be revenue adequate, having a return on investment that exceeds the target cost of capital for 1995.

## BY THE BOARD:

This annual determination of railroad revenue adequacy is made in accordance with the standards developed in *Standards for Railroad Revenue Adequacy*, 364 I.C.C. 803 (1981), *Standards for Railroad Revenue Adequacy*, 3 I.C.C.2d 261 (1986), and *Supplemental Reporting of Consolidated Information for Revenue Adequacy Purposes*, 5 I.C.C.2d 65 (1988). Pursuant to those decisions, a railroad will be considered revenue adequate under 49 U.S.C. 10704(a) if it achieves a rate of return on net investment (ROI) equal to at least the current cost of capital for the railroad industry.

In *Railroad Cost of Capital - 1995*, 1 S.T.B. 46 (1996), we determined that the 1995 railroad industry cost of capital was 11.7%. By comparing this figure to the 1995 ROI data obtained from the carriers' Annual Report R-1 Schedule 250 filings, we have made revenue adequacy calculations for each of the Class I freight railroads that were in operation as of December 31, 1995.

A summary of our findings for all Class I railroads is set forth in the appendix to this decision. We find three carriers, Illinois Central Railroad Company, Norfolk Southern Railroad Company, and Union Pacific Railroad Company, to be revenue adequate for 1995. All other carriers are found to be revenue inadequate for 1995. Our findings with respect to the Class I carriers will be final on the effective date of this decision.

## Environmental and Energy Considerations

We conclude that this action will not significantly affect either the quality of the human environment or the conservation of energy resources.

1 S.T.B.

## Regulatory Flexibility Analysis

Pursuant to 5 U.S.C. 603(b), we conclude that our action in this proceeding will not have a significant economic impact on a substantial number of small entities. The purpose and effect of the action is merely to update the annual railroad industry revenue adequacy finding previously made by the Interstate Commerce Commission. No new reporting or other regulatory requirements are imposed, directly or indirectly, on small entities.

*We find:*

Three carriers, Illinois Central Railroad Company, Norfolk Southern Railroad Company, and Union Pacific Railroad Company are revenue adequate for 1995. All other Class I carriers are revenue inadequate for 1995.

This decision is effective on July 19, 1996.

CHAIRMAN MORGAN, joined by VICE CHAIRMAN SIMMONS, *commenting:*

Just seven months ago, Congress completed an exhaustive review of the Interstate Commerce Act. As a result of that review, in the ICC Termination Act of 1995 (ICCTA), Congress abolished the ICC; further deregulated motor carrier transportation; and further reformed economic regulation of railroads in several respects, transferring responsibility for the remaining core rail regulatory functions, along with less than one-third of the ICC's staff, to the Board. Among those core functions is an annual assessment of railroad revenue adequacy, which is conducted to help achieve the regulatory balance originally contemplated by the Staggers Rail Act of 1980 and carried forward in the ICCTA.

Questions concerning revenue adequacy have been raised regularly over the past several years, before Congress and elsewhere. Under the standards developed by the ICC through rulemaking, and transferred under the ICCTA to the Board, most railroads have historically been found to be revenue inadequate, even though the industry has substantially and steadily improved its performance, as well as its standing in the financial markets. However, notwithstanding the suggestion that revenue adequacy, as measured under those standards, is not realistic enough, Congress chose not to amend the revenue adequacy provisions as part of the regulatory overhaul that it undertook in the ICCTA.

The concurring opinion states that the time is ripe to revisit the revenue adequacy rules, through an informal approach. However, in the ICCTA, Congress mandated several new regulatory initiatives, none of which involve a review of our revenue adequacy procedures. Pursuing those initiatives while managing our hefty caseload has already sorely taxed our sharply reduced resources. Apart from its substantive impacts, a determination to expend the additional resources that would be required to review and revise the revenue adequacy standards that Congress chose to leave intact could compromise our ability to manage our existing docket and to fulfill the intent of Congress in other areas of our jurisdiction.

I believe that government must continue to evolve, to remain flexible in response to the changing marketplace, and to improve how it conducts its business. But fundamental regulatory changes of the sort suggested in the concurring opinion require much time and effort. Congress could have amended, or at least suggested that we amend, the revenue adequacy standards, but instead it directed our limited resources to other priorities. Thus, in my view, now is not the appropriate time to revisit our revenue adequacy standards.

