Freight Rail
Customer Alliance

Revenue Adequacy

FRCA Position

FRCA supports the efforts of the Surface Transportation Board (STB or Board) in Docket No. EP 722, *Railroad Revenue Adequacy*.

A goal of the ***Staggers Rail Act of 1980*** (***Staggers Act***) was to restore financial stability to the U.S. rail system. By all accounts, this goal has been achieved, as demonstrated by the industry's continued high levels of capital investment and shareholder returns including dividends, buybacks, and stock appreciation. However, FRCA has long been concerned that the Board's annual determinations of "revenue adequacy" for Class I carriers does not reflect the true health of the overall rail industry and its individual carriers.

As a part of this and other STB rulemakings, FRCA continues to:

- Support eliminating the statutory requirement for the annual determination because it believes that 1) the carriers' falsely- perceived lack of adequate revenues has served to shield the railroads' exercise of their monopoly pricing power from STB scrutiny; and 2) has prevented shippers from obtaining appropriate relief.

- Strongly oppose railroad efforts (via legislation or proceedings) to evaluate revenue adequacy on the basis of replacement costs.

Issue Background

The ***Railroad Revitalization and Regulatory Reform Act of 1976*** (separating freight rail from passenger rail) mandated that the STB's predecessor, the Interstate Commerce Commission (ICC), promulgate and thereafter, revise and maintain standards and procedures for establishing railroad revenue adequacy.

The ***Staggers Act*** (which partially de-regulated the freight rail industry), revised the nation's freight rail transportation policy to promote a safe and efficient rail transportation system by allowing freight rail carriers to earn adequate revenues, as determined by the agency. Moreover, the ***Staggers Act*** required the ICC to begin determining annually which rail carriers are earning adequate revenues. To implement this requirement, the ICC began a proceeding to adopt standards for determining railroad revenue adequacy. In that proceeding, the ICC concluded that "the only revenue adequacy standard consistent with the requirements of [*Staggers*] is one that uses a rate of return equal to the cost of capital."

These U.S. Congressional mandates still govern the STB (like the ICC before it) when annually determining which rail carriers are revenue adequate by comparing a carrier's rate of return with the cost of capital. Over the years, the ICC/STB has adjusted the methodologies used in determining revenue adequacy.

The ICC declared that once a railroad has become revenue adequate over a period of time, shippers should be able to challenge the railroad's rates on the ground that the railroad is financially healthy, thus, not needing to charge such high rates. However, the methods used by STB (or the previous ICC) to measure revenue adequacy have major flaws and do not accurately reflect today's market conditions. Moreover, neither the ICC nor the STB have fully defined the process for shippers when challenging a rate on this basis.

When reviewing the revenue adequacy determinations for the seven Class I carriers during the past several years, STB determined the following number of railroads revenue adequate:

- 2020: Five.
- 2019: Five.
- 2018: Three.
- 2017: Five.
- 2016, 2015, and 2014: Four.
- 2013: Five.

The concept of revenue adequacy is also a component of the STB's standard for judging the reasonableness of rail freight rates, as set forth in the Coal Rate Guidelines.

Regarding the "replacement cost methodology matter", it has been examined repeatedly, including by the Railroad Accounting Principles Board. The use of replacement cost methodologies has always soundly been rejected. Given the financial strength of the railroads today, including publicly available information indicating that the railroad industry is revenue adequate, there is no plausible basis for the STB to adopt a replacement cost approach to evaluate revenue adequacy or limit the availability of rate relief.

It should be noted that in in 2008 the Association of American Railroads (AAR) submitted a petition to the STB requesting that the Board use replacement cost methodologies when evaluating revenue adequacy (Docket No. EP 679, Replacement Cost). In addition, CSX Transportation falsely asserted that Section 16 (Criteria) of the ***STB Reauthorization Act of 2015***, P.L. 114-110, directs the STB to use replacement cost methodologies when evaluating revenue adequacy in its evidence filed March 7, 2016 in the Consumers Energy Company Rate Case (Docket No. NOR 42142). This docket can be accessed **here.**

