The Dawn of “Revenue-Adequate” Railroads: What Does It Mean?

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Overview

- Pending STB Rulemakings
- Statutory Predicate for Revenue Adequacy
- The STB’s Existing Test for Revenue Adequacy
- Assessment of Existing Test
- Treatment of Revenue Adequacy Constraint in *Coal Rate Guidelines*
- How Might Revenue Adequacy Constraint Apply

Pending STB Rulemakings

- *Railroad Revenue Adequacy*, Ex Parte 722
- *Petition of Western Coal Traffic League to Abolish Use of the Multi-State Discounted Cash Flow Model in Determining the Railroad Industry's Cost of Capital,* Ex Parte 664 (Sub-No. 2)
- Separate Rulemaking Proceedings, But Related

Statutory Predicate

49 U.S.C. § 10704(a)(2) states that:

"The [agency] shall maintain and revise as necessary standards and procedures for establishing revenue levels for rail carriers providing transportation subject to its jurisdiction under this part that are adequate, under honest, economical, and efficient management, to cover total operating expenses, including depreciation and obsolescence, plus a reasonable and economic profit or return (or both) on capital employed in the business."

Statutory Predicate, cont'd

"Revenue levels established under this paragraph should—

(A) provide a flow of net income plus depreciation adequate to support prudent capital outlays, assure the repayment of a reasonable level of debt, permit the raising of needed equity capital, and cover the effects of inflation; and

(B) attract and retain capital in amounts adequate to provide a sound transportation system in the United States."

Statutory Standard, Summarized

- Cover total operating expenses
- Reasonable and economic profit
- Support prudent capital outlays
- Assure repayment of debt
- Permit raising of needed equity and cover the effects of inflation
- Attract and retain adequate capital

STB Standard for Revenue Adequacy

- The STB test for whether a railroad is revenue adequate is "if it achieves a rate of return on net investment (ROI) equal to at least the current cost of capital for the railroad industry."
- So, the STB determination of revenue adequacy can be no better than its calculation of
  - the net investment base, and
  - the current cost of capital.

Railroads' Historical Revenue Adequacy, Using STB Cost of Capital

Year	Cost of Capital	BNSF	UP	NS	CSX
2003	9.40%	6.20%	7.30%	9.10%	4.00%
2004	10.10%	5.84%	4.54%	**11.64%**	4.43%
2005	12.20%	10.32%	6.34%	**13.21%**	6.23%
2006	9.94%	**11.43%**	8.21%	**14.36%**	8.15%
2007	11.33%	9.97%	8.90%	**13.55%**	7.61%
2008	11.75%	10.51%	10.46%	**13.75%**	9.34%
2009	10.43%	8.67%	8.62%	7.69%	7.30%
2010	11.03%	10.28%	**11.54%**	10.96%	10.85%
2011	11.57%	**12.39%**	**13.11%**	**12.87%**	11.54%
2012	11.12%	**13.47%**	**14.69%**	**11.48%**	10.81%

Sanity Check

- Do these results make any sense?
- Railroads have highly rated debt, and no problems raising more, but relatively low leverage.
- No problems covering operating expenses and capital expenditures.
- Railroads have so much equity they have been buying it back.
- Market capitalization is a substantial premium to net asset value, even after merger premiums.
- Berkshire Hathaway pays healthy premium to acquire remainder of BNSF.
- Does this reflect an industry that is revenue inadequate?

Sanity Checked

- It took three decades to get here
- Railroads are capital intensive
  - More than $550 Billion reinvested since 1980
  - Current capacity constraints and predicted future traffic growth require huge capital reinvestment
- Long term/large scale investments require
  - Long term ROI’s that justify the investment
  - Stable regulatory environment
- Does anyone remember the dot com bubble?

Railroads' Adequacy, Assuming CAPM-Only Cost of Equity for 2008-2012

Year	Cost of Capital	BNSF	UP	NS	CSX
2003	9.40%	6.20%	7.30%	9.10%	4.00%
2004	10.10%	5.84%	4.54%	**11.64%**	4.43%
2005	12.20%	10.32%	6.34%	**13.21%**	6.23%
2006	9.94%	**11.43%**	8.21%	**14.36%**	8.15%
2007	11.33%	9.97%	8.90%	**13.55%**	7.61%
2008	9.58%	**10.51%**	**10.46%**	**13.75%**	9.34%
2009	9.74%	8.67%	8.62%	7.69%	7.30%
2010	10.15%	**10.28%**	**11.54%**	**10.96%**	**10.85%**
2011	9.78%	**12.39%**	**13.11%**	**12.87%**	**11.54%**
2012	8.69%	**13.47%**	**14.69%**	**11.48%**	**10.81%**

Revenue Adequacy Constraint Under Coal Rate Guidelines

- *Coal Rate* Guidelines, 1 I.C.C.2d 529 (1985), establishes four constraints on railroad pricing: Stand-Alone Cost, Management Efficiency, Phasing, and Revenue Adequacy.
- Stand-Alone Cost is the only constraint that has been fleshed out and actually applied in railroad rate cases.
- Revenue inadequate carriers are allowed to charge up to stand-alone costs (variant of replacement costs).

Revenue Adequacy Constraint Under Coal Rate Guidelines, cont'd

- "[T]he logical first constraint on a carrier's pricing is that its rates not be designed to earn greater revenues than needed to achieve and maintain . . . 'revenue adequacy. '"
- "We emphasize that revenue adequacy is a long-term concept that calls for a company, *over time*, to average return on investment equal to its cost of capital."
- "Our concept is simply that a railroad not use differential pricing to consistently earn, over time, a return on investment above the cost of capital.

History of Application

- Revenue adequacy has never been applied in a railroad case.
- It was applied in *CF Indus., Inc. v. Koch Pipeline Co.*, 4 S.T.B. 637 (2000), *aff'd sub nom. CF Indus., Inc. v. STB*, 255 F.3d 816 (D.C. Cir. 2001), to find pipeline rate increases were unreasonable.
- It was also invoked in *S. Miss. Elec. Power Ass'n v. Norfolk S. Ry.*, NOR 42128 (STB served Aug. 31, 2011). That case settled before opening evidence was filed.

How Revenue Adequacy Constraint Might Apply

- Some limit on ability of railroads to increase their rates.
- Some relief on existing rates.
- Ability of railroads to adjust to changing costs and market conditions.
- Incentives for railroads to continue to improve.
- Should be a simpler, more feasible alternative to stand-alone cost rate cases.
- Should recognize that railroads are no longer an endangered species.

What Application of the Revenue Adequacy Constraint Might Do

- Cause competitive imbalances between revenue adequate and non-revenue adequate railroads
- Increase pricing pressure on competitive traffic to compensate for loss of pricing freedom on captive traffic leading to pricing death spiral
- Increase cost of capital which would impact revenue adequacy determination
- Discourage reinvestment at a time when reinvestment is most needed