Revenue Adequacy

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Distorted & Misleading

Shippers have long felt that the STB's and predecessor ICC's annual revenue adequacy determinations present a very distorted and misleading picture of the financial health of the railroad industry.

In submissions such as the recent filings of Edison Electric Institute in Ex Parte No. 658, which included earlier analysis by Professors Alfred Kahn and Jerome Hass, and the Western Coal Traffic League, which included Wall Street data, shippers have explained that the measures utilized are simply not realistic and reflect a pro-railroad bias.

STB Members have also noted the limitations of the agency's approach on occasion, such as Vice Chairman Owen's references to the methodology's "flawed premises" and other shortcomings in his comment on the 1996 determination, and Chairman Nober's comments at the STB's October 19, 2005 hearing in Ex Parte No. 658.

These concerns have been exacerbated by the STB's latest determination in Ex Parte No. 552 (Sub-No. 9), *Railroad Revenue Adequacy – 2004 Determination* (served Nov. 23, 2005).

The STB found that Norfolk Southern was the only domestic Class I railroad to be revenue adequate because its return on net investment (ROI) of 11.64% exceeded the 2004 industry average cost of capital of 10.1%, while the ROI of the five other domestic Class I railroads ranged from 3.28% to 8.30%.

By statute, revenue adequacy determinations are to focus on whether the industry is performing well enough to attract needed capital from investors. In the past few years, railroad stocks have performed very impressively, yielding appreciation of 109% since January 2003, compared to only 40% for the S&P 500, according to a November 17, 2005 report by UBS.

A doubling of average stock prices in less than three years constitutes an outstanding return for investors by any reasonable measure. Moreover, BNSF's stock appreciated by 146 percent over that period, compared to 110 percent for Norfolk Southern, even though BNSF's ROI for 2004 as measured by the STB was 5.84 percent, just half that of NS. (STB figures for the twelve months ending September 30, 2005, show some improvement in BNSF's ROI, although the figure is still below the 2004 cost of capital.)

Such discrepancies beg the question whether ROI, which is the STB's sole criterion for determining revenue adequacy, is really a meaningful measure of the financial health of the railroad industry.

ROE Trumps ROI

Some have commented that return on equity (ROE) is better than ROI as a measure of financial performance.

While each measure has its place, ROE is ultimately the more meaningful criterion of a financial entity's performance and attractiveness to investors, especially as there is no question as to railroads' ability to cover their debt.

For example, the primary company and industry analysis web pages of Yahoo Finance present figures for ROE, but not for ROI. Yahoo shows that, as of December 1, 2005, BNSF had a ROE of 15.15 percent compared to a ROE of only 14.25 percent for Norfolk Southern.

Yahoo also calculates that BNSF enjoys a price to earnings ratio of 17.27 compared to 15.33 for Norfolk Southern. The Yahoo data thus confirm that the market assigns far more importance to ROE than to ROI.

In addition, Yahoo presents ROE data on a sector basis that is also quite revealing. The Yahoo analysis depicts a ROE for the railroad sector of 11.90 percent, as contrasted with ROEs of 11.10 percent for the electric utilities sector and 11.22 percent for the technology sector (the single largest sector by market capitalization).

Given this data, it is difficult to view railroads as the poor cousins of the financial community, especially when they are enjoying an average ROE greater than that of electric utilities, which are among their most captive customers.

Another relevant measure of financial health long identified by shippers is the ratio of market capitalization or price relative to book value of assets, with a ratio greater than 100 percent indicating that the market values the firm as earning a positive return on the value of its assets. The railroad sector has an average price to book value ratio of 200 percent, with supposedly revenue inadequate BNSF enjoying a ratio of 242 percent compared to Norfolk Southern's 202 percent, and even UP and CSX, notwithstanding their well-publicized troubles, yielding ratios of 152 percent and 138 percent, respectively.

These figures indicate that the industry is providing a positive long-term return for its investors relative to other investment opportunities.

In light of the disparity between the STB's calculations and other measures of financial health, shipper skepticism of the STB's revenue adequacy determinations should be readily understandable. In so many words, since Wall Street does not appear to give much credence to the STB's calculations, no one else should either, especially since the ostensible purpose of the STB's exercise is to determine if railroads are providing a sufficient return to attract capital as needed.

Notwithstanding the financial community's disregard of the STB's analysis, the problem remains that the STB appears, at least at times, to take the determinations seriously, as do some other decision-makers.

Recent discussions at the STB, particularly in conjunction with Ex Parte No. 658 addressing the 25th anniversary of the Staggers Act, indicate that the STB is aware that the industry's achievement of revenue adequacy would prompt a need to revisit the application of rate regulation principles, especially as revenue adequacy is one of the four constraints to market pricing specified in the *Coal Rate Guidelines–Nationwide*, Ex Parte No. 347 (Sub-No. 1).

Industry representatives were predictably quick to explain that the revenue adequacy at issue is long-term, not short-term, and that precipitous action should be avoided to prevent a return to the conditions prevailing at the time of the Staggers Act itself.

Coddling Uncalled For

To shippers, such statements are misguided. The railroad industry has had 25 years since the Staggers Act to rehabilitate itself, and its accomplishments have been impressive.

The industry's current valuations are, as noted above, now very favorable, particularly as compared to those of its most captive customers, and there is little basis for any further coddling. Indeed, the industry was in somewhat comparable condition 10 years ago when it was approaching revenue adequacy under even the traditional methodology, only to engage in a series of ill-founded, or at least poorly-executed, mergers that harmed shippers far more than they harmed the railroads themselves (and also effected a write-up of railroad assets that skews the ROI analysis).

Most shippers would dispute the notion that railroads should be allowed to charge more because of squandered opportunities.

Hostile Forum

At the same time, shippers are understandably reluctant to push for revision of the STB's revenue adequacy criterion. Over the past few years, shippers have come to view the STB as an increasingly hostile forum. Revenue adequacy, like most other aspects of rail regulation (such as stand-alone costing), can always be made into a theoretically, technically, and/or factually complex and difficult subject requiring the deployment of substantial resources, and the reality is that the railroads are always able to devote far more resources to such issues than are shippers.

In a more perfect world, the STB would find a way to revisit and revise its revenue adequacy methodology on the basis of a fair and reasonable process. At the very least, the STB, Congress, and other decision-makers should put less weight on a narrow and flawed measure of revenue adequacy, and instead take into account how the investment community actually regards the railroad industry.