On March 31, 2016 Senator John Thune, R-SD, chairman of the Senate Commerce, Science and Transportation Committee, sent a letter to the STB Members providing various observations on how the new law is being implemented. Of note, the Chairman emphasized that Section 16 (Criteria) does not require any change in how STB evaluates railroad revenue adequacy – either in statutory language or accompanying report language (or via congressional intent). This letter can be accessed **here.**

Actions

1. Railroad Cost of Capital

On August 4, 2021, the Board determined that the railroad cost of capital for 2020 was 7.89%. This figure represents the Board's Office of Economics' estimate of the average rate of return needed to persuade investors to provide capital to the freight rail industry. This STB proceeding is Docket No. EP 558 (Sub-No. 24), *Railroad Cost of Capital—2020*. This docket can be accessed **here.**

This annual determination is then utilized by the STB to identify which Class I rail carriers are considered "revenue adequate" for the year.

2. Annual Revenue Adequacy Determinations

On December 30, 2020, in response to a petition filed by several Class I carriers (asserting that revenue adequacy should not be based on whether railroads are earning their cost of capital, but instead on whether they are earning the same surplus over their cost of capital as the median firm in the S&P 500), the Board instituted a new proceeding. This is Docket EP 766, *Joint Petition for Rulemaking—Annual Revenue Adequacy Determinations* where comments were due June 24, 2021; reply comments are due August 24, 2021. Although FRCA is not participating in this proceeding, this docket can be found **here.** .

3. Railroad Revenue Adequacy

On December 12, 2019, FRCA **testified and submitted written comments** on December 12, 2019 in response to STB's EP Docket No. 761, *Hearing on Revenue Adequacy* and EP Docket 722, *Railroad Revenue Adequacy* (docket can be accessed **here)**. FRCA key elements raised included:

- Viable and effective revenue adequacy constraint is needed as part of the Board's oversight.
- A recognition that rail carriers need differential pricing to cover their costs and serve as many shippers as possible. But once rail carriers recover their costs and achieve revenue adequacy, allowing further unrestrained rate increases, does not guarantee further infrastructure investment but rather, punishes captive shippers. (The Board's predecessor, the Interstate Commerce Commission, recognized this in 1985.)
- Measuring revenue adequacy based on whether a rail carrier's return on investment exceeds the cost of capital can be a reasonable approach, but other measures should be considered.
- Continued opposition to the use of "replacement cost methodologies" when determining rail carrier revenue adequacy.
- The measurement period should be of a fixed length – five years is sufficient.
- Rate increase constraint should be a key element of a revenue adequacy constraint.
- the Board's proposed suspension of the bottleneck rate protections for revenue adequate rail carries.
- A shipper to use the simplified road property investment analysis in a simplified SAC case against a revenue adequate rail carrier.
- Continued development of the *Report's* recommended use of Incumbent Network Cost Analysis (INCA) in a simplified SAC case.

This hearing was held as a result of revenue adequacy issues raised in the *Rate Reform Task Force Report (**RRTF Report**)* issued on April 25, 2019. This task force was established by then STB Chair Ann Begeman in January 2018. R*RTF* members spent about a year holding informal meetings with stakeholders, including FRCA on June 18, 2018.

On October 31, 2016, in a related proceeding, the Board denied the WCTL petition that the agency abolishes the use of the multi-stage discounted cash flow model in determining the railroad industry's cost of equity capital. This proceeding is Docket No. 664 (Sub-No.2), *Petition of the Western Coal Traffic League to Institute a Rulemaking Proceeding to Abolish the Use of the Multi-Stage Discounted Cash Flow Model in Determining the Railroad Industry's Cost of Equity Capital.* This docket can be accessed **here.**

Status

Various shippers and some individual Class I rail carriers filed replies and/or comments in STB Docket No. EP 766, *Joint Petition for Rulemaking—Annual Revenue Adequacy Determinations.* At the time of this writing, it is uncertain when the STB will take further action in this proceeding.

Also, the STB is considering public comments as part of the Board's own efforts to measure railroad revenue adequacy, as well as to apply the revenue adequacy constraint in judging the reasonableness of rail freight rates in Docket No. EP 722, *Railroad Revenue Adequacy.*