COMMISSIONER OWEN, *concurring*:

Although I vote to approve the 1995 annual determination of railroad revenue adequacy as made in accordance with methods previously developed by this agency, I believe the time is ripe to investigate the appropriateness of those methods.

Consider:

- Class I freight railroads exceeded earnings per share estimates of independent financial analysts in 1995, they have posted sustained ton-mile growth over the past decade, and they have made remarkable and sustained productivity gains through rationalization of the work-force, fixed-plant and equipment.
- The president of the Association of American Railroads, which represents each of the Class I railroads party to this proceeding, repeatedly has spoken in public of "a new Golden Age" for railroads.
- A premium considerably in excess of market value is being bid for a portion of revenue-*inadequate* Southern Pacific by revenue-*inadequate* Conrail, while a premium considerably in excess of market value is being bid for the entirety of revenue-*inadequate* Southern Pacific by barely revenue-adequate Union Pacific.

- Revenue-*inadequate* Burlington Northern-Santa Fe has announced an extraordinary 1997 capital-expenditure budget of almost \$2 billion.
- Revenue-*inadequate* Conrail has increased its dividend in every year since its initial public offering in 1987.
- Since 1985, return on investment for Class I railroads has more than doubled, while return on equity nearly doubled and exceeded the industry's cost of capital in 1994.<sup>1</sup>

Yet of 11 Class I railroads in the United States, only three are found by this agency to be revenue adequate for 1995. Such an incongruity begs for further study of the methods we utilize to determine revenue adequacy.

Without prejudgment, I note, for example:

- The cost of capital is computed for railroad holding companies rather than railroad operating companies. Holding company assets include non-rail assets such as energy companies, trucking firms and hotels.
- The cost of capital is computed for the railroad industry as a whole, even though it is individual railroads -- which may exhibit greater or less risk than the industry -- that raise capital in the financial markets.
- Revenue adequacy is determined by measuring return on net transportation investment (ROI) for each individual railroad rather than return on equity (ROE) even though ROE is a more universal measurement of corporate profitability. Furthermore, when one railroad contemplates buying another railroad, it makes an offer for considerably more than just the net transportation investment of the railroad to be acquired.

The subject of revenue adequacy is important. If any business is to survive in the long run, its revenue must meet or exceed its current cost of capital. If the investor cannot earn the current cost of capital, the investor will transfer the capital to some other use.

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<sup>1</sup> "Yearbook of Railroad Facts, 1995," Association of American Railroads, at 18, 21.

It is 20 years since the Railroad Revitalization and Regulatory Reform (4-R) Act of 1976 instructed the Interstate Commerce Commission to develop a revenue adequacy standard.<sup>2</sup>

Given the sharply improved financial success of railroads in recent years, coupled with the consistent revenue inadequacy of almost all Class I railroads, it is appropriate that we revisit the method by which we measure revenue adequacy.

I prefer an informal approach rather than a formal rulemaking and I encourage suggestions from railroad, shipper and other interested parties as to how we might proceed.

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By the Board, Chairman Morgan, Vice Chairman Simmons, Commissioner Owen. Chairman Morgan joined by Vice Chairman Simmons commented with a separate expression. Commissioner Owen concurred with a separate expression.

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<sup>2</sup> Reaffirmed by the Staggers Rail Act of 1980, which further instructed the ICC to "promote a safe and efficient rail transportation system by allowing rail carriers to earn adequate revenue \* \* \* ." See 49 U.S.C. 10101a(3) and 49 U.S.C. 10704(a)(2).

## APPENDIX

Railroad	ROI	Finding
Atchison, Topeka & Santa Fe Railway Co.	5.3%	Inadequate
Burlington Northern Railroad Co.	6.3%	Inadequate
Consolidated Rail Corp.	6.8%	Inadequate
CSX Transportation Inc.	6.5%	Inadequate
Grand Trunk Western Railroad Co.	NM	Inadequate
Illinois Central Railroad Co.	17.2%	Adequate
Kansas City Southern Railway Co.	7.9%	Inadequate
Norfolk Southern Corporation	12.1%	Adequate
Soo Line Railroad Company	NM	Inadequate
Southern Pacific Transportation Co. (Including St. Louis Southwestern Railway Co. and Denver & Rio Grande Western Railroad Co.)	1.3%	Inadequate
Union Pacific Railroad Co.	11.7%	Adequate

NM = ROI is negative; therefore it is not meaningful.