



FR-4915-01-P

**DEPARTMENT OF TRANSPORTATION**

**Surface Transportation Board**

**49 CFR Chapter X**

**[Docket No. EP 722]; [Docket No. EP 664 (Sub-No. 2)]**

**Railroad Revenue Adequacy: 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**

**AGENCY:** Surface Transportation Board, DOT.

**ACTION:** Notice.

**SUMMARY:** The Surface Transportation Board will receive comments in Docket No. EP 722 to explore the Board's methodology for determining railroad revenue adequacy, as well as the revenue adequacy component used in judging the reasonableness of rail freight rates. The Board will also receive comments in Docket No. 664 (Sub-No. 2) on how it calculates the railroad industry's cost of equity capital. The Board is seeking written comments on these matters, as described below, and later will hold a hearing to address these issues.

**DATES:** Comments in both dockets are due on July 1, 2014. Reply comments are due on August 15, 2014. Following receipt of comments, the Board will schedule a public hearing at the Board's headquarters located at 395 E Street, S.W., Washington, D.C., to allow participants to appear and discuss the submissions that were made. The Board will provide more details regarding the hearing in a future decision.

**ADDRESSES:** All filings may be submitted either via the Board’s e-filing format or in the traditional paper format. Any person using e-filing should attach a document and otherwise comply with the instructions at the “E-FILING” link on the Board’s “www.stb.dot.gov” website. Any person submitting a filing in the traditional paper format should send an original and 10 copies of the filing to: Surface Transportation Board, Attn: Docket No. [EP 722 or EP 664 (Sub-No. 2), as the case may be], 395 E Street, S.W., Washington, DC 20423-0001.

Copies of written submissions will be posted to the Board’s website and will be available for viewing and self-copying in the Board’s Public Docket Room, Suite 131. Copies of the submissions will also be available (for a fee) by contacting the Board’s Chief Records Officer at (202) 245-0236 or 395 E Street, S.W., Washington, DC 20423-0001.

**FOR FURTHER INFORMATION, CONTACT:** For EP 722: Scott Zimmerman at (202) 245-0386; for EP 664 (Sub-No. 2): Amy Ziehm at (202) 245-0391. Assistance for the hearing impaired is available through the Federal Information Relay Service (FIRS) at (800) 877-8339.

**SUPPLEMENTARY INFORMATION:** In Section 205 of the Railroad Revitalization and Regulatory Reform Act of 1976, Pub. L. No. 94-210, 90 Stat. 127, Congress mandated that the Board’s predecessor, the Interstate Commerce Commission (ICC), promulgate—and thereafter revise and maintain—standards and procedures for establishing railroad revenue adequacy. Four years later, in the Staggers Rail Act of 1980 (Staggers), Pub. L. 96-448, 94 Stat. 1895, the agency’s rail transportation policy was revised to include, among other things, “promot[ing] a safe and efficient rail transportation system by allowing rail carriers to earn adequate revenues, as determined by the [agency].” Additionally, Section 205 of Staggers 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.” Standards for R.R. Revenue Adequacy, 364 I.C.C. 803, 811 (1981), aff’d sub nom. Bessemer & Lake Erie R.R. v. ICC, 691 F.2d 1104 (3d Cir. 1982).

These statutory requirements, now codified at 49 U.S.C. § 10704(a)(2) and (3),<sup>1</sup> still govern, and the Board (like the ICC before it) annually determines which rail carriers are revenue adequate by comparing a carrier’s rate of return with the cost of capital.<sup>2</sup> Since the issuance of Standards for Railroad Revenue Adequacy in 1981, adjustments have been made to the agency’s methodology in order to improve the agency’s ability to determine accurately

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<sup>1</sup> Section 10704(a) of title 49 states with respect to adequate revenues:

. . .

(2) The Board shall maintain and revise as necessary standards and procedures for establishing revenue levels for rail carriers . . . 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. . . . 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.

(3) On the basis of the standards and procedures described in paragraph (2), the Board shall annually determine which rail carriers are earning adequate revenues.

<sup>2</sup> The Board annually publishes the annual rates of return of each Class I railroad, as well as the cost of capital experienced by the rail industry, in sub-numbered proceedings of Dockets No. EP 552 and EP 558, respectively. See, e.g., R.R. Revenue Adequacy—2012 Determination, EP 552 (Sub-No. 17) (STB served Oct. 17, 2013) (summarizing Class I rail carriers’ return on investment in Appendix A); R.R. Cost of Capital—2012, EP 558 (Sub-No. 16) (STB served Aug. 30, 2013) (finding industry cost of capital to be 11.12%).

revenue adequacy. See, e.g., Use of a Multi-Stage Discounted Cash Flow Model in Determining the R.R. Industry's Cost of Capital, EP 664 (Sub-No. 1) (STB served Jan. 28, 2009); R.R. Revenue Adequacy—1988 Determination, 6 I.C.C.2d 933 (1990), aff'd sub nom. Ass'n of Amer. R.Rs. v. ICC, 978 F.2d 737 (D.C. Cir. 1992); Supplemental Reporting of Consol. Info. for Revenue Adequacy Purposes, 5 I.C.C.2d 65 (1988); Standards for R.R. Revenue Adequacy, 3 I.C.C.2d 261 (1986), aff'd sub nom. Consol. Rail Corp. v. United States, 855 F.2d 78 (3d Cir. 1988).

The concept of revenue adequacy is also a component of the Board's standard for judging the reasonableness of rail freight rates, as set forth in Coal Rate Guidelines, Nationwide (Coal Rate Guidelines), 1 I.C.C.2d 520 (1985), aff'd sub nom. Consol. Rail Corp. v. United States, 812 F.2d 1444 (3d Cir. 1987).<sup>3</sup> Coal Rate Guidelines established a set of pricing principles known as "constrained market pricing," which imposes three main constraints on the extent to which a railroad may charge differentially higher rates on captive traffic: revenue adequacy, management efficiency, and stand-alone cost. Id. at 534.<sup>4</sup> With respect to the revenue adequacy constraint, the ICC observed

[The] revenue adequacy standard represents a reasonable level of profitability for a healthy carrier. It fairly rewards the rail company's investors and assures shippers that the carrier will be able to meet their service needs for the long term. Carriers do not need greater revenues than this standard permits, and we believe

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<sup>3</sup> Smaller rate cases can be evaluated under the Three-Benchmark methodology, which includes a benchmark (Revenue Shortfall Allocation Method) that is tied to the Board's annual revenue adequacy calculations. See Simplified Standards for Rail Rate Cases, EP 646 (Sub-No. 1), slip op. at 5 (STB served Mar. 19, 2008).

<sup>4</sup> A fourth constraint—phasing—can be used to limit the introduction of otherwise-permissible rate increases when necessary for the greater public good. Coal Rate Guidelines, 1 I.C.C.2d at 546-47.

that, in a regulated setting, they are not entitled to any higher revenues.

Therefore, the 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 this "revenue adequacy" level.

Id. at 535.

As the Board has explained, the revenue adequacy constraint "employ[s] a 'top-down' approach, examining the incumbent carrier's existing operations." W. Texas Utils. Co. v. Burlington N. R.R., 1 S.T.B. 638, 655 (1996). "If the carrier is revenue adequate (earning sufficient funds to cover its costs and provide a fair return on its investment), or would be revenue adequate after eliminating unnecessary costs from specifically identified inefficiencies in its operations, a complaining shipper may be entitled to rate relief." Id.

The Board has not yet had the opportunity to address how the revenue adequacy constraint would work in practice in large rail rate cases. Nearly all large rate reasonableness cases to date have relied upon the stand-alone cost constraint. The few revenue adequacy-based complaints have either settled or involved other transportation modes. See S. Miss. Elec. Power Ass'n v. Norfolk S. Ry., NOR 42128 (STB served Aug. 31, 2011) (proceeding in which revenue adequacy constraint raised in complaint was subsequently settled); CF Indus., Inc. v. Koch Pipeline Co., 4 S.T.B. 637 (2000) (finding rate increases for pipeline transportation unreasonable under 49 U.S.C. 15501 using revenue adequacy constraint), aff'd sub nom. CF Indus., Inc. v. STB, 255 F.3d 816 (D.C. Cir. 2001).

Both the structure of the rail industry and the flow of commerce have continued to change substantially over the past decade. In the last several years, questions have been raised regarding the agency's methodology for determining revenue adequacy and whether it

appropriately measures the financial condition of the railroad industry. These questions cover a range of issues, such as the viability of the Board's current methodology and possible alternative methodologies, what it means to be revenue adequate and how such a finding should impact the railroads, and how to apply the revenue adequacy constraint in regulating rates, among many others.

At this point, the Board believes an examination of revenue adequacy is in order. The Board will now institute a proceeding to address the issues discussed above. This proceeding is intended as a public forum to discuss the Board's methodology in fulfilling its statutory mandate to determine railroad revenue adequacy, as well as the revenue adequacy component of the Board's standard for judging the reasonableness of rail freight rates, with a view to what, if any, changes the Board can and should consider. The Board is providing an opportunity for any person or entity that wishes to participate to file written prepared comments. Subsequently, the Board will hold an oral hearing at the agency to explore the issues in more depth.

The Board also recently instituted a rulemaking proceeding in Docket No. EP 664 (Sub-No. 2) to address how it determines the railroad industry's cost of equity capital.<sup>5</sup> The cost of capital calculation is a component of the methodology that the Board uses to determine revenue adequacy, and the Board therefore stated that it would coordinate the processing of these two proceedings. Accordingly, the Board now invites any person or entity who wishes to participate in EP 664 (Sub-No. 2) to submit written comments addressing the cost of capital calculation in that proceeding, pursuant to the schedule set forth below.

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<sup>5</sup> Petition of the W. Coal Traffic League to Institute a Rulemaking Proceeding to Abolish the Use of the Multi-Stage Discounted Cash Flow Model in Determining the R.R. Industry's Cost of Equity Capital, EP 664 (Sub-No. 2) (STB served Dec. 20, 2013).

Decisions and notices of the Board, including this notice, are available on the Board's website at "www.stb.dot.gov."

This action will not significantly affect either the quality of the human environment or the conservation of energy resources.

It is ordered:

1. Comments in both dockets are due on July 1, 2014. Reply comments are due on August 15, 2014.
2. A public hearing will be announced in a subsequent Board decision.
3. This decision is effective on the date of service.

By the Board, Rachel D. Campbell, Director, Office of Proceedings.

Decided: April 1, 2014.

**Derrick A. Gardner,**

*Clearance Clerk.*

[FR Doc. 2014-07722 Filed 04/04/2014 at 8:45 am; Publication Date: 04/07/2014]